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FASB and IASB Issue Discussion Paper on Revenue Recognition

by Mark Crowley and Ryan Johnson, Deloitte & Touche LLP

Introduction

As a major step in their joint project on revenue recognition, the FASB and IASB (the "boards") have issued a Discussion Paper[1] outlining their preliminary views on a single, contract-based revenue recognition model.

The boards intend to improve current revenue recognition guidance by:

- *Enhancing consistency and comparability.* The proposed model uses a recognition principle that can be applied consistently to various transactions in numerous industries. In addition, the proposed model provides more consistent guidance than currently exists on when an entity should recognize revenue.
- *Simplifying U.S. GAAP.* Currently, there are more than 100 revenue recognition standards in U.S. GAAP. Many of these standards are industry-specific, and some provide conflicting guidance. The proposed model eliminates conflicting guidance and reduces the number of revenue recognition standards.
- *Providing guidance lacking in IFRSs.* The two main IFRS revenue recognition standards are vague, inconsistent, and difficult to apply to complex transactions, such as revenue arrangements with multiple deliverables. The proposed model provides more comprehensive guidance than the current IFRS revenue recognition standards.

Scope

The proposed model applies to contracts with customers. The Discussion Paper defines a contract as "an agreement between two or more parties that creates enforceable obligations." A customer is defined as "a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities." **Agreements do not have to be in writing to be considered a contract.**

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Although the boards have not ruled out any particular contracts from the proposed model, they are considering whether the model provides decision-useful information about the following contracts:

- Financial instruments and some nonfinancial instrument contracts that otherwise would be within the scope of standards such as Statement 133[2] and IAS 39.[3]
- Insurance contracts within the scope of Statement 60[4] (and other related GAAP) and IFRS 4.[5]

[1] FASB Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts With Customers;* IASB Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts With Customers.*
[2] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.*
[3] IAS 39, *Financial Instruments: Recognition and Measurement*.
[4] FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises.*
[5] IFRS 4, *Insurance Contracts.*

- Leasing contracts within the scope of Statement 13[6] (and other related GAAP) and IAS 17.[7]

After reviewing the comments received on the Discussion Paper, the boards will determine whether these or other types of contracts should be excluded from the scope of the project.

Recognition Principles

In a contract, an entity receives consideration (rights) from, and promises to transfer assets (performance obligations) to, a customer. Under the proposed model, the rights and obligations give rise to a net contract position and revenue is recognized when a contract asset increases or a contract liability decreases as an entity satisfies its performance obligations.

The following table, reprinted from paragraph 2.32 of the Discussion Paper, illustrates this process:

	Net Contract Position	Contract Asset	Contract Liability
Customer pays (reduces remaining rights)	Decreases	Decreases	Increases
Entity provides goods and services (reduces remaining obligations)	Increases	Increases (entity recognizes revenue)	Decreases (entity recognizes revenue)

An entity satisfies its performance obligations when "the customer obtains control" of the promised assets in the contract. For example, the promised assets may be products (goods) or services. With a product, an entity satisfies its performance obligations when the customer controls the product and it is considered the customer's asset (typically when the customer takes physical possession). Similarly, with a service, an entity satisfies its performance obligations when the service is the customer's asset (i.e., the customer receives the service). The service can either enhance another asset of the customer or be consumed by the customer immediately.

The proposed model requires an entity to account for multiple performance obligations separately when assets in a contract are transferred to a customer at different times.

Editor's Note: The Discussion Paper distinguishes between the "control of an asset" and "the risks and rewards of ownership," noting that the two concepts are different and that they may sometimes, but do not always, coincide.

Further, the proposed model requires an entity to account for multiple performance obligations separately when assets in a contract are transferred to a customer at different times. (The objective of this requirement is to faithfully represent the pattern of asset transfers over the life of the contract.)

Measurement Principles

Under the proposed model, an entity measures performance obligations on the basis of the amount of the "transaction price" (i.e., the customer's promised consideration) at contract inception. For contracts with multiple performance obligations, the transaction price would be allocated to each obligation on the basis of the relative stand-alone selling prices of the underlying assets (goods, services, or both) to be transferred. After contract inception, the initial measurement of a performance obligation would not be updated

[6] FASB Statement No. 13, *Accounting for Leases.*
[7] IAS 17, *Leases.*

unless the obligation is "deemed onerous." The following table summarizes the proposed measurement of performance obligations:

	Measurement	
	Timing	Basis
Initial measurement	At contract inception.	Transaction price (customer's promised consideration) allocated to performance obligations on the basis of the relative stand-alone selling prices of the underlying assets (goods or services).
Subsequent measurement	As the performance obligation is satisfied and the promised assets are transferred to the customer (i.e., the customer obtains control of the promised assets).	The portion of the transaction price allocated to the performance obligation at contract inception.
Remeasurement	When expected cost to satisfy a performance obligation exceeds the initial measurement (i.e., the obligation is deemed onerous).	Expected costs of satisfying the performance obligation (the initial obligation is remeasured, with the offsetting entry to contract loss).

Potential Effects on Current Practice

While the boards expect the proposed model to "cause little, if any, change" to revenue recognition practices for many contracts (such as common retail transactions), the Discussion Paper highlights the following differences from current practice:

- *Use of a contract-based revenue recognition principle*. An entity would recognize revenue only as a result of satisfying a performance obligation. Cash collection or production of inventory not transferred to a customer (whether under contract or not) would not trigger revenue recognition. For instance, revenue recognition for construction-type contracts would only occur during construction if the customer controls the item as it is constructed.
- *Identification of performance obligations*. Under the proposed model, entities would account for contractual promises as performance obligations and would recognize revenue when these obligations are satisfied. For example, some warranties and other postdelivery services accounted for as cost accruals under current guidance would be performance obligations of a contract.
- *Use of estimates*. Estimates used to recognize revenue would not be as limited under the proposed model as they are under some existing standards. For example, in multiple-element arrangements, entities would estimate the price of the undelivered goods and services and recognize revenue when goods and services are delivered to the customer, regardless of whether objective and reliable evidence of the selling price of the undelivered item exists.
- *Capitalization of costs*. In the proposed model, costs are capitalized only if they qualify for capitalization in accordance with other standards. For example, an entity would expense as incurred, rather than capitalize, commissions paid to a salesperson for obtaining a contract with a customer. These costs typically do not create an asset that qualifies for recognition in accordance with other standards.

Under the proposed model, entities would account for contractual promises as performance obligations and would recognize revenue when these obligations are satisfied.

Next Steps

Comments on the Discussion Paper are due by June 19, 2009. (For a list of discussion questions asked by the boards, see the Appendix.) During the comment period, the boards plan to conduct field tests that will focus initially on industries that the proposed model is most likely to affect. After further deliberations, the boards will develop an Exposure Draft for public comment.

The Discussion Paper is available on both the FASB's Web site and the IASB's Web site.

Appendix: Discussion Paper Questions

Below are specific questions (reprinted from paragraph S34 of the Discussion Paper) that the boards ask entities to consider when submitting comments on the Discussion Paper.

Question 1: Do you agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Question 2: Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Question 3: Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Question 4: Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Question 5: Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Question 6: Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Question 7: Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Question 8: Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Question 9: The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Question 10: In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Question 11: The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

Question 12: Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Question 13: Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

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