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In This Issue:

- Identify the Contracts With the Customer
- Identify the Separate Performance Obligations
- Determine the Transaction Price
- Allocate the Transaction Price to the Separate Performance Obligations
- Recognize Revenue When the Performance Obligations Are Satisfied
- Onerous Performance Obligations
- Costs of Obtaining and Fulfilling a Contract
- Implementation Guidance
- Disclosure and Presentation Requirements
- Transition Method
- Industry Specific Decisions

The Road to Reexposure

Recap of Revenue Recognition Redeliberation Results

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In the nearly six months of redeliberations on their exposure draft (ED) on revenue recognition that was issued in June 2010, the FASB and IASB (the "boards") have made numerous tentative changes to the proposal's guidance. As a result of these changes, and given the importance of the revenue line in the statement of comprehensive income, the boards have decided to expose for public comment a revised ED. In a joint staff paper, the boards indicated that they expect the revised ED to be issued in August or September of this year (stay tuned for a Deloitte *Heads Up* on the revised ED) and that it will be followed by a 120-day comment period (which may push the end date of this project to mid to late 2012). The boards also discussed effective dates pertaining to the revenue project and noted that such dates would not be earlier than January 1, 2015. This *Heads Up* summarizes the tentative decisions that were reached during the redeliberations of the original ED.

Editor's Note: The FASB staff has created a table that compares the ED's main proposals with key decisions made by the boards during redeliberations. Note that all such decisions are subject to change before any standard becomes final.

The ED's core principle is that an entity must "recognize 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." The ED lists five key steps for entities to follow in recognizing revenue for contracts within the proposal's scope:

(a) identify the contract(s) with a customer;

(b) identify the separate performance obligations in the contract;

(c) determine the transaction price;

(d) allocate the transaction price to the separate performance obligations; and

(e) recognize revenue when the entity satisfies each performance obligation.

Although they maintained the ED's core principle and the five key steps to recognizing revenue, the boards made various changes regarding application of the steps, as described in the FASB's summary of decisions (as of July 13, 2011), and highlighted in the discussion below.

Although they maintained the ED's core principle and the five key steps to recognizing revenue, the boards made various changes regarding application of the steps.

Identify the Contracts With the Customer

In a manner consistent with the proposal in the ED, the final revenue standard will apply to an entity's contracts with customers, with certain exceptions for contracts within the scope of other standards (e.g., lease contracts or insurance contracts). The proposed guidance notes that a contract can be written, verbal, or implied and provides specific criteria for entities to consider in determining whether a contract exists. Notably, if both parties to a contract can unilaterally terminate the contract without penalty, a contract would not exist. During deliberations, the boards modified the ED's proposed guidance on contract combination, segmentation, and modification, as discussed below.

Contract Combination

In a departure from the ED's proposed guidance on combining contracts, the boards tentatively decided that an entity should combine two or more contracts that are entered into at or near the same time with the same customer (or related entities) if one or more of the following criteria are met:

1. The contracts are negotiated as a package with a single commercial objective.
2. The amount of consideration in one contract depends on the other contract.
3. The goods and services in the contracts are interrelated in terms of design, technology, or function.

Contract Segmentation

The ED proposed that a contract would be accounted for "as two or more contracts if the price of some goods or services in the contract is independent of the price of other goods or services in the contract." The boards tentatively decided to eliminate this requirement, which effectively makes all decisions about contract separation part of the process of identifying separate performance obligations (see further discussion below).

During redeliberations, the boards modified the criteria for identifying separate performance obligations.

Contract Modification

Under the ED, contract modifications would be accounted for either (1) together with the original contract if the pricing in the new contract provided for a discount (resulting in a cumulative-effect adjustment as if the modified terms existed at contract inception) or (2) as a separate contract. The boards tentatively decided that an entity should account for contract modifications as separate contracts if the modification results "in the addition of a separate performance obligation at a price that is commensurate with that additional performance obligation"; however, they requested that the staffs further consider the criteria for when a contract modification is a separate contract on the basis of indicators for combining contracts (noted above). "Otherwise, the entity should reevaluate the performance obligations [in the contract] and reallocate the transaction price to each separate performance obligation."

Identify the Separate Performance Obligations

The ED proposed that a good or service would 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). During redeliberations, the boards modified the criteria for identifying separate performance obligations as follows:

1. An entity should 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. An entity should account for a promised good or service as a separate performance obligation if:
   a. The pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
   b. The good or service has a distinct function.

3. A good or service has a distinct function if either:

   a. The entity regularly sells the good or service separately, or

   b. The customer can use the good or service either on its own or together with resources that are readily available to the customer.

The boards further decided to delete the word "enforceable" from the definition of a performance obligation, thereby potentially including those that are not legally enforceable (e.g., free when-and-if-available software upgrades that an entity has a history of providing to customers).

Determine the Transaction Price

The ED proposed that if the transaction price is subject to variability, an entity would be required to use an estimated transaction price (based on a probability weighting) if the price can be reasonably estimated. During redeliberations, the boards clarified the objective for determining the transaction price, noting that entities should "estimate the total amount of consideration to which the entity **will be entitled** under the contract" (emphasis added). This estimation would be based on either (1) the probability-weighted amount or (2) the most likely amount (i.e., management's best estimate), "depending on which is most predictive of the amount of consideration to which the entity will be entitled."

The boards tentatively decided to replace the ED's "reasonably estimated" revenue recognition constraint with a "reasonably assured" standard.

In addition, the boards tentatively decided to replace the ED's "reasonably estimated" revenue recognition constraint with a "reasonably assured" standard. Accordingly, an "entity should recognize revenue at the amount allocated to a satisfied performance obligation unless the entity is not reasonably assured to be entitled to that amount . . . . That would be the case in each of the following circumstances:

a. The customer could avoid paying an additional amount of consideration without breaching the contract (for example, a sales-based royalty).

b. The entity has no experience with similar types of contracts (or no other persuasive evidence).

c. The entity has experience, but that experience is not predictive of the outcome of the contract based on an evaluation of the factors proposed in the [ED] (for example, susceptibility to factors outside the influence of the entity, the amount of time until the uncertainty is resolved, the extent of the entity's experience and the number and variability of possible consideration amounts)."

Editor's Note: Although the wording changes described above are slight, they are noteworthy. The boards believe that their decisions to (1) change the objective for determining the transaction price from the amount the entity "expects" to receive to the amount the entity "will be entitled" to receive and (2) require separate adjustment for collectibility outside of gross revenue will help achieve their core objective of revenue recognition in the amount an entity **expects to receive** in exchange for goods or services transferred to a customer.

In addition, before the boards' decision to change the revenue recognition constraint from "reasonably estimated" to "reasonably assured," an entity could have argued that certain amounts could be reasonably estimated and thus revenue could be recognized upon transfer of control. In some situations, such as those involving a sales- or usage-based royalty, an entity may have the experience to reasonably estimate the amount of consideration it expects to receive after it has transferred control to a reseller. However, in many of these cases, that entity is not entitled to consideration because such consideration depends on future events not within the entity's control. The boards believe that changing the constraint to "reasonably assured" and clarifying the constraint will result in a final standard that is more in line with their core objective.

Time Value of Money

The boards affirmed the proposal in the ED that the transaction price should be adjusted to reflect the time value of money when the financing component is significant to the contract. Given the subjectivity associated with determining whether a financing component is "significant" to the contract, the boards provided factors an entity should consider in making this determination:

1. Whether 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
2. Whether there is a significant timing difference between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services
3. Whether the interest rate that is explicit or implicit within the contract is significant.

In addition, the boards tentatively decided that when the period between the transfer of goods or services and ultimate payment is one year or less, this assessment is not required (as a practical expedient).

In redeliberations, the boards tentatively decided that estimates for expected credit losses (i.e., both initial estimates and subsequent adjustments to that estimate) would be recognized in a separate line item within the income statement adjacent to the gross revenue line item (i.e., as contra revenue).

Collectibility

The ED originally proposed that entities adjust the transaction price for credit risk (i.e., collectibility) both initially on the transaction date and subsequently. Such adjustments would be recorded separately in the financial statements — initial adjustments would be part of the probability-weighted transaction price and subsequent adjustments would be accounted for as income or expense rather than revenue. In redeliberations, the boards tentatively decided that estimates for expected credit losses (i.e., both initial estimates and subsequent adjustments to that estimate) would be recognized in a separate line item within the income statement adjacent to the gross revenue line item (i.e., as contra revenue). The boards also tentatively decided that "the final revenue standard should not include a revenue recognition criterion that requires an assessment of the customer's ability to pay the promised amount of consideration." That is, the revenue recognition criterion under current U.S. GAAP that specifically requires collectibility to be reasonably assured will not be retained.

Allocate the Transaction Price to the Separate Performance Obligations

The ED required an entity to "allocate the transaction price to all separate performance obligations in proportion to the standalone selling prices of the goods or services underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis)." During redeliberations, the boards decided "that if the standalone selling price of a good or service underlying a separate performance obligation is highly variable," a residual technique may be the most appropriate method for entities to use in estimating standalone selling price for that good or service.

The boards also decided that an entity may allocate a subsequent change in the transaction price entirely to one or more performance obligations (unlike the requirement proposed in the ED to allocated subsequent changes in the transaction price to all performance obligations in the contract) when both of the following are met:

1. The contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or a specific outcome from satisfying that separate performance obligation.
2. The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

Recognize Revenue When the Performance Obligations Are Satisfied

The ED introduced the concept of "control" in the determination of when a good or service transfers to a customer (and thus, when revenue is recognized), which may be at a point in time (e.g., delivering a good) or continually over a period (e.g., rendering a service). The ED provided specific indicators for analyzing the transfer of control at a point in time and specified that control may be transferred continuously. The boards tentatively decided to (1) slightly modify the proposed indicators of when a customer obtains control at a point in time and (2) provide additional guidance that an entity must consider in determining whether control transfers continuously over time (including clarifying how an entity should measure its progress toward completion of a performance obligation that is continuously satisfied).

Transfers of Control at a Point in Time

The boards tentatively decided to (1) slightly modify the proposed indicators of when a customer obtains control at a point in time and (2) provide additional guidance that an entity must consider in determining whether control transfers continuously over time.

The boards tentatively decided to carry forward most of the proposed guidance in the ED. However, they decided to (1) describe the concept of control instead of specifically defining it, (2) remove the indicator of control that states that "the design or function of the good or service is customer-specific," and (3) "[a]dd 'risks and rewards of ownership' as an indicator of control."

Transfers of Control Over a Period and Measurement Toward Completion

For an entity to recognize revenue over a period, it first must conclude that a performance obligation is continuously satisfied, and then it must select a method to measure progress toward completion. The boards tentatively decided that an entity satisfies a performance obligation continuously if at least one of the following two criteria is met:

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

The boards also decided that the final standard should (1) "[e]mphasize that the objective of measuring progress is to faithfully depict the entity's performance (that is, the pattern of transfer of goods or services to a customer)" and (2) clarify the ED's descriptions of input and output methods. Further, the boards tentatively decided that when an entity that uses an input method to measure progress toward completion purchases goods that are transferred to the customer before the related services (e.g., materials that are controlled by the customer before the related service is provided by the entity), revenue recognized by the entity for the transfer of those goods should be equal to their costs (i.e., zero margin).

Onerous Performance Obligations

The boards modified the ED's requirement that a contract loss must be recognized to the extent that the present value of the expected direct costs of satisfying a **separate performance obligation** exceeds the amount of the transaction price allocated to that obligation. The boards tentatively decided that (1) the unit of account for the onerous test should be at the contract level (i.e., the remaining performance obligations in the contract) and (2) the costs used in the onerous test and measurement of the onerous liability should be the lower of (a) the direct costs to satisfy the remaining performance obligations or (b) the amount that the entity would have to pay to cancel the contract.

The boards further decided to limit the scope of the onerous guidance to those contracts with performance obligations that are continuously satisfied over a "long" period (the boards did not address what constitutes a "long" period). When a contract includes multiple distinct performance obligations, an entity would be required to separate the performance obligations that are satisfied (1) at a point in time or continuously over a short period and (2) continuously over a long period. The entity would then only need to perform the onerous test for the separate performance obligations satisfied continuously over a long period.

Finally, the FASB decided that not-for-profit entities would not be required to perform the onerous test when they enter into a contract for a social benefit or charitable purpose. (The IASB chose not to address this issue.)

Editor's Note: The tentative decisions made by the boards about the onerous test address many of the scenarios identified by constituents in the comment letter process and during the staffs' outreach activities. In these scenarios, the test results were not meaningful because they created an onerous loss contract without taking into account other economic factors. Such scenarios included (1) the first seat booked on an airline or cruise ship or at a performing arts event and (2) products or services sold at a loss in an anticipation of profits from other obligations in the contract or future contracts.

Costs of Obtaining and Fulfilling a Contract

Costs of Obtaining a Contract

The ED proposed that costs of obtaining a contract be expensed as incurred. The boards modified this guidance and tentatively decided that:

1. An entity should recognize an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.
2. An asset recognized for the costs of obtaining a contract should be presented separately on the statement of financial position and subsequently measured on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

Costs of Fulfilling a Contract

The boards tentatively decided to retain the guidance on the accounting for fulfillment costs as proposed in the ED and made only minor drafting improvements. They clarified that "costs of **abnormal amounts of wasted materials, labor, or other resources** that were not considered in the price of the contract should be recognized as an expense when incurred" (emphasis added). Further, the boards clarified that "the costs that relate directly to a contract include costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract" (i.e., precontract costs).

Editor's Note: The boards' tentative decisions require (unless the amortization period is less than a year) entities to recognize an asset for costs of obtaining and fulfilling a contract that meet the criteria in the proposed guidance. Depending on an entity's current accounting policies, this may be a significant change (especially for entities that currently tend to expense such costs).

Impairment and Amortization of Capitalized Costs

As a practical expedient, the boards tentatively decided that for contracts with an expected duration of one year or less, certain acquisition and fulfillment costs incurred **may** be expensed instead of capitalized. The boards also made tentative decisions about impairment and amortization of capitalized costs, as discussed below.

As a practical expedient, the boards tentatively decided that for contracts with an expected duration of one year or less, certain acquisition and fulfillment costs incurred **may** be expensed instead of capitalized.

Impairment

The FASB and IASB staffs observed that if an asset is recognized before the existence of a contract (i.e., precontract fulfillment costs), an immediate impairment charge may be required because there is no transaction price to offset the direct costs related to fulfilling the contract. The boards therefore decided to clarify that the following cash flows be used for the impairment test: "(1) the amount of consideration to which the entity expects to be entitled in exchange for the goods or services to which the asset relates less (2) the remaining costs that relate directly to providing those goods or services." The amount of consideration that the entity expects to be entitled to should be consistent with the principles for determining the transaction price.

Regarding future reversals of previously recognized impairment charges due to changes in circumstances, the IASB decided that such charges should be reversed; however, the FASB decided not to allow for such reversals. The differences in these tentative decisions are consistent with guidance currently in U.S. GAAP and IFRSs on reversals of previous impairment for certain other assets.

Amortization

The boards agreed that the amortization period for costs capitalized under the standard may extend beyond the initial contract term with the customer (e.g., contract renewals, related subsequent sales). Therefore, the boards tentatively decided to allow entities to look forward beyond the initial contract period in determining an appropriate amortization period but only if such entities can demonstrate that there is sufficient historical evidence indicating that the asset will contribute to future cash flows from the **same** customer.

Implementation Guidance

Warranties

The ED proposed different accounting for (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 (essentially eliminating the current cost accrual model for accounting for warranties). The boards eliminated this proposed guidance and tentatively decided that warranties would be accounted for as follows:

1. If a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation. Hence, the entity would allocate revenue to the warranty service.
2. If a customer does not have the option to purchase a warranty separately from the entity, the entity should account for the warranty as a cost accrual unless the warranty provides a service to the customer in addition to assurance that the entity's past performance was as specified in the contract (in which case the entity would account for the warranty service as a separate performance obligation).

The boards further indicated that the final standard would include implementation guidance on the exception in the second criterion (i.e., "the warranty provides a service to the customer in addition to assurance that the entity's past performance was as specified in the contract").

Licenses and Rights to Use

The boards tentatively decided to eliminate the ED's accounting model for exclusive licenses and rights to use an entity's intellectual property (which was a lease-type model). Accordingly, sales of licenses and rights to use intellectual property will be subject to the project's overall revenue recognition model.

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Sales and Repurchase Agreements

The boards tentatively decided that certain agreements that provide for the sale of an asset to a customer and simultaneously provide the customer with the right to require the entity to repurchase the asset at a price below the sales price should be accounted for as a lease when the customer has a "significant economic incentive" to exercise that right (since the customer is effectively paying the entity for the right to use the acquired asset for a period). The boards further indicated that when determining whether a customer has a "significant economic incentive" to exercise this right, the entity should consider various factors, including (1) the relationship of the expected market value to the repurchase price (as of the repurchase date) and (2) the amount of time until the right expires.

Breakage on Prepayments for Future Goods or Services

The ED did not specifically address how to recognize revenue for customers' rights that are not exercised (i.e., breakage on prepayments). Examples include gift cards sold to customers or reward points earned by customers that expire unused. The boards tentatively decided that if the amount of expected breakage can be reasonably estimated, it should be recognized as revenue in proportion to the pattern of rights exercised by the customer. Otherwise, the breakage should be recognized when the likelihood becomes remote that the customer will exercise its remaining rights.

Disclosure and Presentation Requirements

The boards clarified which line items are needed in the reconciliation of contract assets and contract liabilities under the ED.

The boards determined that with the exception of minor amendments and clarifications (as detailed below), the guidance on presentation and disclosure in the ED would be retained.

Disaggregation of Revenue

The ED proposed that revenue be disaggregated into categories that best depict how the amount, timing, and uncertainty of revenues and cash flows are affected by economic characteristics and included examples of categories that might be appropriate. The boards tentatively decided that:

1. The revenue standard should not prescribe the specific categories into which an entity should disaggregate revenue. Rather, the standard should provide a clear disaggregation principle and examples of categories that may be appropriate.
2. An entity should disaggregate revenue either on the face of the statement of comprehensive income or in the notes to the financial statements.
3. An entity would not be required to also disaggregate the impairment loss allowance (for customers' credit risk that is presented adjacent to revenue).

Presentation of Contract Assets and Contract Liabilities

To clarify definitions in the ED, the boards tentatively decided that labels other than "contract asset" and "contract liability" could be used to define such assets and liabilities in the financial statements. The boards emphasized, however, that entities should provide sufficient disclosure to differentiate between conditional rights to consideration (i.e., contract assets) and unconditional rights to consideration (i.e., accounts receivable).

Reconciliation of Contract Assets and Contract Liabilities

The boards clarified which line items are needed in the reconciliation of contract assets and contract liabilities under the ED. They tentatively decided that "an entity does not need to include specified line items in the reconciliation if those reconciling items would not be useful for explaining a material change in that contract asset or contract liability balance." Further, the boards tentatively decided that additional line items should be included in the reconciliation if users would need them to understand the change in the balance.

Disclosure of Remaining Performance Obligations

The ED proposed that entities disclose, for contracts with an expected duration of more than one year, "the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period that are expected to be satisfied" over certain periods. The boards tentatively decided that:

1. An entity should disclose the amount of the transaction price allocated to remaining performance obligations for contracts that have both of the following attributes:
    a. An original expected contract duration of more than one year; and
    b. Terms and conditions that result in the entity, in practice, being required to apply each step of the revenue model (specifically, to determine the transaction price and allocate that transaction price to the separate performance obligations) in order to recognize revenue. An entity would not be required to provide this disclosure if, in practice, the entity would not need to specifically apply those steps of the revenue model to recognize revenue (for example, some "time and materials" contracts).
2. An entity should explain when it expects those amounts to be recognized as revenue, either on a quantitative basis in time bands that would be most appropriate for the duration of the contract or by using a mixture of quantitative and qualitative information.

Disclosures About Assets From Contract Acquisition or Fulfillment Costs

The boards tentatively decided that entities should disclose "a reconciliation of the carrying amount of an asset arising from the costs to acquire or fulfill a contract with a customer, by major classification (for example, acquisition costs, precontract costs, and setup costs)." In addition, the boards tentatively decided that qualitative disclosures should be provided, including "a description of the method used to determine the amortization for the period."

During redeliberations, the boards unanimously decided against prospective application.

Disclosure Exceptions for Nonpublic Entities

During their outreach, members of the FASB staff identified a number of areas in which costs related to certain quantitative disclosure requirements for nonpublic entities did not appear to be justified. The FASB generally agreed with the staff's recommendations and tentatively decided to allow some limited exceptions.

Transition Method

During redeliberations, the boards unanimously decided against prospective application and tentatively determined that a company would be required to adopt the future revenue standard retrospectively through either:

- A full retrospective application.
- A retrospective application subject to transition relief as follows:
    1. An entity should not be required to restate contracts that begin and end within the same reporting period.
    2. An entity should be permitted to use hindsight in estimating variable consideration in the comparative reporting periods.
    3. An entity should be required to perform the onerous test only at the effective date unless an onerous contract liability was recognized previously in a comparative period.
    4. An entity should not be required to disclose the maturity analyses of remaining performance for prior periods.

In addition, the boards tentatively decided that if an entity adopts any of the above forms of transition relief, it will be required to (1) state which forms of relief have been employed and (2) provide a qualitative assessment of the likely effect of applying those forms of relief.

Editor's Note: The FASB decided that public and nonpublic entities will have the same transition requirements. In reaching this decision, the FASB noted that (1) under U.S. GAAP, nonpublic entities are not required to present multiyear financial statements (allowing such entities to potentially avoid some of the complexity of applying the transition guidance to multiple periods) and (2) for nonpublic entities that do provide multiyear financial statements, allowing noncomparable results would be inconsistent with current U.S. GAAP.

Industry Specific Decisions

Telecommunications Industries

As part of the redeliberation process, the boards hosted an education session to receive input directly from telecommunications industry representatives to understand their concerns about the proposed revenue model. The primary concern pertained to the proposed revenue model's potential change to current practice regarding the transaction price allocation between a wireless handset and the related network services. (The staff noted that similar arrangements exist in other industries, such as certain cable or satellite television providers.) Ultimately, the boards decided not to change the proposal's provisions related to transaction price allocation.

Aerospace and Defense Industry — Program Accounting

The boards agreed that the accounting for "costs of products manufactured for delivery under long-term production programs" used by certain entities in the aerospace and defense industry would be outside the scope of the revenue recognition project. The boards indicated that there is diversity in practice and that an opportunity exists to converge U.S. GAAP and IFRSs in this area and to use future standard setting to improve the reporting of such costs.

Rate-Regulated Industry — Alternative Revenue Programs

Certain rate-regulated entities participate in alternative revenue programs and follow the guidance under U.S. GAAP in ASC 980-605, *Regulated Operations: Revenue Recognition*, on regulated operations. The FASB tentatively decided to (1) retain the existing requirements for alternative revenue programs currently within the scope of ASC 980-605 (which the FASB previously identified would be superseded under the revenue recognition ED) and (2) require that revenues from these alternative revenue programs be presented separately from rate-regulated revenues (which would be within the scope of the revenue project). In addition, the FASB identified the guidance in ASC 980 as a potential topic for future convergence standard setting with the IASB.

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