

Major changes proposed to GAAP for revenue recognition

Frank E. Ryerson III
Macon State College

ABSTRACT

In September of 2002, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly adopted the Revenue Recognition Project. The Boards did this in order to address existing revenue recognition problems in U. S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The Boards are hoping to develop a single revenue recognition model using a recognition principle that can be applied consistently across different industries and to various transactions. For a variety of reasons, the Boards chose to abandon the traditional earnings process model of revenue recognition. Instead, the Boards, through the release of their discussion paper, Preliminary Views on Revenue Recognition in Contracts with Customers in December of 2008 and their exposure draft, Revenue from Contracts with Customers in June of 2010 have proposed a new revenue recognition model where revenues will be recognized based on changes in assets and liabilities. This paper reports on the Boards' rationale for abandoning the traditional model of revenue recognition and examines the alternative revenue recognition criteria that were considered as replacements for the current GAAP approach. The paper describes why the Boards chose to focus on the change in an entity's net position in a contract, i.e., an increase in contract asset or decrease in contract liability, as the determinant of revenue. After describing the major features of the proposed asset-liability model of revenue recognition the paper concludes by reporting on the response the Boards received to the new proposed model.

Keywords: GAAP, revenue recognition, Financial Accounting Standards

INTRODUCTION

In May of 2002, the Financial Accounting Standards Board (FASB) added to its technical agenda a project to develop a comprehensive revenue recognition standard and to amend the related guidance on revenues and liabilities contained in some FASB Concepts Statements (FASB 2010b, p. 5). In September of the same year, a formal agreement was reached with the International Accounting Standards Board (IASB) to make the revenue recognition undertaking a joint project of the two Boards (FASB 2010b, p. 5). The stated objective of the Revenue Recognition Project is to develop coherent conceptual guidance for revenue recognition and a comprehensive statement on revenue recognition based on those concepts.

During the initial joint meetings of the Boards, it became clear that the majority of Board members were not in favor of trying to “fix” the existing earnings process model. This is the model described in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises and, to a lesser extent, in the IASB Framework for the Preparation of Financial Statements. While the familiar earnings process model states that revenue is recognized when payment is received from a customer and the goods and services promised have been provided, implementation of the model has led to the proliferation of more than 200 pieces of industry-specific and often conflicting guidance on revenue and gain recognition (IASB, 2007a, par 4). In addition to these deficiencies, the earnings process model was also viewed as creating conflicts with the definitions of assets and liabilities used in the IASB and FASB conceptual frameworks. In short, because the model attempts to account for revenue directly without considering how assets and liabilities arise, deferred debits and credits sometimes arise that do not meet the definitions of assets and liabilities (IASB, 2007a, par.10). The Boards also examined International Accounting Standard 18, Revenue and concluded that its underlying principles are too inconsistent or vaguely described to provide a conceptual basis for developing a comprehensive revenue recognition standard (IASB, 2007a, par. 12).

The Boards’ dissatisfaction with the existing guidance on revenue recognition led it to pursue a model founded on the recognition and measurement of assets and liabilities. They acknowledged that their reliance on this new asset and liability approach would be a departure from current standards-level guidance based on the earning process model. They did note, however, that the new asset and liability approach is consistent with the existing definitions of revenue in both FASB and IASB literature (IASB, 2007a, par.13). These definitions base revenue on increases in assets, settlements of liabilities, or some combination of the two. The Boards concluded that by defining revenue as a residual from recognizing and measuring increases in assets and decreases in liabilities, the new asset-liability approach avoids the necessity of precisely defining what an earnings process is and the attendant disagreements surrounding its interpretation in practice (IASB, 2007a, par. 15).

THE ASSET AND LIABILITY MODEL

In the development of the asset-liability model, the Boards decided to focus their initial efforts on the assets and liabilities that arise directly from a contract with a customer. They decided to focus on the contract itself for two reasons. First, contracts to provide goods and services are real world economic phenomena that are the lifeblood of most companies (IASB, 2007a, par. 26). Second, most of the current revenue recognition literature focuses exclusively on contracts with customers (IASB, 2007a, par. 27). The Boards noted that this initial focus on

contracts did not preclude the possibility that revenue might also be recognized outside contracts with customers. For example, in the agricultural industry revenue might be recognized before a contract is obtained if buyers are readily available in an active market.

Having narrowed the focus of the model to customer contracts, the Boards tentatively defined the following revenue recognition principle: “For a contract with a customer, revenue is recognized when a contract asset increases or a contract liability decreases (or a combination of the two)” (FASB, 2008, 2.35). This definition highlights that revenue arises from a change in assets and liabilities—the contract asset or liability and only those arising from the contract. The asset and liability come into existence when an entity enters into an enforceable contract with a customer, thereby exchanging promises with the customer. The promises impose obligations on the entity to transfer economic resources (in the form of goods and services) and convey rights to receive consideration from the customer in exchange. The combination of rights and obligations is treated as either an asset or liability, depending on whether the remaining rights exceed the remaining obligations (asset) or vice versa (liability). This asset or liability reflects the entity’s net position in the contract with respect to remaining rights and obligations.

The entity’s net contract position can change due to events that give rise to revenue as well as by events that do not result in revenue. An example of a change in net position not leading to revenue would be the customer performing under the contract by paying its promised consideration in advance. This would cause the entity’s net position in the contract to decrease because the entity would no longer have any remaining rights in the contract. Its contract asset would decrease or its contract liability would increase. Neither of these types of changes in net position (due to performance by the customer) would result in revenue being recognized. On the other hand, an entity’s net position in a contract also changes when the entity provides its promised goods or services. This event increases the entity’s net position in the contract by increasing the contract asset or decreasing the contract liability. In short, according to the tentative definition of revenue, revenue arises because goods and services are provided, which ultimately leads to an increase in a contract asset or a decrease in a contract liability. The Boards have reiterated their support for this position through the release of the exposure draft, Revenue from Contracts with Customers in June of 2010. In this document the Boards make the following statement: “An entity shall recognize revenue when it satisfies a performance obligation...by transferring a promised good or service to a customer.” (FASB, 2010a, PG par. 25)

Asset Transfer

The provision of goods and services plays a pivotal role in defining revenue under the asset-liability model. Transferring goods and services to customers results in an increase in the entity’s net position in a contract and, accordingly, results in revenue being recognized. Thus, in order to determine when revenue should be recognized, the asset-liability model must provide guidance on when a good or service is deemed to be transferred. The Boards chose to examine two similar conceptual approaches for determining when asset transfer has occurred. One approach considers the transfer to be made when the risks and rewards of owning the asset have passed to the customer. The other approach deems asset transfer has occurred when control of the asset has been transferred to the customer. (FASB, 2010, PG par.60) In some cases the transfer of risks and rewards and the transfer of control coincide, in other cases they do not. In the Boards’ judgment, an approach focusing on the transfer of control of the asset will result in more consistent decisions being made about when assets are transferred. (FASB, 2008, 4.18) In

the exposure draft the Boards set forth three reasons for recommending control be used for assessing asset transfer. First, control is currently used to determine when an entity should recognize or derecognize an asset. Second, focusing on control rather than risks and rewards should lead to more consistent decisions about asset transfers. Finally, the risks and rewards approach could make it more difficult to identify separate performance obligations. (FASB, 2010, BC par. 60)

MEASUREMENT OF PERFORMANCE OBLIGATIONS

The combination of contractual rights and obligations in a contract with a customer result in a net asset or a net liability. As noted earlier, it is an increase in an entity's net position in the contract that results in revenue being recognized. The measurement of these contractual rights and obligations is fundamental to determining how much revenue is to be recognized, as well as to determining the amount of the corresponding net asset or net liability to appear on the statement of financial position.

In the discussion paper, the Boards set forth their preliminary views regarding the measurement of an entity's performance obligations. They also stated that, with respect to the associated issue of measuring an entity's rights under a contract, they were not ready to express a preliminary view on measuring rights. (FASB, 2008, 5.5) The Boards do note, however, that measuring the entity's performance obligations is generally more difficult than measuring rights. (FASB, 2008, 5.4) In most situations, the entity's performance obligations result in an outflow of nonmonetary goods and services, whereas its rights often result in "inflows" of a fixed monetary amount. The rest of this section reports on the Boards preliminary views on the measurement of performance obligations.

The stated objective of measuring performance obligations is to depict both decision-useful information about an entity's obligations at each financial statement date and its contractual performance during the reporting period. The first purpose served by measuring a performance obligation is quantification of the amount of assets required to satisfy the performance obligation on the financial statement date. The second purpose served is that of depicting, in the income statement, the entity's performance in the contract. The Boards' recommended approach for measuring performance obligations is a departure from existing standards. Under current standards an entity normally recognizes and measures performance using the "earned and realized" criteria and the "percentage of completion" of the contract. The Boards, having embraced the asset-liability model, expressed a preference for assessing contractual performance by measuring the change in contract asset or contract liability from one financial statement date to the next. (FASB, 2008, 5.12) The Boards' view is that this approach to deriving revenue and profit or loss provides a more consistent and coherent framework for determining an entity's performance than that available with existing revenue recognition models. (FASB, 2008, 5.13) In order to measure change from one date to the next, an initial measurement is required.

Two primary approaches for measuring performance obligations at contract inception were considered by the Boards: (1) current exit price approach and, (2) original transaction price approach. The current exit price approach was also referred to as the "fair value" or "measurement" model in earlier deliberations by the Boards. Similarly, the original transaction price approach had been known as both the "allocation" model and the "customer consideration" model.

Current Exit Price Model

The current exit price model was the approach the Boards initially agreed should be used to measure performance obligations. Under this model, the entity's contract asset or liability is measured at its current exit price. This is the amount that the entity would expect to receive or pay to transfer its remaining contractual rights and obligations to a market participant at the reporting date. The Boards set forth four main reasons for favoring the current exit price method:

- (1) It reflects the future cash flows associated with the remaining rights and obligations of the contract, no more, no less;
- (2) The measurement includes a margin at each measurement date for all of the remaining contractual obligation;
- (3) The measurement is current;
- (4) The measurement enhances comparability. (IASB, 2007a, 4C, par. 13)

In short, it appears that the Boards chose to initially support the current exit price approach because they viewed it as conceptually superior to the original transaction price method. The amount of the contractual asset or liability would be determined by what it would cost to pay a market participant to: (a) take over the full responsibility for fulfilling the "remaining" obligation in the contract and; (b) assume any "remaining" rights in the contract. (IASB, 2007a, 4C, par.14) An interesting feature of this exit price measurement is that it would not implicitly capture cash outflows relating to activities that have already been completed by contract inception. These could include cash outflows for marketing the entity's products, visiting potential customers, negotiating and finalizing contracts and, perhaps, even paying the salesman his commission. Therefore, given that the company is a rational entity, it will set its price with its customers at a level to recover all of these costs as well as the additional costs to fulfill the contract and a margin to provide a level of profit. Thus, under the exit price approach, the contract price at the inception of the contract would include an amount the entity requires for fulfilling the contract and an amount it requires for obtaining the contract. (IASB, 2007a, 4C, par.17) That means, then, that the contract price (contract rights) would, or could, exceed the current exit price that market participants would require to fulfill the "remaining" performance obligations in the contract. If, as would normally be the case, the transaction price is greater than the measurement of the remaining performance obligations, the entity would recognize a contract asset and record revenue for the difference. In other words, revenue would be recognized at contract inception

The current exit price model was supported by some members of the Boards because it was considered to be a more representationally faithful measurement of the remaining contractual obligations than using the original contract price. The current exit price approach would use current value measurements to determine the price an entity would expect to receive or pay to transfer its remaining rights and obligations to a market participant "on this reporting date." That price would explicitly reflect prices and circumstances that exist on the reporting date, rather than, say, at contract inception. (IASB, 2007a, 4C, par.27) Since these measurements would be updated to reflect current conditions, the financial information provided would have greater predictive power.

The current exit price approach, however, gradually fell out of favor with the Boards. Several concerns regarding the current exit price approach led the Boards to eventually abandon it in favor of the original transaction price model. One of these concerns was the pattern of revenue recognition the current exit price approach would require. That pattern would lead to revenue being recognized at contract inception if the transaction price (which would likely include an amount to recover the cost and a margin of obtaining the contract) exceeds the current exit price of the remaining performance obligations. The Boards finally concluded that they would be uncomfortable with an approach that allows an entity to recognize revenue before the entity transfers to the customer any of the goods and services that are promised in the contract. (FASB, 2010, BC par. 77) Another major concern was that the Boards felt that a current exit price would rarely be observable for the remaining performance obligations in a contract with a customer. Therefore, measuring performance obligations at current exit price would routinely require the use of estimates. The Boards believed that estimating these current exit prices would be complex and the resulting measurements difficult to verify. They concluded that the decision usefulness of the financial information from using current exit prices generally would not be sufficient to justify the resulting costs. (FASB, 2010, BC par. 77)

Original Transaction Price Model

As an alternative to current exit price, the Boards chose to recommend the original transaction price approach; the consideration the customer promises in exchange for the promised goods and services. Normally, the transaction price is the amount the entity requires in exchange for taking on the related performance obligations. The amount implicitly includes the expected costs to transfer the promised goods and services, the timing of those costs, and the margin required for providing those assets. Unlike exit price, the transaction price also includes any amounts that the entity charges its customers to recover the costs of obtaining the contract and any related margin. Two primary reasons why the Boards selected transaction price were the pattern of revenue recognition it prescribes and its simplicity of measurement. (FASB, 2008, 5.27)

With respect to the pattern of revenue recognition, supporters of the transaction price approach believe it provides a better depiction of the entity's performance in a contract because revenue is only recognized when an entity transfers an asset to the customer under the contract. They view the transaction price as applying only to the goods and services to be provided under the contract. (FASB, 2008, 5.28) In other words, no revenue would be recognized at contract inception. As far as the attribute of simplicity of measurement goes, the transaction price of a contract is always observable. Using it avoids the cost and complexity of searching for another price or estimating one if it is not observable. (FASB, 2008, 5.33)

PERFORMANCE OBLIGATIONS AND REVENUE

After contract inception, an entity's performance obligations change for a variety of reasons. The primary reason for this change is the entity's provision of goods and services to the customer. In addition, performance obligations could also be affected by changes in the quantities and prices of the goods and services required to satisfy the performance obligations. To capture all of the changes affecting its performance obligations, an entity would need to measure them at each financial statement date. This measurement process would then provide

users with a consistent depiction of those performance obligations over the life of the contract. (FASB, 2008, 5.38) The Boards, however, concluded that trying to explicitly measure performance obligations at each financial statement date would be unnecessarily complex for most contracts with customers. Instead, the proposal states that subsequent measurement of performance obligations should capture at least those changes that arise when the entity satisfies a performance obligation by transferring goods and services to the customer. (FASB, 2008, 5.40)

When an entity transfers all of the promised goods and services at one time, the subsequent measurement of the performance obligations is quite simple. Revenue is recognized in that period in an amount equal to the transaction price. In the event the entity transfers the promised good and services at different times, the entity needs to measure the remaining performance obligations at the end of any reporting period during the life of the contract. In the Boards' proposed model, the entity's performance would be depicted by allocating a portion of the original transaction price to each separate performance obligation at contract inception. As performance obligations are satisfied, the entity's net position in the contract increases and revenue is recognized in the amounts allocated to the satisfied performance obligations at contract inception. (FASB, 2008, 5.43)

The amount of revenue recognized when a performance obligation is satisfied is equal to the amount of the transaction price allocated to that performance obligation at contract inception. Since this allocation process will determine the amount and the timing of revenue recognition, how should the transaction price be allocated to different performance obligations? In the discussion paper the Boards state that the transaction price should be allocated to each performance obligation in proportion to the standalone selling price of the promised good or service underlying that performance obligation. The standalone selling price is the price at which the entity would sell that good or service if it was sold separately at contract inception. The best evidence of that price would be the actual standalone selling price, if the entity, in fact, sells the good or service separately. In the event that the good or service is not actually sold separately by the entity or others, the standalone selling prices would have to be estimated. (FASB, 2008, 5.46)

One perceived advantage of the original transaction price approach to measuring performance obligations is that the entity, in most situations, would not have to update or re-measure its performance obligations amounts. The Boards did make an exception to this rule in the case of performance obligations that are deemed to be onerous. These are performance obligations where the expected cost of satisfying the performance obligation exceeds the carrying amount of the performance obligation. In these cases, the Boards recommend the performance obligation be re-measured to the entity's expected cost of performing the obligation and the entity would record a contract loss for the difference. (FASB, 2008, 5.105)

RESPONSE TO THE MODEL PROPOSED IN THE DISCUSSION PAPER

Over the six-month comment period, which ended June 19, 2009, the Boards received a total of 211 comment letters in response to the discussion paper. (FASB, 2009a, par. 3) The vast majority of the respondents expressed support for the Boards' objective to develop a single revenue model for U. S. GAAP and IFRS. (FASB, 2009a, par. 5) Among those expressing support was the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA), who endorsed the proposal to base a single revenue

recognition principle on changes in an entity's contract asset or contract liability. AcSEC also expressed its belief that the Asset-Liability model was consistent with the existing GAAP and IFRS frameworks' balance sheet approach. (AcSEC, 2009, Appendix A, p. 1)

While there was general agreement among the respondents that the single revenue principle goal was laudable, there were also many comments that questioned the feasibility of the objective. The essence of the comments, in this regard, was that existing industry-specific standards were established under GAAP to clarify how to recognize revenue for particular industries and, although those standards might create inconsistency, they provide useful information about the types of contracts for which they were intended. For example, in the Boards' Comment Letter Summary, issued in July of 2009, one respondent noted "...the goal of consistency should be secondary to the goal of providing decision-useful financial reporting." (FASB, 2009a, par. 6) In response to the comment letters questioning the need to replace existing revenue recognition standards, the Boards acknowledged that it would be possible to improve many existing requirements without replacing them. On the other hand, the Boards concluded that, even after recent changes to U. S. GAAP, the existing revenue recognition requirements would still lead to inconsistent accounting for revenue in the future. Also, simply amending existing requirements would not produce a common revenue standard for U. S. GAAP and IFRSs, an important part of developing a single set of high quality global accounting standards. (FASB, 2010a, BC par. 8) Therefore, the Boards chose to proceed with the basic asset-liability approach described in the discussion paper and, with some minor modifications, used it as the model for revenue recognition contained in the Exposure Draft: Revenue from Contracts with Customers. How many other changes, or adjustments, will there be to the model proposed in the exposure draft? The answer should be forthcoming sometime in 2010 or 2011. The comment period on the exposure draft ends in October 22, 2010 and the final standard is expected in the second quarter of 2011.

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