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Heads Up

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Finding the One Size That Fits All

Sharing Views on the Revenue Project

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Introduction

The roundtable discussion on November 23 at Stanford University marks the end of a series of international roundtables hosted by the FASB and IASB (the "boards") to solicit feedback from various constituents on the June 2010 exposure draft (ED), *Revenue From Contracts With Customers*. The roundtables were an integral part of the overall outreach activities the boards have undertaken since the ED was issued. Even before the comments were due on the revenue ED, the boards' outreach activities were extensive and included participation in industry-specific meetings, numerous discussion forums, targeted webcasts, and individual meetings with various constituents.

While the monumental task of reviewing the nearly 1,000 comment letters received on the ED is still progressing, in November the boards discussed some of the common themes already identified in the feedback received on the proposed model. Addressing the concerns raised by constituents will no doubt challenge the boards' ability to finalize this project by June 2011 as originally planned; however, no changes have been made to the project's timeline. In December, the boards plan to review and analyze the comment letter responses and reconsider the overall project plan. Then, starting in January, the boards intend to redeliberate various aspects of the ED, beginning with the concepts of "control" and "separation" (discussed in more detail below). In the meantime, the boards will continue their outreach activities to ensure that they understand and openly discuss any significant changes to specific industry practices.

This *Heads Up* summarizes some of the feedback received in the comment letters and highlighted in the roundtable discussions. Much of the feedback, summarized below, was similar among industries. The appendixes outline some specific industry concerns the boards received.

Summary of Feedback

In comment letters, most respondents indicated support for the boards' efforts to develop a single comprehensive revenue recognition standard. However, such support was tempered by their concerns about specific aspects of the ED. Two concepts that seemed to invoke passionate responses were (1) transfer of control and (2) separation of performance obligations. Both were deemed "fundamental concepts" by the boards' staffs at the November meeting. The boards will also focus on concerns about the

practicality application (and cost vs. benefit) of certain provisions of the ED. Those provisions included the combining or segmenting of contracts, the accounting for contract modifications, variable (contingent) consideration, collectibility, onerous performance obligations, warranties, required disclosures and retrospective application. Further, many respondents encouraged the boards to perform additional field testing of the guidance and to include specific implementation guidance to support the concepts in the ED.

Editor's Note: The ED's core principle is the recognition of "revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it receives, or expects to receive, in exchange for those goods or services." See Deloitte's June 28, 2010, *Heads Up* on the ED.

Transfer of Control

The ED indicates that entities would use the concept of "control" to determine when a good or service has transferred to a customer and hence when revenue is recognized. Paragraph 30 of the ED provides indicators to help entities determine when a customer has obtained control of a good or service.

Many constituents commented that the ED's description of control is not clear enough to allow an entity to determine when control has transferred to the customer. Specifically, they noted that because the indicators seem to focus on control of a tangible product, their application in circumstances other than simple product sales would be unwieldy (such as in service or long-term construction-type arrangements or arrangements currently accounted for under a proportional performance-type model). An example the staffs raised at the roundtable discussion was the transportation of freight from one location to another. Participants discussed whether control transfers over time as the transportation services are performed or whether the freight has to reach its ultimate destination before control transfers. Similarly, yet potentially more complex, is the application of this concept to long-term construction-type contracts. Roundtable participants discussed at length whether control transfers during, or only upon completion, of construction, and their views varied on the appropriate application of control in these and other examples. Addressing such matters, among others, will be a key focus of the boards during their redeliberations.

Many constituents commented that the ED's description of control is not clear enough to allow an entity to determine when control has transferred to the customer.

Separation of Performance Obligations

Under the proposed guidance, an entity would "identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation." A good or service would then be accounted for as a separate performance obligation if it is deemed "distinct" (i.e., sold separately or could be sold separately because it has a distinct function and profit margin).

While most constituents agree that distinct goods or services should be accounted for separately, many believe that an approach under which all goods or services are identified and then aggregated into distinct performance obligations may not be operational and may not result in decision useful information in transactions. Specifically, such constituents commented that the proposed separation rules may result in the identification of units of accounting that are too granular and not consistent with how entities' activities are viewed by management or financial statement users. For example, under the ED, certain contracts historically regarded as arrangements for the provision of a single service (such as in the construction industry) may be disaggregated into a large number of separate performance obligations. Some have suggested that a "top down" approach for identifying performance obligations may be appropriate and more practicable. Further, respondents struggled to understand the concept of goods or services having a "distinct profit margin" as defined in the ED (i.e., those subject to distinct risks and for which the entity can separately identify resources needed to provide

the good or service) and questioned whether the presence of these factors indicates that a good or service is distinct.

Like the concept of control, the separation guidance will be a key focus of the boards during redeliberations because it is also considered fundamental to the application of the proposed guidance.

Contract Combination, Segmentation, and Modification

While many constituents seem to agree with the boards' principle on combining contracts, the same cannot be said for the proposed guidance on contract segmentation and modification. Respondents struggled to understand the difference between segmenting a contract and separately identifying each performance obligation. Respondents questioned whether the indicators of price interdependence in the ED provided a useful framework for evaluating whether a contract modification should be accounted for prospectively or cumulatively. Under the proposed guidance, a contract modification and the original contract are deemed interdependent simply if the pricing in the new contract provides for a discount. In such a case, the cumulative effect of the contract modification is recognized in the period the modification occurred. Many respondents noted that under such an approach, factors that led to the modification could be ignored, potentially resulting in accounting that does not reflect the economics of the arrangement (and the related modification).

Variable (Contingent) Consideration

If the transaction price is subject to variability, an entity is required under the ED to use an estimated transaction price (based on a probability weighting) if it can reasonably be estimated. Unlike current practice, this could potentially allow for the recognition of contingent revenue. While some respondents expressed concerns about allowing for the recognition of contingent revenue, many supported the proposal. However, the concept of probability weighting of estimates was a concern in many of the comment letters. Respondents noted that performing a probability-weighted calculation initially and then potentially doing so each reporting period is not practicable in many instances. Further, in many situations, the use of a probability weighting would result in an amount that would never be realized (such as with an all-or-nothing refund or incentive payment). Other respondents expressed concerns about the ED's guidance on whether a reasonable estimate can be made. Specifically, entities with all or a significant portion of revenue susceptible to external factors (such as market volatility or the judgment of a third party) indicated that the proposed model may cause results that do not reflect the economics and are consequently not meaningful to users.

Respondents noted that performing a probability-weighted calculation initially and then potentially doing so each reporting period is not practicable in many instances.

Collectibility

One area of concern for most respondents is the required accounting for collectibility. Under the proposed guidance, the initial measurement of the transaction price (and hence the total amount of revenue to be recognized) is adjusted to reflect the probability-weighted amount of consideration expected to be received (on the basis of the customer's credit risk), with subsequent adjustments recognized outside of revenue. Many respondents noted they preferred current practice and indicated it should be preserved. That is, many believe that (1) the final standard should include an explicit minimum threshold of collectability (such as the current "reasonably assured" threshold) and (2) adjustments for collectibility should be recognized as bad debt. Further, several respondents noted that users of the financial statements may be misled if adjustments for collectibility (i.e., bad debt) are split within the income statement.

Onerous Performance Obligations

The proposed guidance would require the recognition of a contract loss to the extent that the present value of the expected direct costs of satisfying the separate performance

obligation exceeds the amount of the transaction price allocated to that obligation. Even though the ED did not specifically request comments on the level at which the onerous test should be performed, many respondents noted their disagreement with the level proposed (including its impracticability in many instances) and suggested that such evaluation should be performed at the contract level. Another significant concern respondents noted about the proposed onerous test is the potential for onerous loss that is inconsistent with the economics of the arrangement (e.g., recognizing an onerous loss at the performance obligation level when the overall contract is profitable or when there are other reasons for entering into the contract).

Warranties

Many respondents do not agree with the proposed distinction between (1) warranties that provide coverage for defects existing when the product is transferred to the customer and (2) those that provide coverage for faults that arise after the product is transferred to the customer. While some acknowledged the conceptual merit of the proposed guidance, many commented that it is impractical and operationally difficult to distinguish quality-assurance type warranties from insurance warranties. Many indicated that having to make such a distinction would significantly change practice and that the costs incurred and efforts expended to appropriately track and account for these warranties would be substantial and would not yield significant benefit or value to users of the financial statements.

One particular disclosure, under which information would be required about performance obligations satisfied in future periods, garnered significant opposition.

Further, respondents generally disagree with the proposal to treat products sold with a potential latent defect as failed sales. Many noted that standard warranties provide customers with assurance that the product will operate as intended in accordance with the manufacturer specifications and that any costs to support such warranty should be accounted for under a contingent cost model in accordance with the guidance in ASC 450. Respondents argued that standard warranties are not priced separately and that customers simply expect a standard warranty upon purchase of any product. Further, standard warranties are so closely linked to the delivered product that entities do not view them as revenue generating activities. Respondents contrasted standard warranties with separately purchased extended warranties that offer broader coverage and generally provide protection beyond a product's original warranty period.

Disclosures

The ED would significantly expand the disclosures currently required. While many respondents agreed with the objective for improving disclosures, several commented that the proposed requirements were excessive and unclear. Concerns focused on the volume of the disclosure requirements and whether useful information would be lost in the detail. Some respondents, however, requested further guidance (including examples) to help in the implementation of the proposed disclosures. One particular disclosure, under which information would be required about performance obligations satisfied in future periods, garnered significant opposition. Respondents disagreed with providing forward-looking disclosures, indicating that such information would go well beyond existing requirements and that it may be misleading, may reflect an incomplete picture, and may be susceptible to significant change. Respondents also expressed some disagreement about the proposal's requirement to disclose the reconciliation of contract assets and liabilities, noting that such disclosure would not be relevant or useful to users of financial statements.

Retrospective Application

Feedback on the requirement to retrospectively apply the final standard was mixed. Many focused on the potential cost (relative to the benefits) and the impracticability of retrospective application of the proposed guidance. Respondents overwhelmingly indicated that if retrospective application is required, the boards need to allow ample time for the final standard to be adopted.

Field Testing and Implementation Guidance

While some respondents indicated that less prescriptive guidance that would allow for the use of more judgment in the application of the principles in the proposed guidance might be desirable, many requested more practical examples and additional implementation guidance. Respondents generally indicated that extensive field testing is needed to ensure broad and consistent applicability before a single revenue recognition standard can be developed that applies to all industries.

Appendix A — Aerospace and Defense and Engineering and Construction Industries

The boards received more comment letters from individuals or entities in the aerospace and defense (A&D) and engineering and construction (E&C) industries than from those in any other industry. This feedback included over 200 copies of essentially the same letter submitted by a variety of interested parties, and numerous other letters sent by parties ranging from small, private construction companies to large public A&D and E&C companies.

The underlying theme of the letters received was that the proposed rules would result in significant changes to current reporting and that these changes may not lead to results that represent the economics of the transactions. Respondents noted they were generally content with the accounting guidance in ASC 605-35[1] and indicated that it provides comparable and consistent information to users of financial statements. Most requested that the boards consider retaining the current guidance and, if not, provide clarification and interpretive guidance to address the many concerns associated with the proposal. Their overriding concern was that the accounting under the proposed model would not provide decision-useful information to investors and that comparability and consistency would potentially be sacrificed.

Although many of the concerns noted in the comment letters are discussed in the Summary of Feedback section, themes specific to this industry included concerns about reflecting the economics of a contract, deferred production costs, and certain surety issues.

Reflecting the Economics of a Contract

Many respondents noted that the current accounting model appropriately reflects the manner in which contracts within these industries are bid, negotiated, and managed. They expressed concern that certain of the ED's provisions would result in outcomes that do not reflect the economics of the contract. Specifically, they objected to the transfer of control and identification of separate performance obligations (the two fundamental concepts identified by the boards). Many respondents suggested that the boards consider allowing for consideration of the intent of the contracting parties and the underlying economics of the transactions in the identification of separate performance obligations. Further, respondents requested additional guidance on and clarification of the concept of control, with a specific focus on determining when continuous transfer of control exists (especially for contracts with unique complexities, such as those that are common in both these industries).

Deferred Production Costs

Entities in the A&D and E&C industries have long-established practices for accounting for costs related to construction and production-type contracts, such as costs related to learning curves, bid and proposal, and work in process. The proposal would supersede certain existing guidance on costs (such as that in ASC 605-35 and ASC 912), and entities in these industries expressed concern that potential changes to the manner in which costs are capitalized and expensed under the proposed guidance would not provide useful information to users and would result in costs that are not appropriately matched with the related revenues. Most respondents requested that the current guidance be retained so that the economic substance of the revenue transactions is appropriately depicted in the financial statements.

Certain Surety Issues

Surety companies play a significant role and are important users of the financial statements in the E&C industry. These entities focus on customer contracts as a whole because contracts are bonded at that level. Respondents in the E&C industry expressed concern that recognizing revenue at the performance-obligation level would fail to give these entities the information they need. Respondents further noted that the proposed guidance may result in unwarranted volatility in revenue (as a result of a change at a separate performance obligation) and costs (as noted above) when a change in the overall profitability of the contract has not occurred. As a result, certain members of the surety industry have indicated to entities in the E&C industry that they may need to continue providing information under current reporting requirements, which would potentially require entities to keep two sets of financial records.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Appendix B — Technology Industry

Respondents in the technology industry included software, semi-conductor, computer equipment, and networking entities. Because of the diverse product and service offerings in this industry, the proposed revenue recognition rules may affect each type of entity differently. However, in addition to many of the general issues described in the Summary of Feedback section, some additional common concerns from respondents in this industry included those related to software arrangements involving multiple elements, software warranties, and licensing.

Editor's Note: The boards received numerous comment letters from respondents in the telecommunications industry. One of the most contentious issues noted in the letters was the effect of the new guidance on the manner in which mobile operators recognize revenue related to subsidized handsets. See Deloitte's *Accounting in the Telecommunications Industry* for more information about key concerns specific to this industry.

Software Arrangements Involving Multiple Elements

Under current software revenue recognition guidance, entities can separate software arrangements involving multiple elements (such as a software license and post-contract customer support (PCS)) by using the residual method (when vendor-specific objective evidence (VSOE) of fair value exists for the undelivered PCS). The proposed guidance eliminates the use of the residual method and the VSOE criteria for separating multiple elements and replaces it with the concept of distinct performance obligations. Respondents have requested that the boards clarify how to apply the concept of a distinct performance obligation to software arrangements involving multiple elements. In particular, many believe that the criteria may be too restrictive, requiring the presence of a distinct profit margin in the separation of performance obligations when a product or a service is not sold separately. Software licenses are generally not sold on a stand-alone basis, and while software licenses and PCS may often have distinct functions, determining whether a distinct profit margin exists may be difficult because the same resources are often used to develop a license and PCS.

Several respondents also specifically requested that the Board provide additional implementation guidance and clarification to assist in the determination of when software-related performance obligations would be considered distinct under the proposed guidance. For instance, they questioned how upgrade rights (specified and unspecified), technical assistance support lines, and spare parts replacement programs would be accounted for under the proposed model.

Software Warranties

Many of the respondents questioned the application of the proposed guidance to software warranties because defects are often inherent in software and because patches, fixes, or other updates are usually provided when defects become known. Since the software is generally not returned or replaced in its entirety, the practical application of the proposed guidance is not clear. As a result, some respondents requested the boards to provide clarity on the practical application of the proposed guidance.

Licensing

Of those who responded to the question on licensing and right to use, most disagreed that the pattern of revenue recognition should depend on whether the license is exclusive or nonexclusive. Many viewed the distinction as a bright-line test, noting it was inconsistent with the underlying principles related to performance obligations. With respect to both exclusive and nonexclusive licenses, respondents indicated their belief that an obligation is generally satisfied when a customer is able to use and benefit from the license. While some acknowledged that a vendor may have an obligation to maintain exclusivity to a particular customer, they argued that it is only one factor to consider in determining whether revenue should be recognized over the license period. Other factors noted include renewal and cancellation clauses, length of time the customer receives the benefit, and additional obligations associated with the license.

Appendix C — Energy and Resources Industry

While comments related to this industry were limited, many respondents from regulated industries raised consistent concerns. In addition to those discussed in the Summary of Feedback section, many pertained to scope, effect on "blend-and-extend" arrangements, and long-term power sale contracts. Other concerns were raised by oil and gas entities on the application of the proposed guidance to production-sharing and gas-balancing arrangements (not specifically discussed below).

Regulated Industries Scope

ASC 980 provides guidance on alternative revenue programs, including decoupling programs and incentive revenue plans, and allows for revenue recognition in certain situations. Since the ED would eliminate this guidance, respondents noted concerns that revenue under these programs would change significantly because the recognition of these regulatory assets involves the accrual of revenue as opposed to the recovery of an incurred cost. While respondents acknowledged the goal of eliminating industry-specific revenue rules, they view this guidance as an important part of the overall regulatory accounting framework under U.S. GAAP and noted that it should be retained.

Blend-and-Extend Contract Modifications

Blend-and-extend arrangements typically involve the extension of an existing contract term, with pricing for the remaining deliveries representing a blend between the market price for the extension period and the contract price of the premodification remaining deliveries. The blended price results in an equivalent contract fair value before and after modification; entities effectively recognize changes prospectively by using a blended price over the remaining delivery period (not just the additional period). Under the ED, such a change would be considered a contract modification and accounted for differently depending on whether the modification is considered independent of the original contract or interdependent (on the basis of whether a discount is provided in the modified pricing). Many respondents noted their concern that the contract modification guidance does not properly reflect the economics of a blend-and-extend modification. Further, some also expressed concern that, under the proposed guidance for material financing components, these arrangements may be considered to contain a loan that requires adjustments to revenue for the time value of money.

Long-Term Power Sales Contracts

Like other industry-specific revenue guidance, ASC 980-605-25 would be superseded under the ED. ASC 980-605-25 provides guidance on revenue recognition for long-term power sales contracts with scheduled price changes, formula-based pricing, and contracts with both fixed and variable pricing terms. Respondents are concerned that the ED does not specifically focus on issues addressed by this industry-specific guidance. For example, identifying separate performance obligations and estimating future costs and pricing in these contracts, as would be required under the proposed guidance, may be difficult or impractical (due in part to their long-term nature). As a result, respondents expressed concerns that the proposed guidance would create uneconomic and potentially misleading financial results.

Appendix D — Financial Services Industry

Over 30 comment letters were received from entities in the financial services industry, including those in the banking, insurance, private equity, hedge and mutual fund management, asset management, and credit card industry. While many comments were consistent with those discussed in the Summary of Feedback section, they also focused on uncertainty related to scope and the application of the proposed guidance to performance-based fees.

Scope

Respondents in this industry expressed concerns about identifying the type of transactions that are within the scope of the proposed ED. For example, they noted uncertainties about the scope of the ED and about interplay between the ED and certain fees from financial instruments. Loyalty programs (e.g., credit card reward programs) were a common concern with regard to scope, and many respondents specifically requested that such programs be excluded from the scope of the ED. They noted specifically that loyalty programs may not require a revenue transaction for a customer to generate points (e.g., opening an account, transferring account balances, referring new customers), which would create problems related to the allocation of revenue when no transaction price exists. Respondents requested additional implementation guidance on the operational issues associated with programs that are within the ED's scope.

Performance-Based Fees

EITF Topic D-96[2] (codified in ASC 605-20-S99) provides two acceptable methods for recognizing revenue during interim periods for arrangements that contain performance-based fees that are not finalized until the end of a period specified in a contract. Because this guidance would be superseded under the ED, certain respondents expressed concern about applying the proposed guidance to performance-based fees (common in asset management agreements). Specifically, the proposed guidance suggests that under these arrangements, the transaction price may not be reasonably estimable because it is highly susceptible to external factors (i.e., market volatility), and as a result revenue may need to be significantly deferred. These entities note that they use judgment extensively when estimating the fair value of investment holdings in accordance with ASC 820 and that, accordingly, they should be able to use it to estimate revenue from these fees. Some of these respondents requested that, if they are not able to recognize revenue the way they do under current practice, the boards provide additional guidance on the deferral of related expenses to match these revenues.

Further, these fees are often paid, in part, in the form of equity in the assets being managed (commonly referred to as "carried interest"). Certain respondents were not clear whether the carried interest would be outside the scope of the ED because it represents a financial instrument or whether it represents noncash consideration and would be accounted for in accordance with such provisions in the ED. Some respondents suggested that if the carried interest is deemed to be within the scope of the ED, the accounting for such payments should be consistent with cash payments because they are economically similar.

[2] EITF Topic No. D-96, "Accounting for Management Fees Based on a Formula."

Appendix E — Consumer and Industrial Products

Constituents in the consumer and industrial products industries provided a significant number of comment letters on the ED. This industry includes entities that engage in manufacturing, retail, automotive, and consumer products activities. While many of the comments from this industry are consistent with those discussed in the Summary of Feedback section, respondents also noted concerns about warranties and franchise agreements.

Warranties

In addition to the concerns around the proposed accounting for warranties discussed above, many respondents were concerned that the proposed guidance requiring preparers to distinguish between latent and insurance warranties creates unnecessary complexity. In addition, many disagreed with the notion that all warranties give rise to separate performance obligations. Respondents noted that these additional requirements do not provide meaningful improvement to current guidance and in many situations produce results that do not appropriately reflect the economics of the transactions. Many asked the boards to retain the current guidance on accounting for warranties.

Franchise Agreements

Several respondents expressed concern about the application of the ED to franchise agreements, specifically as it relates to the subjectivity involved in determining the transaction price. Respondents with long-term management and franchise agreements expressed concerns about estimating variable consideration, noting that revenue recognized would not necessarily match the economics for these transactions. While many respondents noted that there may be sufficient history with which to reasonably estimate the variable consideration, they were concerned that because of the long-term nature of these contracts, the amounts would be extremely subjective. Respondents recommended that revenue in these arrangements be based on the amounts due under the contract for each discrete period (in a manner consistent with the economics of the consideration received each period).

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