

Contract-Based Revenue Recognition

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The Financial Accounting Standards Board and the International Accounting Standards Board (IASB) issued a joint discussion paper on revenue recognition, *Preliminary Views on Revenue Recognition in Contracts with Customers*, at the end of 2008. Perhaps the most important feature of the discussion paper is the Boards' preliminary view on a single "contract-based revenue recognition model" intended to serve as a broadly applicable model for recognizing revenue. This model, based on the concept of rights and obligations arising from a contract between a company and its customer, recognizes revenue as the net contract position (contract rights minus obligations) increases over the life of a contract.

The discussion paper was issued in December 2008 with a comment period ending in June 2009. After reviewing comments, the Boards plan to issue an Exposure Draft of a revenue recognition standard for U.S. generally accepted accounting principles (GAAP) and international financial reporting standards (IFRSs). In this article,

we summarize the main points of the preliminary views presented in the discussion paper and highlight specific differences with current standards. Definitions of the terms used in this article are in Exhibit 1.

IMPORTANCE OF REVENUE RECOGNITION

A study of financial statement restatements by public companies between 1997 and 2002 showed that almost 38 percent of the restatements involved problems with revenue recognition.¹ Other research illustrating the importance of revenue recognition highlights the frequency with which class-action lawsuits allege improper revenue recognition² and the widespread changes to revenue recognition policies following Sarbanes-Oxley.³

For restatements specifically involving revenue recognition, the post-restatement damage to the information content of a restating firm's subsequent earnings lasts longer than the damage subsequent to restatements made for other reasons.⁴ Another study of restatements

shows that about half of the revenue-related restatements arose from problematic timing of revenue recognition, and the others from having reported bogus revenues.⁵ It is the first of these issues—achieving appropriate timing of revenue recognition—that can be addressed by accounting standards.

REVENUE RECOGNITION PROJECT

The revenue recognition discussion paper is a product of the revenue recognition project, one of the joint projects of the FASB and IASB in the overall move toward converging the two sets of standards. The stated objectives of the Boards' revenue recognition project are: (1) to converge the two sets of revenue recognition standards, (2) to remedy some omissions from existing standards, (3) to eliminate inconsistencies, and (4) to clarify revenue recognition principles.

Progress toward the convergence objective is demonstrated by the issuance of joint discussion papers that are identical except for minor differences (e.g., the U.S. standard uses the U.S.

Exhibit 1

Definitions

Definitions of Revenue in Current U.S. GAAP and IFRS

Revenues: inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. (FASB Concepts Statement No. 6, *Elements of Financial Statements*, ¶178)

Revenue: the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. (IAS 18, Revenue ¶17)

Definitions proposed in the FASB/IASB discussion paper on revenue recognition, *Preliminary Views on Revenue Recognition in Contracts with Customers*

Contract: An agreement between two or more parties that creates enforceable obligations. (¶2.11)

Contract asset: A contract is an asset if the measurement of the remaining rights exceeds the measurement of the remaining obligations. The contract asset reflects the entity's net position in the contract with respect to its remaining rights and obligations. (¶2.23)

Contract liability: A contract is a liability if the measurement of the remaining obligations exceeds the measurement of the remaining rights. The contract liability reflects the entity's net position in the contract with respect to its remaining rights and obligations. (¶2.23)

Revenue recognition principle: For a contract with a customer, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). (¶2.35)

spelling for “recognize” and the IFRS uses the British spelling “recognise”).

With respect to the objective of remedying omissions, the discussion paper notes that U.S. GAAP do not contain a general standard on revenue recognition for services. Given that U.S. GAAP include over 100 revenue recognition standards, the omission is somewhat remarkable.

The third objective listed above, to eliminate inconsistencies, refers to both U.S. and international standards. Under U.S. GAAP, the plethora of revenue recognition standards can result in inconsistent reporting of economically similar transactions. For example, the treatment of revenues associated with connect-

ing a customer to a network differs for cable television companies and telecommunications companies—not because of economic differences in their respective network connection activities, but rather because the former are governed by an industry-specific reporting standard, FASB Statement No. 51, *Financial Reporting by Cable Television Companies*. Even IFRSs, which have far fewer standards, can give rise to inconsistencies. For example, for sales containing multiple components, the discussion paper notes that some interpret the international standard (IAS 18) as permitting recognition of all revenues when the first component is delivered, while others interpret the same standard

as requiring deferral of all revenues until the last component is delivered.

Most of the problems with both sets of standards are attributed to the lack of a clear revenue recognition principle. It is the project's objective of clarifying revenue recognition principles that gives rise to the contract-based revenue recognition principle presented in the discussion paper.

The contract-based revenue recognition principle relies on:

- viewing revenue-generating activities as contracts between a company and its customers,
- measuring a company's net position in any contract as its

- contract rights minus its contract obligations, and then
- recognizing revenue when that net contract position changes.

This revenue recognition principle is consistent with the conceptual frameworks treating assets and liabilities as the cornerstone elements and then defining revenue in terms of changes in assets and liabilities.

The contract-based revenue recognition principle differs from the existing revenue recognition model (in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*), which is based on the concept that revenue should be recognized when payment is realized (or realizable) and the earnings process is substantially complete. The Boards' rationale for focusing the recognition principle on changes in assets and liabilities rather than on completion of the earnings process is summarized in the discussion paper as follows:

The Boards think that focusing on changes in assets and liabilities will bring discipline to the earnings process approach so that entities can recognize revenue more consistently. In other words, the Boards think there will be more agreement on whether an asset has increased or a liability has decreased than there is currently on what an earnings process is and whether it is complete. This does not mean that judgments will be easy; however, a focus on assets and lia-

bilities provides a clearer objective for making those judgments.⁶

As noted in the discussion paper, the focus on assets and liabilities rather than on the earnings process should not fundamentally change current practice for most transactions.

Even where practice would not be changed, however, the shift from a focus on an earnings process to a focus on contract assets and liabilities does change how we think about and describe revenue recognition. Consider, for example, a simple cash sale in a store. Under current revenue recognition standards, in a sale transaction we would describe a shopkeeper as recognizing revenue when the customer pays cash for the goods *because* the consideration has been realized and the earnings process is complete. Using terminology from the contract-based revenue recognition model, we would describe the transaction as involving a contract, created when the customer presents the product at checkout and pays the shopkeeper. At that moment, the shopkeeper has a net contract obligation (a contract liability) to deliver the product or return the payment. When the product is delivered, we would describe the shopkeeper as recognizing revenue *because* the shopkeeper has performed its obligation and thus has reduced its contract liability.

POTENTIAL CHANGES TO CURRENT PRACTICES: CONSTRUCTION-TYPE CONTRACTS

As part of the conceptual shift to a focus on assets and liabilities, the discussion paper describes some potentially signifi-

cant changes to current practice. Here we first discuss potential changes to recognizing revenue for construction-type contracts.

Currently, companies with construction-type contracts that span multiple reporting periods are expected to use the percentage-of-completion method for revenue recognition. Under that method, during the life of the contract the company recognizes revenue each period based on the percentage of the contract it has completed to that point. The percentage of the project considered to be complete is usually estimated based on project costs to date as a percentage of total estimated project costs.

Under the new contract-based revenue recognition principle presented in the discussion paper, a company would recognize revenue during construction "only if the customer controls the item as constructed" (§S28). This treatment is predicated on making the distinction between whether the company is providing goods or providing manufacturing services. If the company is providing goods, then the company satisfies its performance obligation and thus recognizes revenue only when the goods are delivered to the customer. Alternatively, if the company is providing manufacturing services, the company satisfies its performance obligation and thus recognizes revenue throughout the construction period. Two indicators for determining whether the company is providing goods or providing manufacturing services are (1) the degree of customization of the goods, where more highly customized goods indicates provision of a manufacturing service, and (2) the control of the goods while they are being manufactured, where customer control indicates

provision of a manufacturing service.

The discussion paper offers the following examples:

1. A manufacturer contracts to deliver goods that require three months to manufacture. The contract specifies that the goods are the manufacturer's asset until delivery. Because the manufacturer satisfies its performance obligation only when the goods are delivered, it recognizes revenue only when the goods are delivered.
2. A manufacturer contracts to deliver goods that require three months to manufacture, are unique to the customers' specifications, and have no value to anyone other than that customer because of the unique specifications. The contract specifies that the customer must pay for the work as it is completed and also has the right to take the partially completed goods at any time. Because the manufacturer satisfies its performance obligation as it provides the manufacturing service and materials to produce the goods, it recognizes revenue throughout the contract.
3. A builder contracts with a customer to build a house "in accordance with the features and designs chosen by the customer." If the builder is providing a house and satisfies its performance obligation only when the completed house is transferred to the customer, it recognizes revenue only at that time. Alternatively, if the builder is providing a building service and satisfies its performance obligations as it adds labor and materials to an asset controlled by the customer

(where control is indicated, for example, by the house being situated on the customer's own land), it recognizes revenue throughout construction.

In summary, reporting for construction-type contracts under the new contract-based revenue recognition principle would resemble existing percentage-of-completion revenue recognition in cases where the customer controls the asset such that any construction on the asset is continuously transferred to the customer. Despite the resemblance of the reporting, the conceptual underpinning differs. Under existing revenue recognition principles, a manufacturer using percentage-of-completion revenue recognition would recognize revenue over the life of the contract *because* the act of constructing the asset is the earnings process and the method reflects the company's periodic accomplishment in that process. Under the new contract-based revenue recognition principle, the manufacturer would recognize revenue over the life of the contract *because* the act of constructing the asset satisfies the performance obligation and thus decreases the manufacturer's net contract liability.

OTHER POTENTIAL CHANGES TO CURRENT PRACTICES

The discussion paper describes several other potential changes to current practices. The proposed model would permit more use of estimates—for example, when transactions include multiple components.

Another potential change highlights the concept that there is no matching principle under IFRSs; reporting expenses in the

same period as associated revenues (matched with revenues) is an outcome, not a principle. The example provided in the discussion paper explains that commissions paid to a salesperson for obtaining a contract with a customer "typically do not create an asset qualifying for recognition in accordance with other standards. As a result, an entity would recognize such costs as expenses incurred, which may not be in the same period in which revenue is recognized."

The discussion paper does not specify a change in a method allowed in agriculture that allows revenue recognition for inventory increases, even in the absence of a contract with a customer. The paper does, however, raise the possibility of future changes such that such inventory increases would be reported as a component of comprehensive income rather than revenue.

SUMMARY

Ultimately, the Boards aim to develop a revenue recognition model broad enough to replace most of the existing standards on revenue recognition. The discussion paper presents preliminary views on such a revenue recognition model.

NOTES

1. Government Accountability Office (GAO). (2002). Financial statement restatements: Trends, market impacts, regulatory responses, and remaining challenges. GAO-03-138. Retrieved April 23, 2009, from <http://www.gao.gov/products/GAO-03-138>.
2. Palmrose, Z.-V., & Scholz, S. (2004). The circumstances and legal consequences of non-GAAP reporting: Evidence from restatements. *Contemporary Accounting Research*, 21, 139–190.
3. Business Wire. (2005, October 24). Sarbanes-Oxley has widespread impact on revenue recognition policies; Survey

reveals more than half of all public companies have modified revenue recognition policies to comply with Sarbox. Retrieved April 23, 2009, from <http://www.allbusi->

ness.com/legal/banking-law-banking-finance-regulation/5106759-1.html.
4. Wilson, W. (2008). An empirical analysis of the decline in the information content

of earnings following restatements. *The Accounting Review*, 83, 519–548.

5. See note 2.

6. Discussion paper, ¶ 1.19.

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