FINANCIAL ACCOUNTING STANDARDS BOARD

Proposal for a New Agenda Project

ISSUES RELATED TO THE RECOGNITION OF REVENUES AND LIABILITIES

This proposal discusses a proposed FASB project to address the recognition of revenues and liabilities in financial statements. This proposal requests comments about the objective and scope of the project by March 29, 2002.

THE PROBLEM

Revenue Recognition

Revenue usually is the largest single item in financial statements and studies indicate that revenue recognition is the single largest category of financial statement restatements. Consequently, issues involving revenue recognition are among the most important—and the most difficult—that standard setters and accountants face.

The Gap Between Broad Conceptual Guidance and Detailed Authoritative Literature

Because no general standard on revenue recognition exists, there is a significant gap between the broad conceptual guidance in the FASB's concepts Statements and the detailed guidance in the authoritative literature. Most of the authoritative literature provides detailed implementation guidance that applies to specific transactions or industries, and it has been developed largely on an ad hoc basis and issued in numerous pronouncements having differing degrees of authority. Those pronouncements include Accounting Principles Board (APB) Opinions, FASB Statements, American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guides, AICPA Statements of Position (SOPs), FASB Interpretations, Emerging Issues Task Force (EITF) Issues, Securities and Exchange Commission (SEC) Staff Accounting Bulletins, and the like. Each pronouncement focuses on a specific practice problem and has a narrow scope, and the guidance is not consistent across pronouncements. The proposed project would develop a general standard to close the gap between the broad guidance at the concepts level and the detailed guidance for particular industries or transactions.

The SEC sought to fill the gap with Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements,* which was issued in December 1999 and the companion document, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, which was issued in October 2000. SAB 101 states that if a transaction falls within the scope of specific authoritative literature on revenue recognition, that guidance should be followed, but that in the absence of such guidance, the revenue recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, (namely, that revenue should not be recognized until it is (a) *realized or realizable* and (b) *earned*) should be followed. However, SAB 101 is more specific, stating additional requirements for meeting those criteria, and reflects the SEC staff's view that the four basic criteria for revenue recognition in AICPA SOP 97-2, *Software Revenue Recognition*, should be a foundation for all basic revenue recognition principles.

Some criticize SAB 101 on the basis that the criteria in SOP 97-2 were developed for a particular industry and that broader application of those criteria was neither contemplated nor intended. They assert that that guidance may not be especially appropriate for certain recognition issues, including some that the EITF has considered. Others note that a SAB is designed to provide the SEC staff's interpretive responses and not to change generally accepted accounting principles (GAAP). Because of that, SABs are issued without inviting comments on them. Those critics argue that SAB 101 has in fact changed GAAP by promulgating changes in industry practice without the full due process and deliberation that characterize the FASB's decision-making process. Moreover, the guidance in SAB 101 applies only to SEC registrants. Nonetheless, the work done in developing and implementing SAB 101 has focused attention on revenue recognition issues and will be very useful in this project.

The EITF has been asked to address a number of issues about both when and how much revenue should be recognized. Examples of those issues include prepaid memberships or contracts for services, e-commerce and other marketing service programs with barter elements, frequent-customer reward programs, "sales" subject to substantial post-sale obligations, revenue arrangements with multiple deliverables, and deferred revenue of acquirees in business combinations. While the EITF has been able to reach consensuses on some issues, it has been unable to do so on others. Moreover, the EITF has been hampered in developing guidance in the absence of a general standard on revenue recognition on which to base its discussions and decisions. Lacking that, the EITF is in the position of having to make fundamental decisions about GAAP that have not been subject to the FASB's due process. Many believe, therefore, that the FASB should set those standards.

Flaws in the Conceptual Guidance

FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines revenues (and other components of comprehensive income) in terms of changes in assets and liabilities. For example, the receipt of an asset in a transaction in which the entity does not give up another asset, incur or increase a liability, or receive an investment by owners, by default increases the entity's comprehensive income in the form of revenues or gains.

Inconsistencies arise because the revenue recognition criteria in Concepts Statement 5 do not focus on changes in assets and liabilities. Concepts Statement 5 incorporates two models of income recognition that differ in terms of when certain income items are recognized. One of those models focuses on "earnings" and the second on comprehensive income, with earnings and "other comprehensive income" (OCI) being subsets of comprehensive income. Earnings is similar to net income, and includes revenues and expenses and most (but not all) gains and losses. Any other gains and losses that are recognized are included in OCI.

Gains and losses that are recognized in OCI are subject to the fundamental recognition criteria that apply to all elements of financial statements. However, because revenues are recognized in earnings, they must meet additional criteria that focus on whether they have been realized or are realizable, and have been earned.

The *realized or realizable* criterion may not seem problematic because it focuses on changes in assets (in the form of receipts of cash or claims to cash or transformations into readily convertible assets). However, receipt of such assets does not necessarily result in revenue recognition, and business entities sometimes recognize deferred revenues even though those items do not meet the liabilities definition.

The *earned* criterion creates issues because it requires that the entity must have "substantially accomplished" what it must do to be entitled to the benefits. For example, in a multiple element revenue arrangement in which the customer paid in advance, should an entity record a part of the revenue when it has substantially accomplished one of those elements even though it remains obligated to the customer for the remaining elements, or should it defer all revenue recognition until it has substantially accomplished all of the elements and is no longer obligated?

Those examples illustrate how revenue recognition can conflict with liability recognition by overriding the liabilities definition. In practice, revenue recognition seems to do so even though, conceptually, it should not. One goal of this project would be to address and eliminate, to the extent possible, inconsistencies that can arise from applying the present criteria.

Liability Recognition

While revenue recognition issues often involve liability recognition, other liability recognition issues have arisen absent any association with revenues, and consistent guidance is needed for all issues involving liability recognition.

Concepts Statement 5 sets forth fundamental recognition criteria that must be met for any element of financial statements to be recognized, as follows (the following is a paraphrase of paragraph 63):

> *Definition*—the item meets the definition of an element (the liabilities definition in the case of liabilities).
>
> *Measurability*—the item has a relevant attribute measurable with sufficient reliability.
>
> *Relevance*—the information about the item is capable of making a difference in user decisions.
>
> *Reliability*—the information about the item is representationally faithful, verifiable, and neutral.

Unlike revenues, which must meet both the fundamental criteria and the additional criteria for earnings, liabilities need meet only the fundamental criteria. Aside from the definition criterion, those criteria are very general and have not provided the Board with the tools needed to develop consistent guidance for liability recognition issues. Moreover, the most specific criterion, meeting the definition, has itself raised issues.

The Definition of Liabilities

Questions increasingly are arising about whether particular items meet the liabilities definition. For example, the Board encountered difficulties reaching conclusions in three projects (asset impairment and disposal issues, asset retirement obligations, and financial instruments—liabilities and equity) because of issues about constructive obligations and identification of past events that give rise to liabilities.

Concepts Statement 6 defines liabilities and discusses their characteristics. Paragraph 35 of Concepts Statement 6 states:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnote references omitted.]

The analysis of whether a particular item meets the liabilities definition focuses on the three essential characteristics of a liability:

(a) It embodies a present duty or responsibility to one or more other entities that entails settlement by probable transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.

(b) The duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.

(c) The transaction or other event obligating the entity has already happened.

Any item that has *all three* of those characteristics, therefore, meets the liabilities definition.

In addressing liability recognition issues, the Board has found that resolution of some issues has been impeded by:

- Different interpretations of the term *probable*
- Different interpretations of the term *future sacrifices of economic benefits*
- Confusion between present obligations and future obligations
- Searches for a single obligating event
- Disagreement about the role of management intent
- Lack of guidance for distinguishing between events that give rise to a related asset and liability and events that give rise only to a liability.

PROJECT SCOPE AND DESCRIPTION

This project would develop a general standard on revenue recognition that applies to business entities generally. That standard would resolve many of the revenue recognition issues that have arisen and provide guidance for addressing those that arise in the future. Developing that standard would not preclude issuing narrower recognition standards to provide needed guidance in the interim.

Because that standard must be based on sound conceptual guidance, Concepts Statement 5 would be amended to improve the criteria for recognizing revenues. Those criteria also apply to gains that are included in earnings rather than OCI, but the distinction that Concepts Statement 6 makes between revenues and gains has not proven operational. Consequently, Concepts Statement 6 would be amended to refine the definitions of revenues and gains.

This project also would amend the conceptual guidance for liabilities. The project would refine and clarify the liabilities definition in Concepts Statement 6 (and refine the assets definition to the extent that it parallels the liabilities definition). The project also would improve the recognition criteria in Concepts Statement 5 that apply to liabilities.

Issuing a new, general standard on revenue recognition likely would require amending some related standards on liability recognition to make them consistent with it. Additionally, the improvements to the conceptual guidance for liabilities could eventually lead to a general standard on liability recognition. Such a standard would amend or replace existing standards for liabilities but is not planned as part of this project because it is not as urgently needed as one for revenue recognition, and its development would expand the project significantly. (Question 5 on page 7 asks respondents if a general standard on liability recognition should be included in this project.)

The appendix to this proposal provides examples of issues that this project would address. This proposed project is closely related to the Board's agenda project on financial performance reporting by business enterprises, and certain issues could be addressed in either project. If the Board decides to add this project to its agenda, it will need to decide in which project to address those issues.

Because of the interrelationships and interdependencies of the issues that would be addressed in this project, work on the project would be undertaken in two distinct but interrelated phases that would be pursued simultaneously. One phase would take a "top-down" approach that focuses on the conceptual guidance in Concepts Statements 5 and 6. The other phase would take a "bottom-up" approach that focuses on the detailed authoritative guidance and other accepted practices for revenue recognition, and would include developing a comprehensive inventory of that guidance and those practices. The process of developing guidance at the concepts level and the standards level would be iterative in that tentative conclusions about the conceptual guidance would be tested by applying them to specific recognition issues to be covered by the accounting standard, which might identify the need for further improvements in the concepts, and so on. The simultaneous pursuit of the two phases would not only facilitate the iterative process but also expedite completion of the project.

HOW PRACTICE MIGHT CHANGE

The new general standard on revenue recognition could have a significant effect on current practice. That effect would depend on the extent to which existing authoritative guidance and accepted practices were encompassed in the scope of that standard. The Board, of course, might decide not to immediately change some practices even though they are not consistent with the general standard. The comprehensive inventory of existing revenue recognition guidance and practices that is planned in this project would make clear the effect of the new standard.

Changes to the Board's concepts Statements do not directly affect existing authoritative guidance and accepted practices. However, changes to concepts Statements may in the future lead to new standards or amendments to existing standards that would result in changes to existing guidance and practices.

AGENDA CRITERIA

This proposal is one way that the Board seeks input from its constituents about possible additions to its technical agenda. After receiving that input, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics. Those factors, which are more fully discussed in *Facts about FASB* (http://www.fasb.org/facts/fasfact3.html), include consideration of (a) the pervasiveness of the issue, (b) alternative solutions, (c) technical feasibility, and (d) practical consequences. At this time, the Board believes that this proposed project satisfies each of those factors. However, the Board's resources are limited and it is aware of other potential projects suggested by constituents that also satisfy those factors.

International Considerations

The Board has determined that all topics considered for its agenda should be assessed to determine whether they provide opportunities for cooperative efforts with the International Accounting Standards Board (IASB) or other national standard setters. That assessment includes consideration of (a) the possibility that resolution of the issues addressed would increase convergence of standards worldwide, (b) the opportunities that the topic presents for cooperation with the IASB or other standard setters, and (c) whether appropriate and sufficient resources are available for a joint project or other cooperative effort.

The issues that this project would address are not unique to the United States. The Accounting Standards Board (ASB) in the United Kingdom has undertaken a project on revenue recognition and issued a Discussion Paper, *Revenue Recognition*, in July 2001. The ASB plans to develop a single accounting standard that establishes general principles of revenue recognition that are applicable to all entities. The IASB also has indicated that it expects to consider adding a project on liabilities and revenue recognition to its technical agenda.

In addition, the definitions and related recognition criteria in the Board's concepts Statements were developed more than 20 years ago. Since then, the IASB, ASB, and other standard setters have developed their own definitions and recognition criteria. However, the conceptual guidance differs and those differences could impede efforts for international convergence of accounting standards. This project could stimulate convergence on improved conceptual guidance internationally.

REQUEST FOR COMMENTS

The Board has not decided whether to add a project to its agenda on issues associated with the recognition of revenues and liabilities, nor has it decided what the scope of such a project should be. The Board seeks comments from its constituents on this proposal, particularly on the following major questions:

1. Is there a need for the FASB or others to comprehensively address issues associated with the recognition of revenues and liabilities? If yes, should the FASB take on such an effort or defer to others? If so, to whom?

2. Is the proposed scope of such a project as described in this proposal insufficient, appropriate, or too ambitious?

3. Should specific issues identified above or in the appendix be excluded from the scope of the proposed project? If yes, for each specific issue, please indicate whether it should be addressed as part of another FASB project, by others, or not at all and why.

4. Should specific issues *not* identified above or in the appendix be addressed as part of the proposed project? If yes, please describe the specific issue and indicate why it is sufficiently crucial that it should be addressed as part of the proposed project.

5. Should the proposed project, in addition to developing a new, general accounting standard on revenue recognition and revising the related guidance on revenues and liabilities in Concepts Statements 5 and 6, develop a new, general accounting standard on liability recognition?

Please send comments by March 29, 2002 to director@fasb.org or to: Timothy S. Lucas, Director of Research and Technical Activities, Financial Accounting Standards Board, 401 Merritt 7, Norwalk, CT 06856-5116.

APPENDIX

EXAMPLES OF ISSUES TO BE ADDRESSED

Issues Related to Both Revenues and Liabilities

1. With regard to the fundamental recognition criteria in Concepts Statement 5 that apply to all elements of financial statements:
   (a) Is the criterion pertaining to *measurability* operational, and if not, should it be amplified or eliminated?
   (b) Is the criterion pertaining to *relevance* operational, and if not, should it be amplified or eliminated?
   (c) Is the criterion pertaining to *reliability* operational, and if not, should it be amplified or eliminated?
   (d) Should other criteria be added, and if so, what should those criteria be?
2. Are conceptual criteria for recognition needed or would the definitions of the items to be recognized in financial statements be sufficient if those definitions were refined and clarified?

Issues Primarily Related to Revenues

1. With regard to the additional criteria in Concepts Statement 5 for recognizing revenues in "earnings":
   (a) Should the *realized or realizable* criterion be eliminated, and if not, should it be modified (and how)?
   (b) Should the *earned* criterion be eliminated, and if not, should it be modified (and how)? Should the criterion instead focus on *performance* by the entity, and if so, how should performance be defined?
   (c) Should the criteria explicitly refer to changes in assets and liabilities to eliminate any potential for conflict between the recognition of revenues and liabilities?
2. Should the Board eliminate the notion of earnings and the related recognition criteria so that only one set of recognition criteria would apply to all components of comprehensive income? If not, should the Board develop a conceptual definition of earnings that differs from that for comprehensive income, and develop recognition criteria that are consistent with that definition for determining which items should be included in earnings as opposed to OCI? If so, how should earnings be defined?
3. Should *gains* be defined separately from *revenues?* If so, should revenues continue to be defined in terms of an entity's main or central ongoing operations and should gains continue to be defined in terms of an entity's peripheral or incidental activities? If not, how should they be defined? Should another element, in addition to revenues and gains be defined?
4. Should revenues continue to be defined in terms of asset inflows, asset enhancements, or liability reductions? If not, how should they be defined? Should they be defined

in terms of asset inflows or liability reductions stemming from the entity's fulfilling its obligations to its customers (as the ASB has proposed)? If so, how should asset enhancements that result from an entity's main or central ongoing operations be defined?

5. In what circumstances, if any, should revenue recognition be required when the entity has partially but not fully performed? In the context of revenue arrangements that consist of several distinct elements, in what circumstances should recognition occur on the completion of individual elements?
6. Should revenue recognition be prohibited if the customer retains the right to return or should both revenue and a related liability to accept returns be recognized?
7. To what extent is estimation appropriate in revenue recognition? For example, should recognition be prohibited if consideration in an arrangement is subject to variability even though that variability is estimable? Should contingencies affect the recognition or measurement of revenue?
8. Should revenue recognition guidance address how to determine the units of accounting in an arrangement that consists of more than one distinct arrangement? Should it address how to allocate consideration to those units?
9. In what circumstances, if any, should the amount of revenue recognized be based in some way on the proportionate part of costs that it has already incurred?
10. Is additional guidance needed on how to determine the fair value of assets and liabilities associated with revenues being recognized?
11. In what circumstances should revenues be presented on a "net" rather than a "gross" basis?

Issues Primarily Related to Liabilities

1. Should *probable* be eliminated from the liabilities definition?
2. Should the liabilities definition continue to focus on *future sacrifices of economic benefits*?
3. Should liabilities be defined as arising only from *legal* obligations (as opposed to also arising from *equitable* and *constructiv*e obligations)? Should the legal doctrine of *promissory estoppel* be incorporated in the definition either directly or indirectly?
4. Should the liabilities definition encompass conditional or contingent obligations?
5. Should the liabilities definition encompass obligations of an entity to *stand ready*?
6. Should the liabilities definition encompass obligations of an entity to *stand aside* (such as those arising from noncompete agreements)?