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The boards aim to improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

## Wrapping Up Revenue Redeliberations

### Boards Preparing to Issue Final Standard on Revenue Recognition

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The FASB and IASB have essentially finished redeliberating their November 2011 revised exposure draft<sup>1</sup> (ED) *Revenue From Contracts With Customers* and plan to jointly issue a final standard in the second quarter of 2013. The standard<sup>2</sup> will outline a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and will supersede most current revenue recognition guidance.

In addition to discussing the background and key provisions of the proposed model, this *Heads Up* briefly summarizes the decisions made by the boards to date in the revenue project, including those related to the proposed model's (1) steps, (2) disclosure requirements, and (3) effective date and transition. It also provides insight into some potential income tax and industry-specific implications.

### Background and Key Provisions of the Proposed Revenue Model

The goal of the revenue recognition project (which began in 2002) is to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The boards aim to improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

The core principle of the proposed revenue model is that "an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." The proposed model would apply to all contracts with customers except those that are within the scope of certain other topics in the *FASB Accounting Standards Codification*.<sup>3</sup> Further, contracts with counterparties that are collaborators or partners, rather than customers, do not represent contracts with customers and would be outside its scope.

<sup>1</sup> Issued by the FASB as a proposed Accounting Standards Update.

<sup>2</sup> References in this document to the "standard," the "proposed model," or the "proposed revenue model" are to the [original \(June 2010\) revenue ED](#) as modified by the [revised ED](#) and by subsequent board decisions. Quoted material is also from those sources. For a comprehensive summary of board decisions to date, see the boards' [revenue recognition project](#) update. Board decisions are tentative until the standard is finalized.

<sup>3</sup> The proposed model would not apply to contracts within the scope of ASC 840 (leases) and ASC 944 (insurance); contractual rights or obligations within the scope of ASC 310, ASC 320, ASC 405, ASC 470, ASC 815, ASC 825, and ASC 860 (primarily various types of financial instruments); contracts within the scope of ASC 460 (guarantees other than product warranties); and nonmonetary exchanges whose purpose is to facilitate a sale to another party. (For titles of *FASB Accounting Standards Codification* references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#).")

**Industry Insight:** During their redeliberations, the boards acknowledged that parties to collaborative arrangements (which are common in certain industries such as pharmaceuticals and biotechnology, oil and gas, and health care) could represent customers and that therefore certain collaborative arrangements would be within the scope of the proposed model. The boards agreed that an entity would be required to assess (1) the structure and purpose of the arrangement to determine whether the transaction is for the sale of goods or services as part of the entity's normal business activities and (2) whether the counterparty represents a customer (as defined under the proposed model). If the counterparty meets both criteria, the collaborative arrangement would be within the scope of the proposed standard.

In applying the proposed model to contracts within its scope, an entity would:

- "Identify the contract with a customer."
- "Identify the separate performance obligations in the contract."
- "Determine the transaction price."
- "Allocate the transaction price to the separate performance obligations in the contract."
- "Recognize revenue when (or as) the entity satisfies a performance obligation."

Transfers of assets that are not an output of an entity's ordinary activities (such as the sale of property, plant, and equipment, real estate, or intangible assets) would be within the scope of certain aspects of the proposed model. Specifically, the proposed model's criteria for determining the existence of a contract, measurement, and control principles would apply to these transfers, and the accounting guidance currently used to account for these transactions (e.g., ASC 360-20) would be superseded.

The first step in applying the proposed model is to identify the contract with a customer.

## Applying the Proposed Revenue Model



### Identifying the Contract With the Customer

The first step in applying the proposed model is to identify the contract with a customer. A contract can be written, verbal, or implied; however, the standard will apply to a contract only if:

- "The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract)."
- "The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations."
- "The entity can identify each party's rights regarding the goods or services to be transferred."
- "The entity can identify the payment terms for the goods or services to be transferred."

The standard will provide guidance on accounting for “approved” modifications to contracts with a customer.

Although these provisions would most likely be applied to a single contract, in certain circumstances entities may be required to combine a group of contracts.<sup>4</sup> Under the proposed model, an entity would combine contracts entered into at or near the same time with the same customer (or parties related to the customer) if one or more of the following criteria are met:

- “The contracts are negotiated as a package with a single commercial objective.”
- “The amount of consideration to be paid in one contract depends on the price or performance of the other contract.”
- “The goods or services promised in the contracts (or some goods or services promised in the contracts) are a **single performance obligation** [as defined].”

The standard will also provide guidance on accounting for “approved” modifications to contracts with a customer. Like a contract, a contract modification can be approved in writing, orally, or in accordance with another customary business practice. Further, the boards clarified during redeliberations that a contract modification would only be considered “approved” when the modification creates enforceable rights. A contract modification would be accounted for as a separate contract when it results in (1) a separate performance obligation that is “distinct” (as defined in the standard) and (2) additional consideration that reflects the entity’s stand-alone selling price of that separate performance obligation (including any appropriate adjustments). If the entity determines that the modification is not a separate contract, the entity would do either of the following depending on the facts and circumstances:

- Evaluate the contract modification and allocate the remaining transaction price<sup>5</sup> to the remaining performance obligations in the contract prospectively.
- For certain performance obligations being satisfied over time, update the performance obligation’s measure of progress toward completion (which could result in a cumulative catch up of revenue).

**Industry Insight:** There are established practices in various industries (e.g., aerospace and defense, and engineering and construction) for accounting for both approved and unapproved change orders and claims. It is common for entities to seek price adjustments for changes in scope or cost for various reasons. During their deliberations, the boards decided that before recognizing any related revenue, an entity would need to ensure that any change in scope or price meets the definition of a contract (which might not be the case for unapproved change orders or claims). When a contract exists (as defined above), an entity would apply the modification guidance. Consequently, entities may need to evaluate change orders and claims to determine the appropriate manner in which to recognize the related revenue.

## Identifying the Separate Performance Obligations

The second step in applying the proposed revenue model is to identify the separate performance obligations in the contract. The standard will provide specific guidance on evaluating the goods or services in a contract to identify each separate performance obligation (i.e., the unit of accounting). Although the standard will not define goods or services, it will provide several examples, including goods produced (purchased) for sale (resale), granting a license, and performing contractual acts. A good or service will represent a separate performance obligation if it is both of the following:

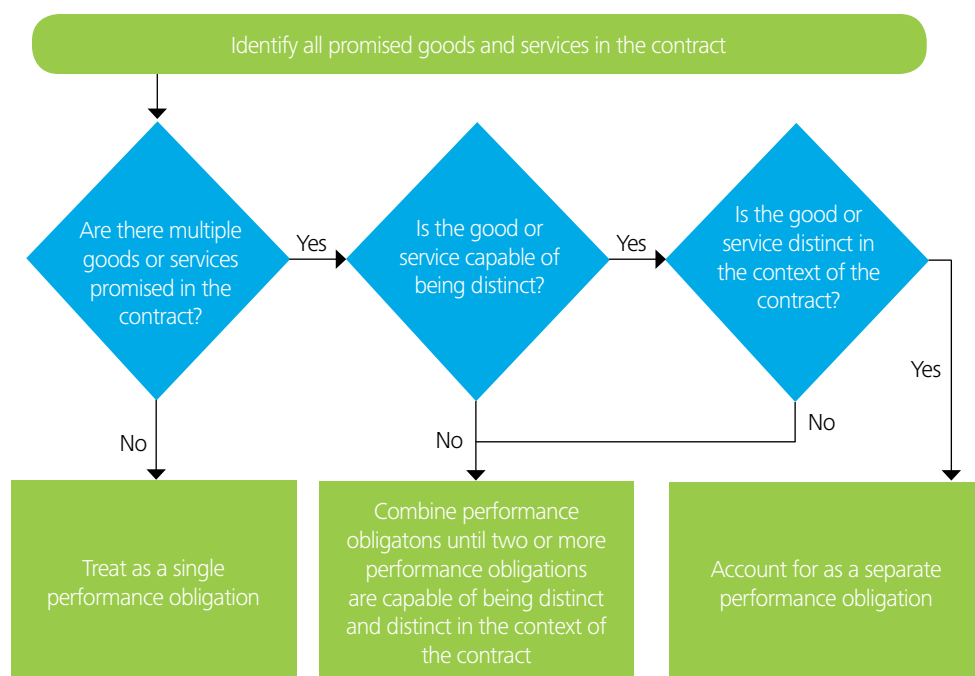
- Capable of being distinct (i.e., the customer can benefit from the good or service on its own or with other readily available resources).
- Distinct in the context of the contract (i.e., the good or service is not highly dependent or highly interrelated with other promised goods or services).

<sup>4</sup> Contract combination is permitted under current U.S. GAAP in certain circumstances. In contrast, contract combination would be required under the proposed model if one or more of the specific criteria are met, potentially resulting in more contract combinations.

<sup>5</sup> Under the proposed model, “the transaction price available for allocation to the remaining separate performance obligations should be the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay that has not been recognized as revenue.”

**Editor’s Note:** In their comments on the revised ED, many respondents indicated their belief that determining whether a good or service is “capable of being distinct” will generally be consistent with determining whether a good or service has “stand-alone value” under current U.S. GAAP. However, during redeliberations the boards decided to add the requirement that a good or service must also be “distinct in the context of the contract,” which is not a specific requirement under current U.S. GAAP. Accordingly, entities might be required to combine certain goods or services into a single performance obligation (unit of account) that they would not be required to combine under current U.S. GAAP.

The following diagram illustrates the boards’ proposed model for identifying the separate performance obligations in a contract:



The proposed model also includes the following indicators (or similar indicators) of whether a good or service is distinct in the context of the contract:

1. "The entity does not provide a significant service of integrating the good or service . . . into the bundle of goods or services that the customer has contracted."
2. "The customer was able to purchase or not purchase the good or service without significantly affecting the other . . . goods or services."
3. "The good or service does not significantly modify or customize another good or service."
4. "The good or service is not part of a series of consecutively delivered goods or services promised in a contract that meet the following two conditions:
  - a. The promises to transfer those goods or services to the customer are performance obligations that are satisfied over time . . . .
  - b. The entity uses the same method for measuring progress [to assess delivery to the customer]."

**Industry Insight:** During redeliberations, the boards agreed to clarify the guidance on accounting for sales incentives offered in a distribution network (e.g., an automobile manufacturer that offers free maintenance to a dealer's end customer). Specifically, when an entity offers goods or services to the reseller's customer in the form of sales incentives, those goods and services should be evaluated in accordance with the standard as part of the entity's sale to the reseller. For example, if an automobile manufacturer offers free maintenance to a dealer's end customer, the entity should evaluate whether the free maintenance represents a separate performance obligation in the agreement between the automobile manufacturer and the dealer. In addition, the boards agreed to clarify that if a sales incentive is offered to a reseller's customer after the customer's performance obligations in a contract are satisfied, the sales incentive would not be a separate performance obligation unless it was an implied performance obligation in the original contract.

Contingent consideration would only be included in the transaction price when an entity has a "high level of certainty" that the amount of revenue to be recognized would not be subject to future reversals.

## Determining the Transaction Price

The third step in applying the proposed revenue model is to determine the transaction price. That is, an entity must determine the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of discounts, rebates, refunds, credits, incentives, performance bonuses/penalties, contingencies, price concessions, outcome-based fees, or other similar items. Under the proposed model, an entity would estimate the transaction price by considering the effect of variable consideration, the time value of money (if a significant financing component is deemed to exist), noncash consideration, and consideration payable to the customer. Entities would use a probability-weighted approach to estimate a transaction price that is subject to variability (expected value) or an approach based on the single most likely amount, whichever is more predictive of the amount to which the entity would be entitled.

Contingent consideration would only be included in the transaction price when an entity has a "high level of certainty" that the amount of revenue to be recognized would not be subject to future reversals (this is commonly referred to as the "constraint guidance"). During redeliberations, the boards agreed that the revised ED's indicators, subject to further clarifications during drafting of the final standard, would help preparers assess when the constraint should be applied. Those indicators are as follows:

- "The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions, and a high risk of obsolescence of the promised good or service."
- "The uncertainty about the amount of consideration is not expected to be resolved for a long period of time."
- "The entity's experience (or other evidence) with similar types of performance obligations is limited."
- "The contract has a large number and broad range of possible consideration amounts."

The standard will note that the best evidence of stand-alone selling price is the price at which the good or service is sold separately by the entity.

**Industry Insight:** During redeliberations, the boards noted that a number of asset managers (namely those entities that manage alternative asset portfolios) expressed concerns that the standard would supersede the guidance in EITF Topic D-96,<sup>6</sup> specifically on the accounting for performance-based incentive fees under “Method 2” in that guidance.<sup>7</sup> However, the boards decided not to amend the standard to address these concerns. Accordingly, asset managers would be required to follow the constraint guidance on recognizing revenue from these fees (essentially precluding recognition of revenue in a manner similar to Method 2 in EITF Topic D- 96).

Further, the boards decided not to amend the contract-cost guidance to address specific concerns raised by asset managers related to accounting for fees associated with a “back-end load” fund. Rather, the FASB agreed to retain the existing fulfillment-cost guidance in ASC 946.

## Allocating the Transaction Price

The fourth step of the proposed model is to allocate the transaction price to the separate performance obligations. When a contract contains more than one separate performance obligation, an entity would allocate the transaction price to each separate performance obligation on a relative stand-alone selling price basis (with certain limited exceptions). The standard will note that the best evidence of stand-alone selling price is the price at which the good or service is sold separately by the entity. If the good or service is not sold separately, an entity will be required to estimate it by using an approach that maximizes the use of observable inputs. Acceptable estimation methods will include, but are not limited to, expected cost plus a margin, adjusted market assessment, and a residual approach (when the selling price is highly variable or uncertain).

**Industry Insight:** In their comments on the revised ED, entities in the telecommunications industry expressed significant concerns that it would result in the recognition of revenue in a manner that is inconsistent with the economics of their arrangements. Specifically, entities expressed concerns about (1) the requirement to identify as a separate performance obligation a free or deeply discounted handset provided to customers and (2) the manner in which consideration would then be allocated between the handset and the wireless services in their contracts with customers. Despite such concerns, the boards decided not to amend the guidance on identifying performance obligations or allocating the transaction price. However, the boards did acknowledge that when applying the proposed revenue model, entities may use a portfolio technique to aggregate contracts with customers that exhibit similar characteristics. The boards also decided to add clarifying language to the proposed model to emphasize that it is acceptable for all industries, including the telecommunications industry, to use a portfolio technique as long as all aspects of the revenue model are taken into account and the technique yields results that are similar to those the entity would have obtained if it had applied the guidance to each individual contract.

<sup>6</sup> EITF Topic No. D-96, “Accounting for Management Fees Based on a Formula.”

<sup>7</sup> Under Method 2, an entity recognizes performance-based fee revenue in “the amount that would be due under the [contract] at any point in time as if the contract was terminated at that date.”

## Recognizing Revenue When (or As) Performance Obligations Are Satisfied

The fifth and final step in the model is to recognize revenue when (or as) each separate performance obligation is satisfied. A performance obligation is deemed satisfied when control of the underlying goods or services (the “assets”) for the particular performance obligation is transferred to the customer. “Control” is defined under the proposed model as “the ability to direct the use of and obtain substantially all of the remaining benefits from the asset” underlying the good or service. In applying the proposed model, an entity will first evaluate whether control of a good or service is transferred over time. A performance obligation is deemed to be satisfied over time (i.e., control of the good or service is transferred over time) when at least one of the following is met:

- The “entity’s performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.”
- The customer receives and consumes the benefits of the entity’s performance as the entity performs, and another entity would not need to substantially reperform the work the entity has completed to date.
- The “entity’s performance does not create an asset with an alternative use to the entity” and the entity has a “right to payment for performance completed to date.”

If any of the criteria are met, an entity would be required to recognize revenue over time as control of the goods or services is transferred to the customer. In such case, an entity would recognize revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The standard will provide specific guidance on measuring progress toward completion, including the use and application of output and input methods.

**Industry Insight:** As a result of the boards’ decisions on measuring progress toward complete satisfaction of a performance obligation, contract manufacturers, suppliers of customized products, and other similar manufacturers may see a dramatic change in the manner in which revenue is recognized for certain contracts with their customers. If an entity’s obligation to produce a customized product meets the criteria for recognizing revenue over time (i.e., the entity’s performance does not create an asset with an alternative use and the entity has a right to payment for performance to date, as defined in the standard, if the customer terminates the contract), revenue related to that product would be recognized as the product is produced, not when the product is delivered to the customer.

For example, an entity that has a contract with an original equipment manufacturer (OEM) to produce a customized part for the OEM’s product may meet the criteria for revenue recognition over time (the customized part may have no alternative use other than as a part on the OEM’s product, and the contract may ensure the entity’s right for payment for performance to date if the OEM terminates the contract). The entity would then be required to select a method of recognizing revenue over time that most faithfully depicts the entity’s performance to date for producing the product. Such methods may include units produced (if the entire contract is deemed a single performance obligation) or other measures of progress toward completing production of the product (such as percentage of labor hours or costs complete). Therefore, under the standard, the entity would recognize revenue (and relieve inventory to cost of goods sold) as the products are produced rather than when the product is delivered to the customer (which is when revenue is generally recognized under current U.S. GAAP). Entities with these type of contracts that ship products to customers immediately after production may not see much of a change in the manner in which revenue is recognized (or the impact may not be material); however, entities that maintain finished customer goods for a certain time after production could see a dramatic change since revenue and the related cost of goods sold would be recognized much earlier than they are under existing guidance.

If a performance obligation does not meet the criteria to be satisfied over time, it is deemed to be satisfied at a point in time. Under the proposed model, entities would consider the following indicators in evaluating the point in time that control of an asset has been transferred to a customer:

- “The entity has a present right to payment for the asset.”
- “The customer has legal title to the asset.”
- “The entity has transferred physical possession of the asset.”
- “The customer has the significant risks and rewards of ownership of the asset.”
- “The customer has accepted the asset.”

**Editor’s Note:** The standard will not include an explicit collectability threshold (like the “reasonably assured” hurdle under U.S. GAAP) that entities must overcome to recognize revenue. However, the boards noted that a reasonable expectation of collectability is implicit in the standard’s definition of a contract. To ensure that users clearly understand the magnitude of uncollectible revenues, the boards decided during deliberations that adjustments for collectability should be presented “prominently” within operating expenses (i.e., presented on a separate line item when material).

## Required Disclosures

The standard will significantly expand the current disclosure requirements about revenue recognition. The boards’ objective in requiring the additional disclosures “is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.” Under the proposed model, the disclosures required under the standard will include:

- A disaggregation of revenue to “depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.” To achieve this objective, an entity would need to consider (1) “[d]isclosures presented outside the financial statements, for example, in earnings releases, annual reports, or investor presentations”; (2) information reviewed internally for evaluating operating segment performance; and (3) other factors used by the entity or by users of its financial statements to evaluate performance or allocation of resources. A reconciliation of the disaggregated information to total revenue would also be required.
- Certain information about changes in contract balances (e.g., unbilled receivables, deferred revenue), including (1) the “opening and closing balances of contract assets, contract liabilities, and receivables from contracts with customers (if not separately presented)”; (2) unusual or nonrecurring changes in an entity’s contract assets and contract liabilities; and (3) the amount of revenue recognized in the period related to previously recognized contract liabilities. Entities would also be required to disclose the opening and closing balances for trade accounts receivable (unless these amounts are otherwise included in the financial statements or notes to the financial statements).
- For contracts that are expected to extend past one year, (1) the “aggregate amount of the transaction price . . . allocated to [remaining] performance obligations” and (2) an “explanation of when the entity expects to recognize that amount as revenue.” Unless a renewal represents a material option, revenue related to the renewal would not be included in the entity’s analysis. Further, the transaction price an entity includes in its analysis of the remaining performance obligations would be the transaction price after it applies constraint guidance. An entity would not be precluded from including in its analysis contracts extending less than a year.
- Information about assets recognized from costs to obtain or fulfill a contract, including (1) the closing balances (by main category of asset), (2) the amount of amortization recognized for the period, and (3) the method of amortization.

The standard will significantly expand the current disclosure requirements about revenue recognition.

- Certain information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition.
- Information about the policy decisions made by the entity related to the time value of money and costs to obtain or fulfill a contract (i.e., whether the entity used the practical expedients allowed under the proposed model).
- Information about the methods, inputs, and assumptions used to determine the transaction price and to allocate amounts to performance obligations. Further, a description of the “methods and assumptions an entity uses when determining the amount of the transaction price that will not be subject to a revenue reversal (that is, the constrained amount).”

The FASB decided that on an interim basis, entities would be required to disclose the following in addition to the information required under ASC 270: (1) disaggregation of revenue, (2) contract asset and contract liability balances and an explanation of significant changes in those balances since the previous period-end, and (3) analysis of the remaining performance obligations. The IASB, however, decided that entities would be required to disclose only the disaggregation of revenue in addition to the information required under IAS 34.<sup>8</sup>

Entities would have the option of using either retrospective transition (with certain practical expedients) or a modified approach in applying the proposed model.

## Effective Date and Transition

Entities would have the option of using either retrospective transition (with certain practical expedients) or a modified approach in applying the proposed model. As part of their retrospective application, entities would also have to consider the requirements in ASC 250 to determine the effect such application would have on direct and indirect costs. Under the modified approach, an entity would recognize “the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings in the year of initial application (that is, comparative years would not be restated).” The standard would apply to new contracts created on or after the effective date and to existing contracts as of the effective date but would not apply to contracts that were completed before the effective date. In the year of adoption, entities would also be required to disclose the financial statement line items that have been directly affected by the standard’s application.

The boards decided that the final standard will be effective for reporting periods (fiscal and interim) beginning on or after January 1, 2017, for public entities. Early application would not be permitted.

**Editor’s Note:** The FASB is expected to discuss the effective date and required disclosures for nonpublic entities at a future meeting.

## Other Notable Provisions of the Proposed Model

In addition to those discussed above, the standard will provide guidance on several other important topics, including the accounting for certain revenue-related costs. Some of the more significant provisions are highlighted below.

<sup>8</sup> IAS 34, *Interim Financial Reporting*.

The standard will contain specific criteria for capitalizing certain costs associated with obtaining and fulfilling a contract.

## Contract Costs

The standard will contain specific criteria for determining how to capitalize certain costs associated with obtaining and fulfilling a contract. Specifically, entities would be required to recognize an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered. Further, costs to fulfill a contract would be capitalized only when they are related directly to a contract, generate or enhance resources that will be used to satisfy performance obligations, and are expected to be recovered (unless these costs are within the scope of other ASC guidance). As a practical expedient, entities will be permitted to expense qualifying costs to obtain a contract as incurred when the expected amortization period is one year or less. Capitalized costs would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset relates and, in certain circumstances, may extend beyond the original contract term with the customer (e.g., future anticipated contracts, expected renewal periods).

**Editor’s Note:** The proposed model may make the accounting for costs to obtain and fulfill a contract more consistent throughout U.S. GAAP. However, depending on how an entity currently accounts for revenue-related costs, the standard may also result in significant changes in practice. For example, entities that apply ASC 605-35 (formerly SOP 81-1<sup>9</sup>) will most likely have to reevaluate whether the capitalization of certain contract costs for construction and other long-term contracts remains appropriate under the standard. Further, entities will be required to capitalize and amortize certain precontract costs (e.g., certain bid or proposal costs) if such costs represent direct incremental costs of obtaining the contract that an entity expects to recover and that would not have been incurred if the contract had not been obtained.

## Right of Return

Entities would apply the proposed model’s guidance on variable consideration to determine the amount of revenue to recognize for goods (or payments) that are expected to be returned (or refunded). Further, the standard will stipulate that a right of return (e.g., a stand-ready obligation to accept a return during a specified period) does not represent a separate performance obligation. Accounting for product returns is therefore not expected to change significantly under the new standard.

## Warranties

The standard will allow entities to continue to use a cost accrual model to account for warranty obligations (in accordance with ASC 460) but only for warranties that assure that the good or service complies with agreed-upon specifications. To the extent that a warranty provides a service beyond assuring that the good or service complies with agreed-upon specifications, it would be accounted for as a separate performance obligation. Further, if the customer has the option to purchase the warranty separately, it would also be accounted for as a separate performance obligation.

Product liabilities, such as compensation paid by an entity for harm or damage caused by its product, would not represent a separate performance obligation in the contract and would continue to be accounted for in accordance with the existing literature on loss contingencies in ASC 450-20.

## Customer Options for Additional Goods or Services

Under the proposed model, an option given to a customer to acquire additional goods or services would represent a separate performance obligation if it gives the customer “material right” that the customer otherwise would not have received without entering into the contract. If an option is deemed to be a separate performance obligation, an entity would allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

<sup>9</sup> AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

Tax departments will need to assess changes in book revenue recognition methods to prepare for the tax effects of the proposed model.

## Customers' Unexercised Rights

Customer contracts may include a nonrefundable prepayment for the right to receive goods or services in the future (e.g., prepaid gift cards). In certain instances, a customer may not exercise all of its rights (which results in "breakage" related to the contract liability). The standard will permit recognition of the expected breakage amount in proportion to the pattern of rights exercised by the customer but only for an amount that the entity has a "high level of certainty" would not be reversed in the future. Otherwise, the breakage amount would not be recognized until it is "remote" that the rights will not be exercised by the customer.

## Licenses

The standard will require an entity to assess the nature of a promised license (i.e., whether the license gives the customer the "right to use" or "access to" a license) before applying the revenue recognition model to the contract. The standard will include indicators (currently being developed by the boards' staffs) to help entities determine whether a promise is a right to use the license and, thus, control transfers at a point in time. If the license is not deemed to be a right to use the license, the license would represent a promise to provide access to an entity's intellectual property over which control would be deemed to transfer over time.

**Editor's Note:** The boards decided not to retain the constraint guidance that would have required entities to limit the cumulative amount of revenue recognized in licenses of intellectual property when such revenue varies on the basis of the customer's subsequent sales (e.g., a sales-based royalty). Rather, the general constraint guidance, as discussed in [Determining the Transaction Price](#) above, would apply to all arrangements with variable consideration and would require entities to use a significant amount of judgment in determining the amount of revenue to recognize. Accordingly, determining whether an intellectual property license is the sale of a right (control transfers at a point in time) or access to the intellectual property (control transfers over time) will be critical in determining the manner in which entities recognize revenue related to such licenses.

## Additional Topics

Other topics addressed under the proposed model include presentation of contract assets and liabilities, principal-versus-agent considerations, nonrefundable up-front fees, repurchase agreements, consignment arrangements, bill-and-hold arrangements, and the impact of customer acceptance terms. The proposed model also contains examples illustrating the application of many of its provisions.

**Editor's Note:** The revised ED contained guidance on accounting for onerous performance obligations. However, after considering feedback, the boards narrowly agreed to remove it and instead maintain the existing guidance on accounting for onerous losses under U.S. GAAP (e.g., ASC 450, ASC 605-35) and IFRSs (i.e., IAS 37<sup>10</sup>). The FASB plans to consider this topic as a separate project in the future.

## Income Tax Implications

Tax departments will need to assess changes in book revenue recognition methods to prepare for the tax effects of the proposed model. Federal income tax law contains specific rules about certain types of revenue, such as income from long-term contracts and advance payments for goods and services. Those rules often overlap with a taxpayer's financial reporting policies, in which case the taxpayer often applies, as its tax method, the revenue recognition method it uses in maintaining its books and records. Because the proposed model may change the amount and timing of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs, there may be implications related to the taxation of cash or to new book-tax differences that will need to be captured, calculated, and tracked.

<sup>10</sup> IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

If a change in a tax accounting method is advantageous or expedient, the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use such method, including circumstances in which the book method has historically been used. There may be similar tax implications for foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs.

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