Project **Revenue Recognition**

Topic **Estimates of uncertain consideration**

Purpose

1. At previous Board meetings[1], the Boards considered how an entity should determine the transaction price and recognize revenue when a customer promises an uncertain amount of consideration. The Boards decided that:

    (a) At contract inception, the transaction price is the probability-weighted estimate of consideration to be received;

    (b) After contract inception, an entity should allocate changes in the transaction price to all performance obligations. The effects of those changes on satisfied performance obligations would be recognized as revenue in the period of change; and

    (c) Revenue recognition should be constrained only if an entity cannot reliably estimate the consideration amount.

[1] March 17, 2009 Agenda Paper 6B (IASB only), April 1, 2009 Memo 116 (FASB only), and May 21, 2009 Memo 117/Agenda Paper 15 (joint FASB-IASB)

2. The Boards directed the staff to develop potential application guidance to help an entity determine when an estimate is “reliable”. Hence, **the purpose of this paper is to consider the application guidance to include in an Exposure Draft to help an entity determine whether to include estimated amounts of uncertain consideration in the transaction price.**

3. This paper does not reconsider the Boards’ previous decisions on the definition of the transaction price and how an entity would account for changes in the transaction price after contract inception.

4. This paper also does not consider disclosures of information about contracts in which the customer promises an uncertain amount of consideration. The staff plans to take the topic of disclosures to the Boards at a future meeting.

5. As a reminder, uncertain consideration is recognized as revenue only with respect to *satisfied* performance obligations. Uncertain consideration relating to *unsatisfied* performance obligations does not affect revenue.

Summary of recommendations

6. The staff recommends the following:

   (a) An entity should include an estimated amount of uncertain consideration in the transaction price only if the entity can identify the possible outcomes of a contract (i.e. consideration amounts) and reasonably estimate the probabilities of those outcomes.

   (b) In the context of revenue recognition, an entity can identify the possible outcomes of a contract and reasonably estimate the related probabilities only if the entity:

      (i) Has experience with identical or similar types of contracts, and

      (ii) Does not expect circumstances surrounding those types of contracts to change significantly.

   (c) An entity should exercise judgment and consider all relevant facts and circumstances when assessing whether circumstances surrounding a contract will change significantly.

Structure of this paper

7. This paper is structured as follows:

   (a) Background (paragraphs 8–21)

      (i) Feedback from responses to the Discussion Paper

      (ii) Summary of the Boards' previous considerations

   (b) The nature of estimates to include in the transaction price (paragraphs 22–38)

      (i) The role of an entity's previous experience

      (ii) The relevance of an entity's experience

   (c) Staff recommendations (paragraph 39)

   (d) Appendix A Examples

Background

Feedback from responses to the Discussion Paper

8. The Discussion Paper did not consider the effects of uncertain consideration on the proposed revenue recognition model (and did not ask a question on the topic). However, the Boards had reached tentative decisions on uncertain consideration before the end of the comment period. Hence, some respondents to the Discussion Paper commented on the Boards' decisions.

9. A majority of those respondents expressed support for the Boards' tentative decisions. They noted the instances in current practice when entities recognize revenue on the basis of estimated consideration amounts (e.g. construction contracts). They also noted that the use of estimates can enable entities to recognize revenue in a way that faithfully depicts the transfer of goods and services to customers.

10. Others expressed concern about increased subjectivity in revenue recognition. One respondent noted:

> We think that any deviation from the current approach (which requires a very high level of certainty for recognition of revenue)

> will create confusion. Overall it is our view that the benefits of a more faithful depiction of the economics of revenue transactions that could be brought by a "measurement" approach are outweighed by the potential loss of confidence placed by investors in reported revenues. (European Software Accounting Group)

11. Some Board members have expressed similar concerns. Those concerns contributed to the Boards' decision to constrain revenue recognition when an entity cannot estimate an uncertain amount of consideration reliably.

Summary of the Boards' previous considerations

12. Before considering the application guidance to help an entity implement the Boards' tentative decisions, the staff thinks it is worthwhile to summarize the Boards' previous considerations on the topic of uncertain consideration. At previous meetings, the Boards considered and rejected various alternatives for accounting for uncertain consideration:

    (a) Alternative 1: Require estimates of the transaction price without constraint.

    (b) Alternative 2: Require estimates of the transaction price, but constrain cumulative revenue recognized to amounts that are certain.

    (c) Alternative 3: Require estimates of the transaction price for only some types of uncertainty.

    (d) Alternative 4: Redefine the transaction price as an amount of a specified probability (e.g. "probable" or "most likely").

Alternative 1: Require estimates of the transaction price without constraint

13. Proponents of this alternative think that a revenue standard should not constrain estimates of the transaction price. Hence, revenue would be subject to the same recognition constraints that the Boards' respective conceptual frameworks place on any element of the financial statements (i.e. it must be able to be measured "reliably"). They think that users of financial statements should rely on the information an entity discloses about estimates and uncertainty.

14. However, the Boards rejected this alternative for a few reasons:

(a) It would significantly change some existing revenue standards and practices.

(b) It could be subject to abuse by preparers.

(c) Some board members doubted whether a requirement to disclose information about estimates and uncertainty would provide adequate information to users of financial statements, if there are no constraints on the amounts recognized in the financial statements.

Alternative 2: Require estimates of the transaction price, but constrain cumulative revenue recognized to amounts that are certain

15. This alternative is similar to some existing standards that limit the amount allocated to delivered items to amounts that are not contingent on future performance (paragraph 605-25-30-5 in U.S. GAAP, formerly EITF Issue No. 00-21, "Revenue Arrangements With Multiple Deliverables"). This alternative also minimizes the risk of an entity having to reverse revenue that it previously recognized on the basis of estimated amounts.

16. Some respondents to the Discussion Paper (primarily those from the telecommunications industry) prefer this approach because it allows an entity to recognize revenue in some contracts as the customer is billed. For example, consider an entity that transfers a handset to a customer and promises to provide future services related to the handset. If payment for the handset is contingent on the provision of future services, the entity would not recognize revenue when the customer obtains control of the handset. Revenue would be recognized as the customer is billed for the ongoing services.

17. The Boards rejected this alternative for the following reasons:

(a) It would significantly change practice for some industries, such as the construction industry, that recognize revenue on the basis of estimates.

(b) It conflicts with the proposed model that recognizes revenue when an entity transfers goods and services to a customer.

Alternative 3: Require estimates of the transaction price for only some types of uncertainty

18. Some people think that a revenue standard should require estimates of uncertain consideration for some types of uncertainty, but not for other types. For example, an entity might be able to estimate uncertain amounts that are controlled by the entity, but not amounts that are controlled by other parties. This alternative would be consistent with some current practice.

19. However, the Boards rejected this alternative for the following reasons:

    (a) Uncertainty rarely, if ever, is controlled by just one party. Hence, it can be very difficult and subjective to draw lines between the various types of uncertainty (e.g. seller-controlled versus customer-controlled uncertainty).

    (b) Even if it were possible to distinguish the various types of uncertainty (and the Boards specified different approaches for different types of uncertainty), some exceptions to each approach might still be necessary depending on the *amount* of uncertainty. For example, some people might think that an entity should not estimate uncertain consideration that is primarily controlled by the customer. However, many are comfortable with estimates of customer-controlled uncertainty if the entity has extensive experience with those types of contracts (e.g. trailing commissions of an insurance agent, refundable services).

    (c) The revenue standard could become unnecessarily complex and would lack a clear principle for how to account for uncertain consideration.

Alternative 4: Redefine the transaction price as an amount of a specified probability (e.g. "probable" or "most likely")

20. This alternative would redefine the transaction price as an amount of consideration that meets some specified hurdle such as "probable", "most likely", or "certain".

21. The Boards rejected this alternative for the following reasons:

(a) The Boards would need to specify a hurdle (e.g. “probable” or “most likely”). Defining and implementing that hurdle could be very subjective.

(b) Contracts that meet the hurdle would be accounted for differently from contracts that miss the hurdle. That could result in different accounting for contracts that are very similar, depending on how closely a contract reaches or misses the specified hurdle.

(c) The transaction price (as redefined) often would not be a useful measurement of the performance obligations in a contract. For example, an entity might recognize a loss at contract inception because of the onerous test, although the contract is expected to be profitable.

The nature of estimates to include in the transaction price

22. The Boards rejected the four alternatives in the previous section in favor of an approach that requires estimates of the transaction price only if uncertain amounts can be estimated “reliably”.[2] The Boards have defined the transaction price as the entity’s probability-weighted estimate of consideration to be received.

23. By definition, a probability-weighted estimate requires an entity to:

(a) Identify the possible outcomes (i.e. consideration amounts) in a contract with a customer, and

(b) Estimate the probabilities associated with those outcomes.

24. Probability-weighted estimates are required in contexts other than revenue recognition. Some existing standards state that an entity must be able to measure amounts reliably. Many of those standards do not provide further guidance as to what “reliable” means.

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[2] Some Board members have suggested that a word other than “reliable” would be more appropriate because of recent deliberations in the joint Conceptual Framework project. The staff acknowledges that another term might be more appropriate (e.g. “verifiable” or “reasonable”). However, this paper focuses on the nature of the estimates that an entity should include in the transaction price rather than on the single word to describe those estimates.

25. However, some of those standards provide further guidance as to what a "reliable" or "reasonable" estimate is. For example, paragraph 410-20-25-8 of the Asset Retirement and Environmental Obligations Topic of the *FASB Accounting Standards Codification* (formerly FASB Interpretation 47, *Accounting for Conditional Asset Retirement Obligations*) states:

> …An asset retirement obligation would be reasonably estimable if either of the following conditions exists:
>
> a. The settlement date and method of settlement for the obligation have been specified by others. For example, the law, regulation, or contract that gives rise to the legal obligation specifies the settlement date and method of settlement.
>
> b. The information is available to reasonably estimate all of the following:
>
> 1. The settlement date or the range of potential settlement dates
> 2. The method of settlement or potential methods of settlement
> 3. The probabilities associated with the potential settlement dates and potential methods of settlement.

26. Similar to standards that provide additional guidance on reliable estimates in other contexts, the Boards have decided to provide additional guidance on what a "reliable" estimate is in the context of revenue recognition. That guidance should help an entity determine whether to include an estimate of an uncertain consideration amount in the transaction price.

The role of an entity's previous experience

27. The staff thinks that an entity should include an estimated amount in the transaction price only if the entity has previous experience with identical or similar types of transactions. An entity's previous experience provides some objective evidence that can be used by the entity to identify the possible outcomes (i.e. consideration amounts) in a contract and reasonably estimate the probabilities associated with those outcomes.

28. If an entity does not have experience itself (maybe because it is a newly-formed entity), the staff thinks that the entity could reference the experience of other entities in the same business if that information is available. Reference to the experience of other entities in the same business is similar to paragraph 460-10-25-6 of Topic 460, *Guarantees* which states the following with relation to an

entity's ability to reasonably estimate the amount of warranty claims in accordance with paragraph 450-20-25-2 of Topic 450, *Contingencies*:

> Satisfaction of the condition in paragraph 450-20-25-2(b) will normally depend on the experience of an entity or other information. In the case of an entity that has no experience of its own, reference to the experience of other entities in the same business may be appropriate.

29. The staff acknowledges that an entity might be able to identify possible outcomes and estimate probabilities based on other inputs—that is, without its own or others' previous experience. Indeed, other standards might require the entity to do so in other contexts (e.g. in accounting for a business combination).

30. However, in the context of revenue recognition, the staff thinks that an entity's experience (or the experience of other entities) with similar contracts should be required to identify the possible outcomes of a contract and reasonably estimate the related probabilities. Without experience with similar contracts, the level of uncertainty in the estimate is likely to be so high that the estimate may not be particularly useful to a user. In other words, a user might find it more useful if an entity recognizes revenue only when the uncertainty is resolved.

31. In addition, if the entity does not have previous experience with identical or similar types of transactions (or access to experience of other entities), the staff thinks that the costs of developing estimates based on other inputs are likely to exceed the benefits of doing so, particularly when the entity has many different types of contracts. That could be a reason why it is useful for an entity to estimate uncertain amounts in a one-time business combination, but not on an ongoing basis as part of an entity's ordinary activities.

32. Requiring experience with similar contracts in order to reliably estimate an uncertain amount is consistent with some existing standards. For example, when accounting for the sale of a product with a right of return, Paragraph 605-15-25-3 notes that the following factor may impair an entity's ability to make a reasonable estimate:

> Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling entity's marketing policies or relationships with its customers.

Relevance of an entity's experience

33. The staff thinks that experience with similar contracts is a necessary but insufficient condition for an entity to include an estimated consideration amount in the transaction price. Previous experience is relevant to identifying the possible outcomes of a contract (and the related probabilities) only if circumstances surrounding those types of contracts are not likely to change significantly.

34. Various factors could indicate potentially significant changes in circumstances (and decrease the relevance of an entity's experience). Those factors include:

    (a) High susceptibility of the consideration amount to external factors (e.g. changes in the market, judgment of third parties),

    (b) Long period of time until the uncertainty is expected to be resolved, and

    (c) Limited experience with that type of contract.

Susceptibility of an uncertain consideration amount to external factors

35. If an uncertain consideration amount is highly susceptible to external factors, it is more likely that circumstances could change significantly and the entity's experience will not be relevant. External factors include changes in the market and the level of obsolescence risk of related goods and services. For example, an entity might have experience with contracts in which the entity transfers a product to a customer and the customer promises to pay for the product based on future use of the product. If the product is nearing technological obsolescence and a competitor releases an improved product with similar functionality (and has an aggressive marketing campaign), the entity's experience with similar contracts might not be relevant to the possible outcomes of the contract (and related probabilities) because of significant changes in the marketplace.

36. Another external factor that an entity should consider is the judgment of third parties. If the amount of consideration in a contract depends on the subjective approval or opinion of a third party (e.g. performance bonuses in a services contract based on third-party surveys), it might be difficult for an entity to

identify the possible outcomes in the contract and estimate the related probabilities.

The length of time until the uncertainty is resolved

37. Depending on the nature of the uncertainty, the length of time until that uncertainty is resolved also might affect the relevance of an entity's experience to the possible outcomes of a contract and related probabilities. If an uncertainty is expected to be resolved in a relatively short period of time, it is unlikely that circumstances will change significantly. Conversely, if an uncertainty is expected to be resolved in a long period of time, the circumstances surrounding a contract are more likely to change significantly.

The extent of previous experience with that type of contract

38. If an entity's experience consists of a large volume of identical contracts, that experience might be more relevant than the experience of an entity that has only a handful of similar contracts.

Staff recommendation for the Boards

39. On the basis of the previous analysis, the staff thinks that an entity should exercise judgment and consider all relevant facts and circumstances when assessing whether circumstances surrounding a contract will change significantly. Some of the factors an entity might consider when making that assessment are included in paragraph 34. Appendix A illustrates how those factors and the staff's recommendations might be applied to various examples.

Question 1 Application guidance on when an entity should include estimates of uncertain consideration in the transaction price
The staff recommends that: An entity should include an estimated amount of uncertain consideration in the transaction price only if the entity can identify the possible outcomes of a contract (i.e. consideration amounts) and reasonably estimate the probabilities of those outcomes. In the context of revenue recognition, an entity can identify the possible outcomes of a contract and reasonably estimate the related probabilities only if the entity: (a) has experience with identical or similar types of contracts, and (b) does not expect circumstances surrounding those types of contracts to change significantly. An entity should exercise judgment and consider all relevant facts and circumstances when assessing whether circumstances surrounding a contract will change significantly. Do the Boards agree?

Appendix A Examples

A1. This appendix contains various examples that illustrate the proposed model and how the staff's proposed application guidance might help an entity determine whether to include uncertain consideration amounts in the transaction price:

Example 1 Consulting services with a performance bonus/penalty

Example 2 Agent with trailing commissions

Example 3 Legal services with a contingent fee

Example 4 Management fees based on an index

Example 1 Consulting services with a performance bonus/penalty

A2. This example focuses on the mechanics of how the proposed revenue recognition model would be applied when the amount of consideration is uncertain. Subsequent examples focus more on whether to include an estimated amount of uncertain consideration in the transaction price. Consider the following:

> A consultant enters into a contract and promises to provide cost management consulting services to a client over six months. The client promises to pay CU200 at the beginning of each month. At the end of the contract, the consultant either will give the client a refund of CU100 or will be entitled to an additional CU100, depending on the client's level of cost savings.
>
> The consultant has some experience with similar types of contracts and knows the average cost savings for contracts with this type of client. At contract inception, the consultant determines the transaction price by identifying the following possible outcomes and related probabilities:

Possible outcomes	*Probabilities*	*Expected consideration*
CU1300 [CU200 × 6 + CU100]	0.80	CU1040
CU1100 [CU200 × 6 − CU100]	0.20	CU 220
Transaction price at contract inception		CU1260

After three months, the consultant becomes less optimistic about the client's potential cost savings. Hence, the transaction price changes as follows:

Possible outcomes	*Probabilities*	*Expected consideration*
CU1300 [CU200 × 6 + CU100]	0.75	CU 975
CU1100 [CU200 × 6 − CU100]	0.25	CU 275
Transaction price after three months		CU1250

At the end of the contract, the consultant receives the additional consideration of CU100.

A3. At contract inception, the consultant would allocate the transaction price of CU1260 to the performance obligations to provide consulting services. Because those services are provided evenly over the six months, the consultant would recognize revenue of CU210 per month [CU1260 ÷ 6 months].

A4. Because the client pays CU200 per month (CU10 less than the revenue recognized), the consultant would recognize a contract asset of CU10 in the first month to reflect the revenue recognized in excess of cash. That contract asset would increase by CU10 each month.

A5. After three months, the transaction price decreases CU10 [CU1260 − CU1250]. Because half of the performance obligations in the contract have been satisfied [three months ÷ six months], half of the CU10 decrease in the transaction price would be allocated to the satisfied performance obligations. Hence, the consultant would recognize revenue of CU625 for the first three months [CU1250 × three months ÷ six months]. The contract asset would decrease by CU5 [half of the CU10 decrease in the transaction price].

A6. At the end of the contract, the consultant would record the following entry upon receipt of the additional consideration of CU100:

DR Cash	CU100	
CR Contract asset		CU50
CR Revenue		CU50

A7. If the consultant could not reliably estimate the probabilities of each outcome throughout the contract, the transaction price would not include uncertain amounts. Hence, the transaction price at contract inception would be limited to CU1100.

Example 2 Agent with trailing commissions

A8. Consider the following:

> LizCo introduces clients to AdamCo's funds. On introducing a client into the fund LizCo receives a commission of CU500. In addition, it will receive ongoing commission of CU50 per year that the client remains in AdamCo's fund.
>
> LizCo has entered into many similar contracts previously. LizCo therefore has data about how long clients are likely to remain in AdamCo's fund. Although the average investment in the fund is three years, LizCo has no evidence to suggest that circumstances surrounding the contract will change significantly.

A9. At contract inception, LizCo would include three years of uncertain consideration in the transaction price on the basis of previous experience and expectations that circumstances surrounding those type of contracts will not change significantly. Hence, the transaction price would be CU650 [CU500 + CU50 × 3 years]. LizCo would allocate CU650 to the performance obligation to introduce a client to AdamCo.

A10. Upon satisfying that performance obligation, LizCo would record the following:

DR Cash (Accounts receivable)	CU500	
DR Contract asset	CU150	
CR Revenue		CU650

A11. The CU150 contract asset reflects the revenue recognized in excess of the certain consideration. Subsequently, LizCo would update the transaction price to reflect changes in transaction price. Those changes would result in an adjustment to the measurement of the contract asset and a corresponding adjustment to revenue.

A12. In U.S. GAAP, SEC SAB Topic 13, Revenue Recognition considers a commission example in which an insurance agent receives a commission from an insurer upon selling an insurance policy. That commission is refundable in whole for 30-days and then refundable on a declining pro rata basis until the policyholder has made six monthly payments. The SEC staff observed in that case that the particular registrant demonstrated that it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations. Accordingly, the staff did not object to that registrant's policy of recognizing its sales commission as revenue when its performance was complete, with an appropriate allowance for estimated cancellations.

Example 3 Legal services with a contingent fee

A13. Consider the following:

> An attorney promises to provide legal services to a client on a contingent fee basis. The legal services are provided evenly over three months. The client promises to pay the attorney 30% of whatever settlement amount is reached by the end of the three months.
>
> The attorney has previous experience with these types of cases. However, the outcome of the contract is highly susceptible to the judgment of other parties.

A14. In this contract, the attorney has performance obligations to provide legal services over three months. Those performance obligations are satisfied continuously over the three months. However, the amount of consideration received in exchange for those services depends on a highly uncertain future event.

A15. Although the attorney has previous experience with these types of cases, there are numerous possible outcomes of the contract and those outcomes are highly susceptible to the judgment of other parties. Therefore, the attorney is not able to reasonably estimate the probability of possible outcomes because it is likely that circumstances will vary significantly from the attorney’s previous cases.

A16. Consequently, the attorney would not recognize revenue until the uncertainty is resolved. However, the reason for not recognizing is because the attorney cannot identify the possible outcomes of the contract and related probabilities. It is not because the attorney has not satisfied a performance obligation.

Example 4 Management fees based on an index

A17. Consider the following:

> On 1 January AdamCo enters into a contract with a client to provide fund management services for a year. The customer is required to pay 10% of any increase in the fund's value relative to an observable index at the end of the year.
>
> AdamCo has entered into many similar contracts previously. However, AdamCo determines that the circumstances surrounding these types of contracts could change significantly, because the consideration amount is highly susceptible to external factors such as market risk.

A18. Because the outcome of the contract is highly susceptible to external factors, it is likely that the circumstances surrounding the contract will change significantly from the entity's previous experience. Therefore, AdamCo would not include an estimated amount of uncertain consideration in the transaction price until the uncertainty is resolved (which would be at the end of the year).

A19. In current practice, entities often estimate uncertain consideration in similar situations on the basis of the current index data at each reporting date. However, similar to the staff's recommendations in this paper, entities typically are precluded from recognizing revenue for management fees on the basis of estimates of future index data.