

Technical Line

FASB – proposed guidance

New revenue recognition model is taking shape

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What you need to know

- ▶ The FASB and IASB have been addressing constituents' concerns about their June 2010 proposal on revenue recognition.
- ▶ The Boards' new recognition model for services and long-term contracts that are satisfied continuously will likely result in more transactions being accounted for using a proportional performance recognition method.
- ▶ The Boards' revised criteria for identifying separate performance obligations could change when revenue (or a loss) is recognized.
- ▶ The Boards have not reached a consensus on changes to the proposed guidance on estimating the transaction price (including variable consideration) and allocating the transaction price to the identified performance obligations.

Overview

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) are redeliberating various aspects of their joint revenue recognition proposal¹ in response to feedback received from constituents. The good news for some US companies is that many of the changes the Boards are making to their proposal resemble current practice under US GAAP.

The IASB recently updated its work plan to indicate that while all decisions will be made and final votes will be completed on the revenue recognition standard by June 2011, no final standard will be issued until the second half of the year. However, the Boards recently could not reach conclusions on important issues and, therefore, it's not clear whether these issues will delay a final standard.

Further, we understand that the FASB still plans to expose the proposed changes to the Accounting Standards Codification before finalizing this standard. As a result, it seems unlikely that a final standard will be issued by June 2011.

Through the end of March 2011, the Boards have addressed many of the most significant matters identified in their redeliberation plans. The most significant changes made to the proposed model include:

- ▶ *Distinguishing between goods and services for the purpose of determining the appropriate timing of revenue recognition.* Revenue associated with goods is recognized when the goods are transferred, while revenue associated with services is recognized over time as the services are provided.
- ▶ *Defining the specific attributes of a “distinct” good or service for the purpose of determining when a good or service can be accounted for separately.* The Boards have tentatively agreed to move away from the current practice of considering whether the good or service can be “sold separately” to determine if it is distinct.
- ▶ *Revising the proposed determination of whether an arrangement includes onerous performance obligations.* The Boards have tentatively concluded that the assessment of whether performance obligations are onerous should be performed on the remaining performance obligations in a contract, taken as a whole, rather than on single performance obligations.
- ▶ *Revising the proposal that all warranties resulted in a deferral of revenue.* The Boards have now proposed a model that, while not identical to current US GAAP, is more closely aligned with current treatment of warranties.
- ▶ *Changing the treatment of incremental costs to obtain a contract.* The Boards have tentatively concluded that such amounts should be capitalized, not expensed as originally proposed.
- ▶ *Changing the classification of uncollectible amounts.* All uncollectible amounts would now be recognized in the income statement in a separate line item that is presented next to revenue (as contra revenue), rather than presenting some amounts as a reduction of revenue and some amounts as part of other income or expense as originally proposed.

Each of these topics is discussed more fully in the following sections, along with the other revisions the Boards have made during their redeliberations to date.

The Boards still have several significant issues to address, including uncertain consideration, allocating the transaction price, accounting for costs and accounting for licenses or rights of use. These issues will be addressed in coming months.

Identifying the contract(s) with the customer

Existence of a contract

The first step in the Boards' proposed five-step revenue model requires an entity to identify the contract, or contracts, with its customers. Constituents generally agreed with the proposal in the exposure draft (ED) that any contracts that create an enforceable obligation should fall under the proposed guidance.

Some constituents questioned whether the Boards' assertion that contracts may be written, oral or implied could be applied practically to all transactions. The Boards acknowledged in their redeliberations that, in some cases, a written agreement may be required to show that the parties to the contract are committed to fulfilling their respective obligations. The language in the final standard will reflect this acknowledgment.

The Boards also addressed questions on required contract terms. The proposed guidance required that parties to a valid contract be able to identify the terms and manner of payment for the goods and services. The Boards have clarified that the transaction price need not be specified for a company to recognize revenue for satisfied performance obligations. Rather, the company would apply the model for estimating transaction price and account for the contract accordingly. While this issue was raised by the construction industry relating to unpriced change orders, we believe this change could have implications beyond that industry.

Other contract matters

Combining contracts

In most cases, an entity would apply the proposed model to an individual contract with a customer. In some situations, however, an entity executes multiple contracts that are linked economically or in some other way and comprise one arrangement among the parties. In the ED, the Boards proposed requiring the combination of such contracts for accounting purposes when there are indicators of price interdependence. Because many respondents found this concept confusing, the Boards agreed to revise this language (without necessarily changing the principle).

The final standard will state that contracts are interrelated and should be combined when they are executed at or near the same time, generally with the same counterparty, and when *any* of the following conditions are met:

- ▶ The contracts are negotiated as a package with a single commercial objective
- ▶ The amount of consideration received in one contract depends on the performance of the other contract
- ▶ The goods and services in the contracts are closely interrelated and interdependent in terms of design, technology or function

We believe the revised proposal is much clearer than the ED and is very similar to current US GAAP.

Modifying contracts

The ED stated that contract modifications could include: (1) changes in the nature or amount of the goods or services promised to the customer, (2) changes in the method or timing of performance under the contract by any party, or (3) a change in the previously agreed-upon pricing under the contract.

The ED further stated that the contract modification should be treated as part of the original contract if the two exhibited price interdependence. As discussed above, the Boards have decided to move away from the notion of price interdependence. As a result, the Boards have agreed to focus on other factors, such as the commercial objective and the dependency of consideration or interrelationship of goods and services, to determine whether a contract modification should be treated as part of the original contract or as a new contract.

The Boards intend to move away from “price interdependence” when considering whether to combine contracts and in accounting for contract modifications.

Although no final decision has been made, the Boards appear to support accounting for a modification that leads to a new, separate performance obligation (priced commensurate with the value of that additional performance obligation) as a separate contract. Otherwise, the modification would lead to reevaluating the performance obligations and reallocating the transaction price.

Illustration 1 – Contract modification

Company A contracts with its customer to deliver an imaging device and 50 replacement cartridges to be used with the device. The contract price for the device is \$100,000, and the cartridges, which are expected to be delivered over six months, are priced at \$1,000 each. The standalone selling price for the device is \$100,000, and the standalone selling price of each replacement cartridge is \$1,250. The allocation of the transaction price based on the relative selling prices is as follows:

	Standalone selling price	% of total	Contract price	Allocation
Imaging device	\$ 100,000	61.5%	\$ 100,000	\$ 92,250
Cartridges	62,500	38.5	50,000	57,750
	\$ 162,500	100%	\$ 150,000	\$ 150,000

Three months after the device is delivered, the customer initiates a modification to the contract to increase the number of cartridges. Company A's estimate of the standalone selling price for the cartridges has not changed.

Scenario A

Company A agrees to increase the number of cartridges by 50 units at a price of \$1,250 each. Under the Boards' tentative decisions, Company A would account for the obligation to deliver an additional 50 units as an additional performance obligation and would not change the accounting for the original contract.

Scenario B

Company A agrees to increase the number of cartridges by 50 units at a price of \$1,000 each. Based on the revised guidance, because these additional cartridges were not priced at current market prices, Company A would reevaluate the performance obligations and reallocate the transaction price as if the additional cartridges were included in the original contract. The provision of additional cartridges at a discount to the standalone selling price would result in additional discount allocated to the imaging device based on the revised relative-selling-price allocation:

	Standalone selling price	% of total	Contract price	Allocation
Imaging device	\$ 100,000	44.4%	\$ 100,000	\$ 88,800
Cartridges	125,000	55.6	100,000	111,200
	\$ 225,000	100%	\$ 200,000	\$ 200,000

Company A would record a cumulative adjustment to the revenue recorded on delivery of the equipment of \$3,450 (\$92,250 – \$88,800) and on the previously delivered cartridges by \$43 per cartridge (\$57,750/50 – \$111,200/100).

Segmenting a contract

The Boards agreed with constituents that their proposed guidance on segmenting a contract was confusing. The Boards therefore decided to eliminate the requirement to segment a contract and instead require separation of a contract solely into separate performance obligations.

Identifying the separate performance obligations

Under the original proposal, an entity would have to evaluate the terms of the contract as well as the entity's normal business practices to identify all promised goods and services. The entity then would have to determine whether these goods and services represent separate performance obligations by determining whether they are *distinct*.

Defining a performance obligation

The ED defined a performance obligation as "an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer." Constituents interpreted this to mean that only *legally* enforceable obligations would meet the definition. The Boards concluded that a performance obligation need not be legally enforceable to be considered in its model and revised their definition to eliminate the word "enforceable." The final standard will include the revised definition.

The Boards also agreed that a performance obligation should be viewed from the perspective of the customer. That is, a performance obligation exists when the customer reasonably expects performance by the entity. We expect the final standard to clarify this view.

How we see it

Eliminating the word "enforceable" from the definition of "performance obligation" was necessary to capture constructive obligations (e.g., existing business practices that would be understood by customers but are not explicitly stated in the contract). That change, combined with the explicit statement that a performance obligation should be viewed from the perspective of the customer, emphasizes that implied performance obligations (i.e., those based on past business practice) are just as relevant as contractual performance obligations.

The requirement to identify performance obligations from the perspective of the customer may be challenging at times. The Boards believe that a performance obligation is any obligation that the *customer would reasonably expect* to be satisfied by the vendor. Not all customers will have similar expectations; therefore, entities will need to use judgment when determining whether constructive performance obligations exist.

Separating performance obligations

After identifying the performance obligations in a contract, an entity must determine whether the performance obligations are separable. The key is determining whether one or more good or service is "distinct."

During their redeliberations, the Boards made sweeping changes to the guidance on identifying and accounting for separate performance obligations.

The exposure draft indicated that a good or service is distinct if the entity, or another entity, sells an identical or similar good or service separately or if the entity could sell the good or service separately because it meets both of the following conditions:

- ▶ The good or service can be used, either on its own or together with other goods and services available in the marketplace (from other entities)
- ▶ The good or service has a distinct profit margin

The Boards received a significant amount of feedback on this proposal that indicated constituents did not understand the proposed concept of *distinct*. While the Boards concluded that the principle of *distinct* goods and services is still an appropriate concept for identifying performance obligations that should be accounted for separately, they changed the model for making this determination.

The Boards decided the following two-step model should be used to determine whether promised goods and services should be accounted for separately:

1. Account for a bundle of promised goods or services as one performance obligation if the entity provides a service of integrating those goods or services into a single item that the entity provides to the customer
2. Account for a promised good or service, or a bundle of goods or services, as a separate performance obligation if both of the following conditions are met:
 - a) The good or service has a different pattern of transfer to the customer from other goods and services in the contract (if the pattern of transfer does not differ between the goods or services, revenue recognition would be the same whether they are separated or combined).
 - b) The good or service has a distinct function. A good or service has a distinct function if either of these criteria applies:
 1. The entity regularly sells the good or service separately.
 2. The customer can use the good or service either on its own or with resources that are readily available to the customer. Resources that are readily available to the customer include resources obtained in previous transfers of goods or services (including those transferred pursuant to the same contract) or that the customer could purchase separately from the entity or another entity.

Illustration 2 – Distinct function

Company A enters into an agreement with its customer to provide a software license and help desk support for 12 months after the delivery of the software license.

Company A must determine whether the software license and help desk support meet the criteria to each be considered distinct performance obligations that can be accounted for separately. The first criterion is not applicable, as Company A is not providing a single integrated item; therefore, Company A considers whether the second criterion has been met. The second criterion requires that there be both a distinct pattern of transfer of the individual goods or services and that the individual goods or services have distinct functions. As the software license and help desk support are transferred at different points, Company A focuses on whether the two have distinct function from one another.

Illustration 2 – Distinct function (continued)

In this case, Company A determines that the software license has a distinct function because the customer can use the license as is and does not have to purchase the help desk support to obtain the benefit from the software license. The help desk support has a distinct function because the customer can “use” the help desk support with resources that are “readily available” to it. In this case, since the software license had been delivered previously, that resource is considered readily available to the customer for purposes of this assessment.

Many constituents, especially those in the construction industry, disagreed with the proposed guidance on separation because they were concerned about the prospect of having to identify an unreasonable number of performance obligations. The Boards' objective in revising the model (and the reason for including criterion 1 in the separation model) was to more clearly articulate that, while certain arrangements may have multiple goods and services, those goods and services may represent a single performance obligation. The Boards believe the proposed model will allow construction firms to account for most pure construction contracts as single performance obligations.

However, while the revised model will accommodate accounting for a construction contract as a single performance obligation in many cases, the Boards acknowledged that certain contracts will still contain multiple distinct performance obligations that will be accounted for separately. The Boards explained that contracts such as “build-and-run” arrangements and contracts to construct two or more largely independent assets would likely result in accounting for more than one performance obligation.

Another important change to the separation criteria is the elimination of the requirement for a distinct profit margin. Many constituents were confused by this criterion, while others believed it could prohibit separation for goods or services that otherwise would appear to be distinct (e.g., software and post-contract customer support of that delivered software).

How we see it

This revision to the model seems to be a significant step in the right direction. However, it will likely have broad implications beyond the construction industry. For example, it may affect other arrangements that involve delivering integrated goods and services such as software customization arrangements or those that include the installation of a good.

Because unintended consequences may result, we believe the Boards should request additional input from constituents. Additionally, we believe that thorough implementation guidance will be necessary to explain the principles and promote consistent application of those principles.

Determining whether a promised item represents a good or a service

In addition to identifying the performance obligations within an arrangement, an entity must determine whether those performance obligations represent goods or services. In a change from the ED, the Boards tentatively decided to differentiate between goods and services, agreeing with constituents who said the revenue recognition pattern for goods and services may be different.

To help entities make this determination, the Boards defined a service as any performance obligation that is satisfied continuously, and concluded that a performance obligation is satisfied continuously if one of the following criteria is met:

1. The entity's performance creates or enhances an asset that the customer controls as the asset is being created
2. The entity's performance does not create an asset with alternative use to the entity and at least one of the following conditions is met:
 - a. The customer receives a benefit as each task is being performed
 - b. Another entity would not need to re-perform all of the task(s) performed to date if that other entity were to fulfill the remaining obligation to the customer
 - c. The entity has a right to payment for performance to date even if the customer or the entity could cancel the contract for convenience

The Boards believe that all services will fall under at least one criterion. For example:

- ▶ A contract to develop an IT system on the customer's premises would be accounted for as a service under Criterion 1, because the customer controls the system while it is being developed or enhanced.
- ▶ Training or consulting services that are consumed immediately by the customer (with or without any final deliverable) are addressed by Criterion 2a.
- ▶ Most shipping services would fall under Criterion 2b because a new vendor would only have to perform the incremental services to deliver a package to its destination from the point the new vendor took possession of the package.
- ▶ Legal or other services for which vendors are compensated based on time incurred rather than an outcome or deliverable would fall under Criterion 2c.
- ▶ The determination of whether a performance obligation is a good or service affects the timing of the revenue recognition (as discussed further in the "Transfer of control for services" section below), both in terms of how an entity recognizes revenue for identified performance obligations and how an entity identifies separate performance obligations. For example, performance obligations that involve the delivery of integrated goods and services are generally accounted for as services.
- ▶ Further, an entity that determines it is providing integrated goods and services likely will identify only one performance obligation related to that integrated item. However, the order in which an entity applies these aspects of the model (determination of good versus service and distinct performance obligations) may affect the conclusions reached and the timing of revenue recognition. It is not currently clear whether these two criteria are applied in a sequential manner (and which is first) or applied in contemplation of one another.

The construction industry's criticism of the exposure draft was a key factor in the development of new separation guidance.

Illustration 3 – Contracts for goods and services

Assume a vendor contracts with a manufacturer to provide a piece of equipment and a service to integrate the machinery with existing machinery in the production line. The integration services are expected to take three months to complete. The machinery is fully functional without being integrated into the production line (although efficiency improves if it is integrated) and the customer did not have to hire the vendor to provide the integration services (i.e., the customer could have performed the integration or it could have hired another vendor).

Under the proposed model, the vendor would first identify the performance obligations within the arrangement. One view is that the vendor has agreed to provide a single, integrated item (installed, fully integrated piece of equipment), indicating that the vendor has a single performance obligation. In this scenario, the single performance obligation is comprised of a good (machinery) and a service (integration services).

However, an alternative view is that the vendor is not providing a “service of integrating those goods or services into a single item,” because the customer could elect not to purchase the integration services and the equipment is fully functional without those services.

In that scenario, the vendor would likely determine that the machinery and integration services are each separate performance obligations, because they have a different pattern of transfer from one another and each has a distinct function. It is unclear whether this is an acceptable view under the proposed model (i.e., whether the elective nature of the installation services could be considered when identifying the separate performance obligations).

See Illustration 4 in the “Recognition of revenue” section below for a discussion of the pattern of revenue recognition for this example.

Other contractual obligations

Many constituents challenged the proposed accounting for certain contractual obligations, such as perfunctory or incidental obligations and marketing activities. In particular, constituents expressed varying opinions on whether loyalty points should be considered separate performance obligations.

The telecommunications industry, among others, argued that incidental obligations, including discounted handsets, that are incidental to the core business of providing voice and data services should not be separate performance obligations that are ultimately allocated a portion of the consideration received for the ongoing monthly services.

The Boards believe that the proposed model results in no different accounting than under today’s literature, except that today’s accounting limits the recognition of revenue to amounts collected in certain cases (i.e., when realization of consideration allocated to a deliverable is contingent on delivery of future goods or services). In the telecommunications industry, the amount otherwise allocated to the discounted handsets and recognized as revenue under current US GAAP is limited to the cash collected, resulting in revenue recognition over time for all or part of the standalone selling price of the handset.

The Boards will not revise the proposed guidance to exclude any perfunctory or incidental performance obligations, including marketing incentives, from the proposed model.

Determining the transaction price

Variable (uncertain) consideration

The third step in the Boards' five-step model is to estimate the transaction price. The ED required that an entity estimate the transaction price, including variable consideration such as performance bonuses or royalties, using probability-weighted estimates at the inception of the contract. Constituents expressed a number of concerns, which the Boards are attempting to address in current redeliberations. However, the Boards did not reach any conclusions in their initial redeliberations on this topic.

The first matter addressed by the Boards is the use of probability-weighted estimates (expected value). Many constituents said probability-weighted estimates are overly complex and can lead to results that are not meaningful. This is particularly true in scenarios with binary outcomes, such as performance bonuses in which an entity may receive either 0% or 100% of a specified amount depending on an outcome. Using a probability-weighted estimate would likely result in the recognition of an amount that is not a potential outcome (i.e., an amount between 0% and 100%).

The Boards considered a staff proposal to allow for two acceptable approaches. For transactions that occur frequently and are homogenous in nature, the staff proposed an expected-value approach. For transactions that do not occur frequently and are heterogeneous in nature, the staff proposed allowing the use of management's best estimate, or a more-likely-than-not approach that provides the most likely outcome. The Boards did not reach a conclusion on this matter.

Another point of contention regarding variable consideration is whether and how to constrain revenue recognition when the expected amounts are uncertain. For example, entities frequently enter into arrangements in which some of the consideration is in the form of future royalty payments based on sales of the customer. Under the ED, entities would include those expected future royalty payments (based on a probability-weighted expected outcome approach) in the amount of total expected consideration, assuming the entities had an ability to "reasonably estimate" such royalty amounts.

Many constituents indicated that even when these amounts can be reasonably estimated, revenue should not be recognized until the customer has taken the action that entitles the vendor to payment (i.e., when the customer has sales that entitle the vendor to royalty payments in the above example).

The Boards recently deliberated a series of staff papers on this topic. In those papers, the staff proposed that an entity should (1) determine whether a right to consideration exists, (2) if a right exists, estimate the transaction price, and (3) recognize revenue when the amounts expected to be received can be reasonably estimated. Amounts can be reasonably estimated when the entity has sufficient relevant experience or other persuasive data and the entity does not expect significant changes in the circumstances. However, the Boards were unable to reach a consensus on this issue and will consider it further in a future meeting.

Collectibility

The ED proposed that amounts estimated to be uncollectible at the time the performance obligation is satisfied should be reflected as a reduction of revenue. Subsequent changes in the estimate of uncollectible amounts would be recorded as other income or expense.

In recent redeliberations, the Boards decided to amend the proposed guidance for presentation of the allowance for uncollectible amounts and subsequent changes to the allowance. Entities will present revenue without giving effect to amounts that may not be collectible and will present amounts expected to be uncollectible on a separate contra-revenue line immediately below gross revenue. The contra-revenue line will include recognition of the initial allowance as well as the effects of subsequent changes in collectibility.

How we see it

The Boards made the change to the presentation of the allowance for uncollectible amounts in response to feedback from constituents. We believe most constituents will prefer this revised approach to the original proposal.

The revised model is very similar to current US GAAP in terms of the timing and amount of bad debts reflected in the income statement. However, the revised requirement to present these bad debt amounts as a contra-revenue will have the effect of reducing reported gross margins (as such bad debt amounts generally were previously reported below gross margin).

Time value of money

The ED proposed that an entity would consider the effects of the time value of money when there is a timing difference between customer payment and the entity's satisfaction of the performance obligation (e.g., when the consideration is prepaid or is paid well after the services are provided). The Boards affirmed their decision to require the entity to consider the time value of money in measuring the transaction price when the effects would be material. However, the Boards agreed to provide criteria to help entities determine when the effects would be material.

The Boards tentatively concluded that an entity must consider the effect of the time value of money only when an arrangement contains a financing component that is significant to the contract. Further, the Boards agreed that an entity should consider the following factors in determining whether a contract contains a significant financing component:

- ▶ The amount of customer consideration would be substantially different if the customer paid in cash at the time of transfer of the goods or service
- ▶ There is a significant difference in the timing of the provision of goods and services and the receipt of payment
- ▶ The interest rate within the contract (implicit or explicit) is significant

The Boards plan to provide additional implementation guidance in the final standard to assist preparers in determining when the time value of money is material based on these guiding conditions.

Additionally, the Boards tentatively concluded that an entity is not required to consider the time value of money when the period between the customer's payment and the entity's satisfaction of the performance obligation is less than one year.

How we see it

We believe that these changes to the principle for recognizing the effect of the time value of money will result in far fewer transactions being subject to discounting than would have been true under the ED. This change will significantly simplify the accounting for multiple-element arrangements and construction contracts compared to the accounting proposed in the ED.

Allocating the transaction price

The Boards' staffs intended to present recommendations on allocating the transaction price in the March meetings; however, the extended discussion on estimating the transaction price left no time to address allocating the transaction price. Based on the staff agenda papers made available for the March meeting, we believe the Boards will revisit in a future meeting (1) the relative selling price method of allocating the transaction price and (2) reallocation as a result of subsequent changes in the transaction price.

Satisfying the performance obligations

Recognition of revenue

The ED proposed that revenue allocated to a particular performance obligation should be recognized at the point the customer obtains control of the underlying good or service. The proposal stated that the customer "obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service." The proposed model did not distinguish between *goods* and *services*.

Many entities indicated that determining when (or if) control of a service transfers to the customer would be difficult under the proposed model. As a result, the Boards agreed to address the provision of services separately from the provision of goods. Although the core principle of the model – revenue is recognized to depict the transfer of control of goods and services to the customer – will not change, the Boards are revising the proposal to better articulate when services are transferred to the customer.

Transfer of control for goods

The Boards decided not to modify the core principle on transfer of control for goods. However, the Boards decided to make some minor revisions to that proposed model, including removing the definition of "control" and instead including the following indicators to help entities determine whether a customer has obtained control of a particular good or service:

- ▶ The customer has an unconditional obligation to pay
- ▶ The customer has legal title
- ▶ The customer has physical possession
- ▶ The customer has the risk and rewards of ownership

The Boards developed an entirely new recognition model for performance obligations satisfied over time.

Transfer of control for services

The Boards concluded that revenue for services should be recognized continuously as those services are provided. (See “Determining whether a promised item represents a good or service” above for further discussion on the distinction between a good and a service.)

Once an entity determines that a performance obligation is a service (based on the criteria specified above), it must select an appropriate measure of progress toward completion. The Boards will carry forward most of the guidance in the ED related to measuring progress to a final standard. That guidance requires the entity to select a single revenue recognition method that best depicts the continuous transfer of that service (using an output method, input method or a method based on the passage of time). That method would be applied to all arrangements containing similar performance obligations.

How we see it

The revised guidance will likely result in an increase in the number of transactions accounted for on a continuous basis. Under the ED, revenue for a number of services such as shipping would have been recognized upon completion of the service.

However, arrangements that appear similar may be accounted for differently. For example, an entity that is creating an asset that has no alternative use for the entity will likely determine that the arrangement represents a service if the entity is entitled to payment for performance to date. However, if the entity is not entitled to payment for performance to date and the other criteria are not met, it may conclude the arrangement is for a good.

We encourage entities to consider how this guidance would affect their accounting and to notify the Boards or their staffs of any results that are not consistent with the underlying economics of the transaction.

Uninstalled materials

The Boards also clarified how the measurement of progress toward completion would be affected for a single performance obligation containing both goods and services. In such situations, the Boards made clear that the delivery of goods must contribute to the completion of the performance obligation to be included in the measurement of progress.

In situations where the goods are being procured for the arrangement but have not yet been integrated (e.g., steel for an office building has been delivered but not erected), the Boards concluded that an entity using an input method (e.g., cost-to-cost) should record revenue at an amount equal to the cost of the good. Once the entity installs the material or places the item(s) in service, it would record revenue equal to the profit component of that good (e.g., as the steel structure is erected, profit would be recognized on the portion of the structure erected, but not on the unused supply of steel).

How we see it

The revised proposal for accounting for uninstalled materials may cause a significant change from current practice for some entities. Under current US GAAP, practice is mixed as to how entities treat these types of costs when recognizing revenue on a percentage-of-completion basis using a cost-to-cost approach.

We believe the final standard will need to provide sufficient guidance on how broadly this principle should be applied. For example, it is unclear whether this guidance applies to all materials when delivered or whether there is a basis for recognizing some (or all) of the margin associated with highly customized goods that have no alternative use (e.g., customized hardware used in the development of an IT system).

Contracts for both goods and services

Since the final standard will distinguish between goods and services and provide specific revenue recognition guidance for each, the Boards also addressed accounting for transactions containing both goods and services. They concluded that if the goods and services are separable, they should be accounted for separately using the appropriate model.

However, if the goods and services are not separable (i.e., they represent an integrated bundle that must be accounted for as a single performance obligation or they do not have distinct function from one another), the model for services should be applied to the combined unit. The Boards believe this would more faithfully depict the economics of the transaction.

Illustration 4 – Contracts for goods and services

This illustration is a continuation of Illustration 3 – Contracts for goods and services, above.

As discussed above, under the first view the vendor determines that it has a single performance obligation comprised of a good and a service. As a result, for purposes of revenue recognition, the vendor would apply the transfer of control model described above for services.

The vendor would likely treat the delivery of the machinery as uninstalled materials, and upon delivery of that machinery recognize revenue equal to the cost of the equipment (i.e., recognize no profit). The vendor would then have to select the most appropriate revenue recognition pattern associated with the services (input method, output method or method based on the passage of time) to recognize the remaining revenue (and the profit component of the equipment) as the integration services are provided.

Conversely, under the second view the vendor determines that it has two distinct performance obligations – the machinery and the integration services. Therefore, the vendor would allocate the total estimated transaction price to the two performance obligations based on their relative selling prices. The amount allocated to the machinery would be recognized when control is transferred to the customer, while the amount allocated to the installation services would be recognized over time as those services are provided.

Breakage and prepayments for future goods or services

In certain industries, customers pay for goods or services but may not ultimately exercise their rights under the contract (referred to as “breakage”). This is often the case for retailers that sell gift cards that are not completely redeemed and other entities, such as airlines, that sell tickets to customers who allow tickets to expire unused. The ED did not address the accounting for breakage.

The Boards have now concluded that when an entity can reasonably estimate breakage, the entity should recognize the expected breakage as revenue in proportion to the pattern of transfer of goods or services to the customer. Conversely, if an entity cannot reasonably estimate breakage, it should recognize the expected breakage as revenue when the likelihood of the customer exercising his or her rights on *remaining* balances becomes remote.

How we see it

Providing guidance for breakage is a significant improvement to the model and is generally consistent with current practice.

The Boards have largely reverted to current practice in accounting for breakage.

Other important decisions

Accounting for product warranties

The Boards have tentatively concluded that accounting for warranties will be similar to current US GAAP.

In the ED, the Boards proposed a model whereby revenue would be allocated to and deferred for all warranties, with the subsequent recognition of the deferred balance dependent upon the type of warranty offered. This would have resulted in a significant change from current practice, and many constituents expressed concerns about the proposed approach.

The Boards have now tentatively agreed that certain warranties will be accounted for as warranty *obligations*, using a cost accrual approach, rather than a revenue deferral approach. If the warranty provides the customer with assurance that the delivered product is as specified in the contract, an entity should account for a warranty obligation in accordance with the FASB’s guidance on contingencies.² Conversely, only warranties that provide a service to the customer in addition to assurance that the delivered product is as specified in the contract should be treated as a separate performance obligation.

The Boards discussed various scenarios in reaching their conclusion on warranties and ultimately concluded on the following points:

- ▶ If a customer could purchase a warranty separately from the entity, the warranty is clearly a separate performance obligation (i.e., revenue deferral).
- ▶ If a customer could not purchase a warranty separately from the entity and the warranty is offered to all similarly situated customers, the warranty would likely be accounted for as a warranty obligation (i.e., cost accrual).
- ▶ If a warranty is included with the good only to satisfy statutory or legal requirements, the warranty would be accounted for as a warranty obligation (i.e., cost accrual).

- ▶ The entity must consider whether a quality assurance warranty provided to a single customer or group of customers also includes services in addition to the warranty (e.g., more comprehensive coverage, extended time period). If so, the services (not the quality assurance warranty) would be accounted for as a separate performance obligation (i.e., revenue deferral).

The staff will develop application guidance for accounting for warranties that represent both an obligation (i.e., cost accrual approach) and an additional service (i.e., separate performance obligation).

How we see it

Although the Boards' revised model will be very similar to today's accounting under US GAAP, it will result in changes for some entities.

Under current revenue recognition guidance for services,³ entities that provide separate extended warranties defer an amount equal to the *stated price* of the warranty and record that amount as revenue over the warranty period. Under the revised proposal, an entity will instead defer an *allocated* amount, based on a relative-selling-price allocation.

For many warranties, the distinction of whether they represent a separate performance obligation will be straightforward (either because it is clear the warranty covers only defects that existed upon delivery or because the warranty is separately priced). However, this distinction may be more difficult in other situations. The Boards have asked their staffs to provide additional guidance for entities to make this determination; the staffs have not yet done so.

The Boards addressed and revised all aspects of contract costs during redeliberations.

Accounting for contract costs

In addition to the proposed revenue model, the ED also provided guidance for accounting for an entity's costs incurred in obtaining and fulfilling a contract to provide goods and services to customers. While the Boards have not yet redeliberated the accounting for fulfillment costs, they have made significant decisions on the accounting for costs to obtain a contract.

Costs of obtaining a contract

The ED proposed that costs incurred to obtain a contract with a customer would be expensed as incurred unless they can be capitalized under other authoritative guidance. That requirement would have applied to selling costs (including commissions), marketing and advertising costs and costs incurred while bidding for, proposing or negotiating a contract.

Based on feedback from constituents, the Boards decided that an entity should recognize the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) as an asset. Costs should be capitalized only when they are recoverable, either directly (i.e., reimbursable under the contract) or through the margin inherent in the contract. Capitalized costs would then be recorded as a separate asset and amortized systematically over the period that the goods or services under the contract are transferred. This guidance applies to costs on contracts that have been obtained and contracts that are under negotiation.

How we see it

The revision to the proposed guidance on contract acquisition costs is a significant change for many entities. Entities that currently capitalize contract acquisition costs, such as sales bonuses, by analogy to other authoritative guidance will welcome this change. However, entities that currently expense these costs will now be required to capitalize them.

The revised guidance implies that the unit of account for costs of obtaining a contract is the contract, which may force some entities to analyze contract acquisition costs in more detail than they currently do.

Onerous contracts

The ED required an entity to recognize a liability and a corresponding loss when an individual performance obligation becomes onerous. Those losses would be assessed and measured at the performance obligation level, not at the contract level. Under that proposal, a performance obligation was deemed onerous when the present value of the direct costs of fulfilling the performance obligation is greater than the amount of the transaction price allocated to the performance obligation.

Direct costs include direct labor, direct materials, allocated costs that relate directly to the performance obligation's activities (e.g., depreciation), costs explicitly chargeable to the customer based on the contract terms and other costs incurred only because the entity entered into the contract with the customer. This approach would have potentially resulted in liabilities recorded for onerous performance obligations when the overall contract was expected to be profitable.

In response to constituent concerns, and in a significant change to the proposal, the Boards tentatively decided that the unit of account for the onerous test should initially be the contract and, as performance obligations are satisfied, the remaining performance obligations in the contract.

The Boards also affirmed their decision to include in the analysis the direct costs in satisfying the performance obligations under the contract. However, when an entity has made a decision and communicated that it will cancel the contract, the entity would use the costs to exit the contract rather than the costs to satisfy the performance obligations. The redeliberation plan indicates the Boards still plan to discuss the definition of fulfillment costs, which may change the costs included in the onerous test.

While the changes to the proposal will resolve some issues with the proposed model, they do not alleviate the concerns of all constituents. Some constituents raised questions about transactions in which the per-unit cost of providing the good or service exceeds the income expected on a per-unit basis, yet the transaction contributes to net income by covering certain fixed costs.

Airlines, for example, may sell tickets for a price that is less than the direct cost to operate the aircraft on a per-seat basis. The sale nevertheless contributes to net income by covering a portion of the fixed costs that would have been incurred, regardless of whether the seat was occupied. Further, because of sales of high-margin tickets on the same flight (e.g., last-minute travel, premium seats), the airline may expect the flight to be profitable. Today the "loss" on the sale of a

discounted ticket is recognized on the date of travel (and may be offset by profits on other tickets). The proposed revenue model would require the airline to record the loss on the date the customer purchases the ticket (and greater profit when the flight occurs and margins are recognized on profitable tickets).

This difference in timing also affects manufacturers and retailers that enter into “loss leader” contracts to provide goods or services at a loss when profits on follow-on sales are expected to exceed the initial loss. While the entity now records a loss on that loss leader, it does not do so until the good or service is transferred. Under the proposed guidance, the loss would be recorded when the entity enters into the contract, if that date differs from the date of delivery.

How we see it

In our view, the revisions to the guidance on onerous contracts improve the guidance proposed in the ED. Constituents overwhelmingly disagreed with the proposal to perform the analysis at the performance obligation level, due to the potential for recording losses on components of a contract and higher income on other components of the same contract. However, the revised definition of onerous contracts will still result in earlier recognition of losses on some arrangements than is the case today.

Next steps

- ▶ 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.

Endnotes:

¹ Proposed Accounting Standards Update, *Revenue from Contracts with Customers*

² ASC 450, *Contingencies*

³ ASC 605-20, *Revenue Recognition – Services*

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