REVENUE RECOGNITION: UNCERTAIN CONSIDERATION

OBJECTIVE

1. At previous board meetings, the boards considered how an entity should measure its net contract position and recognize revenue when a customer promises an uncertain amount of consideration. The boards agreed that:

    - At contract inception, the transaction price (i.e. the measure of rights and performance obligations) is the probability-weighted estimate of consideration to be received.

    - After contract inception, an entity should update the measurement of rights to reflect changes in the transaction price and allocate those changes to the performance obligations. The effects of those changes on satisfied performance obligations would be recognized as revenue in the period of change.

2. Although the boards agreed with that expected consideration approach for measuring performance obligations, they disagreed on whether to constrain the amount of revenue recognized (and measurement of rights) in some instances.

    - The IASB decided tentatively that the approach should not be constrained. Rather, an entity should disclose information about estimates and uncertainty.

    - The FASB decided tentatively that the cumulative revenue recognized should be limited to an amount that is certain or noncontingent. That constraint results in a 3-step process whereby an entity 1) measures performance obligations based on an expected consideration amount, 2) determines how much revenue to recognize based on satisfied performance obligations, and 3) adjusts the measurement of rights (and

revenue) so that the increase in the net contract position is limited to the amount of consideration that is certain.

3. The staff thinks that the boards' differing conclusions create a fundamental issue that must be resolved before the development of an exposure draft. Therefore, the objective of this paper is to get a consistent view from the boards on whether to constrain the expected consideration approach when the customer promises an uncertain amount of consideration.

4. To reach that objective, this paper:

   a) Considers existing standards and practices related to uncertain consideration,

   b) Provides examples that illustrate various types of uncertainty,

   c) Analyzes the boards' alternatives for resolving the issue,

   d) Recommends that an expected consideration approach should be constrained, but only if it is impracticable for an entity to reliably estimate a consideration amount.

5. This paper does not consider the effects of uncertainty arising from a customer's credit worthiness, i.e. it deals only with uncertainty in the amount contractually due from a customer.

EXISTING STANDARDS AND PRACTICES

Existing standards are inconsistent

6. When considering whether to constrain revenue, the staff notes that existing standards and practices are not consistent on the issue (Appendix B to this paper summarizes some of those standards for both IFRS and U.S. GAAP). In some cases, revenue is recognized based on estimates of the consideration an entity expects to receive. That is, uncertainty of the amount of customer consideration is

a *measurement* issue that affects how much revenue to recognize. In other cases, uncertainty of the amount of consideration is a *recognition* issue that affects whether to recognize revenue.

7. The staff thinks that the boards' differing views on uncertain consideration in the proposed model could be characterized similarly to existing standards. The IASB seems to view uncertain consideration as affecting how much revenue to recognize (measurement). On the other hand, the FASB seems to view uncertain consideration as affecting whether to recognize revenue (recognition).

8. To illustrate, consider an entity that provides services to a customer over time in accordance with a contract, but the consideration amount is contingent on a future event.[1] In the IASB's view, the entity would recognize revenue as services are provided. The uncertainty of the consideration amount would affect *how much* revenue the entity recognizes as services are provided. In the FASB's view, the contingency would preclude the recognition of revenue (and a net contract position) until the uncertainty is resolved.

9. In considering whether to constrain the amount of revenue recognized in the proposed model, the staff thinks it is useful to consider some of the reasons for the inconsistency in existing standards and practices.

Reasons for constraining revenue

10. Existing standards and practices constrain revenue for various reasons—both conceptual and practical. In concept, revenue could be constrained either because it is uncertain whether an asset has increased (FASB CON 6 paragraph 78, IAS 18 paragraph 7) or because the amount of the increase cannot be measured reliably (FASB CON 5 paragraph 63, IASB *Framework* paragraph 89).

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[1] Even if the consideration amount is entirely contingent (e.g. a "no win, no fee" legal case), the company has a contract with present unconditional rights and performance obligations. Although the company's right to cash is contingent at contract inception, the company nonetheless has a present unconditional right to the customer's promised performance. In other words, the customer has an unconditional stand-ready obligation and the company has a corresponding unconditional contractual right.

11. Those conceptual constraints on revenue are similar to the constraints that apply to all financial statement elements. However, in practice revenue recognition is often constrained more than other financial statement elements—i.e. revenue recognition often requires greater certainty than recognition of other elements.

12. Existing standards and practices require greater certainty for revenue recognition for various reasons:

- *Relative importance of revenue*: revenue is a key metric to users of financial statements when valuing an entity. Therefore, some people prefer higher certainty for recognition of revenue than for other elements of financial statements.

- *Tradition*: for many people, revenue intuitively represents cash received or due from the customer—i.e. the consideration "earned". Therefore, if goods and services have been provided to a customer but the amount of consideration is uncertain, many people think revenue has not been earned until the uncertainty is resolved.

- *Conservatism/abuse prevention*: historically, a significant portion of financial statement restatements relates to the intentional overstatement of revenue (or premature recognition of revenue). Consequently, some existing standards delay the recognition of revenue until reaching some level of certainty.

13. Another reason for constraining revenue is that in some instances less preparation cost is required by a model that recognizes revenue only when an uncertainty is resolved. For example, consider an entity that has transferred a product to a customer in exchange for 10 annual payments that vary based on highly uncertain future events. It might be more practical, but perhaps just as decision useful, for the entity to recognize revenue as payments are received, than to recognize

revenue at an estimated amount when the product is delivered (and revise that estimate as it changes over 10 years).

Reasons for *not* constraining revenue

14. In practice, entities sometimes do not constrain revenue to amounts that are certain—i.e. they recognize revenue based on an expected consideration amount. Two reasons for that approach are (a) a better depiction of the economics of the transaction, and (b) an ability to estimate reliably.

Better depiction of economics

15. In many contracts, goods and services are transferred to the customer before the amount of consideration is certain. If revenue is not recognized until the consideration amount is certain, the pattern of revenue recognition would not depict the transfer of goods and services to the customer. Hence, recognizing revenue based on expected consideration can better depict the increase in the net contract position, even if the amount of the increase is uncertain.

16. The FASB's Conceptual Framework states that the definitions of elements of financial statements "are not intended to require that the existence and amounts of items be certain for them to qualify as assets, liabilities, revenues, expenses, and so forth, and estimates and approximations will often be required unless financial statements are to be restricted to reporting only cash transactions." (CON 6 paragraph 46)

17. Because an amount does not need to be certain to qualify as an asset (and revenue), many existing standards require the recognition of revenue in an amount that reflects uncertainty.

Ability to estimate reliably

18. In practice, revenue recognition reflects uncertain consideration amounts if the effects of that uncertainty can be reliably estimated. For example, entities often adjust revenue for the sale of a product based on estimates of future price adjustments (e.g. rebates, discounts, refunds).

19. Estimates also are common to construction contract accounting. Paragraph 27 of SOP 81-1 states the following:

> Estimating is an integral part of contractors' business activities, and there is a necessity to revise estimates on contracts continually as the work progresses. The fact that circumstances may necessitate frequent revision of estimates does not indicate that the estimates are unreliable for the purpose for which they are used. Although results may differ widely from original estimates because of the nature of the business, the contractor, in the conduct of his business, may still find the estimates reasonably dependable.

20. The reliability of estimates in existing standards is often judged by factors such as the existence of historical evidence, the number of similar transactions, the significance of the uncertainty, and the type of uncertainty.

Existing practices vary by type of uncertainty

21. In practice, the type of uncertainty can affect whether an entity recognizes revenue in an estimated amount before the uncertainty is resolved. Uncertain consideration comes in countless forms but generally can be categorized according to who (or what) primarily controls the uncertainty.

Customer-controlled uncertainty

22. In some contracts the customer controls the amount of consideration. For example, a seller might receive additional consideration based on a customer's usage of a particular product. In other cases, the seller might receive less consideration based on the customer's decision to redeem a discount or rebate. In practice, entities

generally do not recognize revenue for uncertain consideration amounts that the customer controls.

23. A notable exception to that general practice is accounting for the sale of goods with a right of return. If an entity can reasonably estimate the goods that will be returned by customers, the entity recognizes revenue based on the estimated consideration to be retained even though the entire consideration amount is subject to the customers' actions.

24. Similar accounting is seen in practice for refundable services. For example, SAB 104 notes that the SEC staff does not object to the recognition of refundable discount retailer membership fees, net of estimated returns, as earned revenue over the membership term in circumstances where the retailer has a history of reasonably estimating the refunds and the membership fee otherwise is a fixed amount. In other words, the entire consideration amount is contingent until the end of the contract but SAB 104 permits revenue recognition throughout the contract based on estimates.

Seller-controlled uncertainty

25. In any contract, the seller's actions affect the amount of consideration to be paid. That is because a seller is not entitled to consideration unless the seller performs as promised. Because a seller can predict its actions more easily than those of another party, revenue sometimes is recognized on the basis of estimated consideration when the seller primarily controls the amount of consideration.

26. For example, a services provider might have a history of price concessions for failing to provide timely services in some contracts. Because the seller controls the timing of the services and amount of consideration, revenue often is recognized on the basis of expected consideration (i.e. estimates of price concessions).

27. In other cases the seller controls the consideration amount but does not recognize revenue until a significant uncertainty is resolved. For example, a customer might promise to pay a performance bonus if the seller achieves a particular milestone or level of performance. In those cases, entities typically do not recognize revenue until they achieve the specified level of performance. In U.S. GAAP, that often occurs because entities applying EITF Issue No. 00-21 "Revenue Arrangements with Multiple Deliverables" may not allocate consideration to a deliverable in a contract if the consideration is contingent on the seller's future performance.

Uncertainty outside the control of the seller and customer

28. In some contracts, the consideration amount is based on uncertainty that is controlled neither by the seller nor the customer. In those cases, entities typically do not recognize uncertain amounts as revenue until the uncertainty is resolved. For example, consider a biotechnology entity that researches and develops potential drug compounds. If the entity is entitled to a significant bonus upon regulatory approval of a drug compound, no portion of that bonus is recognized as revenue prior to the regulatory approval.

29. In other instances, the actions of a third party might decrease the consideration amount. For example, consider a retailer that promises a customer that it will refund a portion of a product's sales price if a competitor sells the same product for a lower price within a year. In those cases where the third party's actions might reduce the amount of consideration, entities often recognize revenue based on an expectation of the third party's actions.

Uncertainty based on an index

30. In many long-term contracts, the amount of consideration varies based on an index (e.g. a consumer price index). In practice, entities often recognize revenue on the basis of the current index data rather than on an estimate of future index data. For example, the SEC staff concluded in EITF D-96 *Accounting for*

Management Fees Based on a Formula that it is not appropriate for an entity to recognize revenue based on the expectation of future performance. A reason for that decision is that if the contract were cancelled, the customer and the entity would be likely to settle the contract at an amount determined using the current index data.

Summary of existing standards and practices

31. Existing standards and practices are not consistent. Sometimes entities recognize revenue based on reliable estimates of consideration amounts. The reliability of estimates depends on factors such as the existence of historical evidence, the number of similar transactions, the significance of the uncertainty, and the type uncertainty. Other times entities recognize revenue only when the consideration amount is certain, regardless of whether the entity can make reliable estimates.

EXAMPLES BY TYPE OF UNCERTAINTY

32. The staff thinks it is useful to illustrate the boards' different views with examples that vary by type of uncertainty:

- Example 1 Customer-controlled uncertainty
- Example 2 Seller-controlled uncertainty
- Example 3 Uncertainty outside the control of the seller and customer
- Example 4 Uncertainty based on an index
- Examples 5 and 6: Examples with high uncertainty

Example 1 Customer-controlled uncertainty

Company A transfers to a customer the rights to an intangible product and has no remaining performance obligations. The customer promises to pay consideration of CU10,000 three months from receipt of the product. However, if the customer uses the product fewer than 20 times during those three months, Company A promises to give the customer a CU5,000 discount. Historically, forty percent of customers use the product fewer than 20 times. Assume that this particular customer receives the discount.

Unconstrained Revenue Approach

	Contract Inception	Product Delivery	Three Months from Delivery
Rights	8,000 [a]	8,000	5,000
Performance obligations	(8,000)	(0)	(0)
Net contract position	0	8,000	5,000
Revenue for period	0	8,000	(3,000)

(a) CU8,000 at contract inception = (60% probability × CU10,000) + (40% probability × CU5,000)

Constrained Revenue Approach

	Contract Inception	Product Delivery	Three Months from Delivery
Rights	8,000 [a]	5,000 [b]	5,000
Performance obligations	(8,000)	(0)	(0)
Net contract position	0	5,000	5,000
Revenue for period	0	5,000	0

(a) CU8,000 at contract inception = (60% probability × CU10,000) + (40% probability × CU5,000)
(b) CU5,000 at product delivery = CU5,000 “certain” amount of customer consideration

Observations

- Arguably the accounting should be the same if the customer instead promised to pay CU5,000 plus a CU5,000 bonus if the product is used 20 or more times.
- For some people, reversing revenue of CU3,000 in the unconstrained approach is troublesome at the individual contract level (even though the revenue in the previous period reflected the circumstances at that time and is not necessarily “wrong”). However, it is less troublesome if the entity has a large volume of similar contracts because the average consideration per contract will approximate the expected consideration amount.

Example 2 Seller-controlled uncertainty

Company B promises to deliver equipment to a customer within 30 days, and to install the equipment within 10 days of delivery. The customer promises to pay CU25,000 but is entitled to a CU10,000 discount if the equipment is not installed within 10 days.
Company B assesses a ninety percent probability of installing the equipment within 10 days. Assume the equipment is installed on time.
The transaction price at contract inception is CU24,000 [(90% probability × CU25,000) + (10% probability × CU15,000)]. That transaction price is allocated to the performance obligations as follows:

	Standalone Selling price	Relative Proportion	Allocation of Transaction price
Equipment	21,000	75%	18,000
Installation	7,000	25%	6,000
	28,000	100%	24,000

Unconstrained Revenue Approach

	Contract Inception	Equipment Delivery	Equipment Installation
Rights	24,000	24,000	25,000 [(a)]
Performance obligations	(24,000)	(6,000)	(0)
Net contract position	0	18,000	25,000
Revenue for period	0	18,000	7,000

(a) The measurement of rights is updated to reflect the current transaction price of CU25,000 based on the resolution of the uncertainty of installation. If the installation were delayed, then the rights would be updated to CU15,000 and the company would reverse revenue of CU3,000 (CU18,000 – CU15,000).

Constrained Revenue Approach

	Contract Inception	Equipment Delivery	Equipment Installation
Rights	24,000	21,000 [(a)]	25,000
Performance obligations	(24,000)	(6,000)	(0)
Net contract position	0	15,000	25,000
Revenue for period	0	15,000	10,000

(a) CU21,000 is calculated by adding the "certain" consideration of CU15,000 to the CU6,000 measurement of the remaining performance obligations. That is, the rights are adjusted so that the increase in the net contract position is limited to the consideration amount that is certain.

Observations

- Assume the customer prepaid the CU25,000 and was entitled to a refund of CU10,000 for delayed installation. The company would recognize a monetary liability of CU1,000 at contract inception (CU25,000 cash − CU24,000 transaction price). That liability is the company's estimate of consideration to be refunded. When the uncertainty is resolved, the transaction price is updated and reallocated to the performance obligations (total revenue would be CU25,000 in this case).

Example 3 Uncertainty outside the control of the seller and customer

Company C enters into a contract with a customer to provide biotechnology research and development services for one year. If those services result in a drug that achieves regulatory approval, the customer will pay Company C CU1,000,000 for the rights to market the drug. Assume the notice of drug approval/rejection is received at the end of the year and that the services are provided evenly over the year.

The transaction price is determined as follows throughout the contract:

	Probability of approval	Transaction price
Contract inception	5%	50,000
Month 6	10%	100,000
End of year*	0%	0

*assumes that the drug is not approved by the regulatory agency

Unconstrained Revenue Approach

	Contract Inception	End of Month 6	End of Year
Rights	50,000	100,000	0
Performance obligations	(50,000)	(50,000) [(a)]	(0)
Net contract position	0	50,000	0
Revenue for period	0	50,000	(50,000)

(a) CU50,000 = CU100,000 transaction price × 50% remaining performance obligations.

Constrained Revenue Approach

	Contract Inception	End of Month 6	End of Year
Rights	50,000	50,000 [(a)]	0
Performance obligations	(50,000)	(50,000) [(b)]	(0)
Net contract position	0	0	0
Revenue for period	0	0	0

(a) Because no amount of consideration is certain, the measurement of rights is adjusted so that the net contract position is zero.
(b) CU50,000 = CU100,000 transaction price × 50% remaining performance obligations.

Observations

- Some people might ask whether achieving regulatory approval is a separate performance obligation. A performance obligation is a promise to transfer an asset to a customer. Because an entity cannot be obliged to transfer an asset it does not control, regulatory approval is not a separate performance obligation. Rather, regulatory approval is an uncertainty that affects the transaction price.[2]

[2] In March 2009, the EITF reached a consensus for exposure on Issue No. 08-9 "Milestone Method of Revenue Recognition" which permits the recognition of a milestone payment as revenue in its entirety in the period in which a substantive milestone (such as regulatory approval) is achieved.

Example 4 Uncertainty based on an index

Company D enters into a contract with a customer to provide fund management services for six months. The customer promises to pay CU5,000 per month plus 3% of any increase in the fund's value relative to an observable index (determined at the end of the six months). Assume the services are provided evenly over the contract.

The transaction price is determined as follows throughout the contract:

	Total fixed fees	Estimated variable fees	Estimated transaction price
Contract inception	30,000	30,000	60,000
Month 3	30,000	40,000	70,000
End of month 6	30,000	10,000	40,000

Unconstrained Revenue Approach

	Contract Inception	End of Month 3	End of Contract
Rights	60,000	70,000	40,000
Performance obligations	(60,000)	(35,000)	(0)
Net contract position	0	35,000	40,000
Revenue for period	0	35,000	5,000

Constrained Revenue Approach

	Contract Inception	End of Month 3	End of Contract
Rights	60,000	65,000 (a)	40,000
Performance obligations	(60,000)	(35,000)	(0)
Net contract position	0	30,000	40,000
Revenue for period	0	30,000	10,000

(a) Because only CU30,000 (CU5,000 × 6 months) is "certain", the measurement of rights is adjusted so that the cumulative revenue recognized at the end of Month 3 does not exceed CU30,000.

Observations

- In this example, the entity recognizes revenue based on an estimate of future index data rather than on an observation of current index data.
- In the leases project, the FASB decided tentatively that a lessee initially should measure contingent rent subject to an index using the index data available at inception of the lease. The IASB decided tentatively that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable (regardless of the type of uncertainty).

33. The following examples illustrate scenarios where it might be difficult to determine who primarily controls the uncertainty. Moreover, they illustrate that the costs of estimating a consideration amount in some instances might exceed the benefit of recognizing revenue on the basis of expected consideration.

Examples 5 and 6 Examples with high uncertainty

Example 5 Real estate agent

A real estate agent signs a contract with a potential home buyer. The agent promises home-finding services in exchange for a 2% commission on the selling price of any home that the home buyer purchases within 6 months. The commission is paid only if the customer buys a home within 6 months.

Example 6 Sale of a patent

Company E is a product development entity that sells a patent to a customer. The patent gives the customer the right to manufacture and distribute products using a particular technology (and to prevent others from doing so). Those products have never been sold by Company E or by any other entity. The customer promises to pay 3% of any sales of the devices for the next 10 years.

Observations

- Example 5 contains uncertainty about whether the customer purchases a home and the price of the home the customer eventually buys. The agent might have market data, customer price ranges, and a history of success rates to estimate a consideration amount. However, the cost of preparing the estimate might exceed the benefit of recognizing revenue in this example.
- Example 6 illustrates the difficulty in categorizing uncertain consideration amounts by who (or what) primarily controls the uncertainty. It also shows the difficulty of estimating a consideration amount for new products and markets.

ALTERNATIVES FOR RESOLVING THE ISSUE

34. The staff thinks that the boards have 4 alternatives for resolving the issue of whether to constrain revenue in the proposed model:

- Alternative 1: Specify a different approach depending on the type of uncertainty
- Alternative 2: Constrain revenue to consideration that is certain

- Alternative 3: Do not constrain revenue, but disclose information about estimates and uncertainty

- Alternative 4: Constrain the expected consideration approach only if a consideration amount cannot be reasonably estimated.

Alternative 1: Specify a different approach depending on the type of uncertainty

35. The previous examples illustrate various types of uncertainty to see if the boards view each type of uncertainty differently. If so, the boards could resolve the issue of whether to constrain revenue by specifying a different approach depending on the type of uncertainty.

36. For example, the boards might want to constrain revenue when the customer or another party primarily controls the consideration amount, but not when the seller does. The basis for those different approaches would be a presumption that the seller can predict its actions (and therefore estimate the consideration amount) more reasonably than the seller can estimate the consideration amount controlled by another party.

37. For various reasons (see below), the staff thinks that such an approach would be difficult to articulate in the proposed model, and would be difficult for entities to apply consistently.

Drawing the line

38. If a revenue constraint depends on how a particular uncertainty is categorized (e.g. seller-controlled versus customer-controlled), drawing a line between the types of uncertainty would be critical. Drawing any line by who primarily controls the uncertainty would be difficult because uncertainty rarely, if ever, is controlled by only party or factor. For example, at first glance a volume rebate might seem to be controlled by the customer who decides whether to purchase a particular volume

of products. However, that customer decision might be influenced significantly by the seller's marketing efforts or the actions of the seller's competitors.

39. The boards could draw a line by precluding revenue recognition in instances when the consideration amount varies based on customer usage of an asset that a seller has transferred. That line would be somewhat subjective but at least would provide a clear cut for some contracts.

40. However, the staff thinks that even if a line were clearly drawn by type of uncertainty, some people might want exceptions based on the *level* of uncertainty. For example, assume that a standard precluded entities from recognizing revenue for consideration amounts that vary by customer usage of a transferred product. Some people might argue that an exception should be granted if an entity has reliable estimates of customer usage based on historical evidence.

Complexity

41. A revenue standard would be more complex if revenue is constrained by type of uncertainty. Many contracts have complex pricing structures with a combination of fixed fees, volume discounts, rebates, price protection clauses, cost of living adjustments, milestone payments, and other performance bonuses or penalties. Accounting for some consideration amounts differently from others depending on the type of uncertainty would increase the complexity when accounting for those contracts.

Inconsistency

42. Inconsistency in existing standards and practices is more likely to persist if revenue is constrained in some instances and not others. That is, if a single revenue standard includes different approaches to account for a similar issue (uncertain consideration), it is more likely that entities will apply that standard inconsistently and account for similar economic phenomena differently.

Alternative 2: Constrain revenue to consideration that is certain

43. As another alternative, the boards could constrain the revenue to a certain amount of consideration. That alternative is consistent with the view of the FASB in a previous board meeting. However, the staff notes the following consequences of that alternative:

a) *A need to define "certain"*: if revenue is constrained to a certain consideration amount, then the boards would need to define "certain". "Certain" could be defined in various ways such as fixed, firm, not likely to change, or noncontingent. But regardless of how the term is defined, the boards would need to consider the many instances in existing standards when revenue is recognized before the consideration amount is certain and whether to allow exceptions to the constraint. Examples include discounts, rebates, rights of return, refundable services, and percentage of completion accounting.

b) *Failure to recognize a net contract position*: if a net contract position is not recognized because of uncertain consideration, entities would fail to report useful information to users of financial statements. In other words, valuable information about an entity's existing contractual rights and obligations would not be recognized in the financial statements. For example, failing to recognize revenue in a contingent fee services arrangement would fail to report to users the possibility of future cash inflows for the services provided to the customer.

c) *Inconsistency with the proposed model*: the proposed model as developed to date suggests that revenue is recognized when goods and services are provided to the customer. Requiring a "certain" consideration amount would be inconsistent with the proposed model because no revenue would be recognized as goods and services are transferred to the customer.

d) *Cost pressure*: when revenue is not recognized because the consideration amount is uncertain, many people want to defer costs so that the entity's profit margins are reported in a manner that seems intuitive. In existing standards, costs often are deferred to "match" deferred revenues. In the proposed model, the boards have decided tentatively that costs should be expensed as incurred unless eligible for capitalization in accordance with other standards. The staff thinks that requiring consideration to be "certain" before revenue is recognized would put tremendous pressure on the boards' decision to not allow cost deferral.

Alternative 3: Do not constrain revenue, but disclose information about estimates and uncertainty

44. As a third alternative, the boards could require that entities disclose information about estimates and how uncertainties affect the amount of revenue recognized. However, the principle in the proposed model would not be constrained. That alternative is consistent with the IASB's view in a previous board meeting. The staff notes the following consequences of that alternative:

a) *Simplicity and clarity of principle*: the revenue recognition principle in the proposed model would be simpler and clearer if revenue is not constrained. That is, revenue would be recognized when goods and services are transferred to the customer. The amount of revenue recognized would be the portion of the consideration amount (estimated if necessary) allocated to the satisfied performance obligations.

b) *Complexity of estimates*: in some contracts, the consideration amount is highly uncertain and hence, estimating that amount could be complex. Adding to that complexity, an entity would have to revise estimates continuously throughout the contract—the costs of which in some cases (paragraph 13) might exceed the benefits of more relevant and reliable financial reporting.

Alternative 4: Constrain the expected consideration approach only if it is impracticable for an entity to reliably estimate a consideration amount

45. As a fourth alternative, the boards could require that entities constrain the expected consideration approach only if it is impracticable for an entity to determine a reliable estimate of an uncertain consideration amount.

46. In the staff's view, it is rare for an entity to not be able to reliably estimate a consideration amount for a contract. One reason for that view is that estimates of consideration amounts are critical to the process of pricing and negotiating a contract with the customer. Another reason is that many contracts have various payment streams from the customer—some of which are fixed and others of which are variable. Some of those variable payment streams might be reliably estimated and others might not. If a variable payment cannot be reliably estimated, the staff thinks that other payment streams in the contract can be reliably estimated. That would enable the entity to estimate a reasonable consideration amount for the total contract.

47. Moreover, although the outcome of a single contract might be highly uncertain, an entity might have sufficient data from other contracts with similar characteristics so that it can reasonably estimate the probabilities of the possible outcomes.

48. Arguably, constraining the expected consideration approach to "reliable estimates" would be consistent with both the boards' respective conceptual frameworks. The FASB's framework states that an asset, liability or change in equity should be recognized only if it can be quantified in monetary units with sufficient reliability (CON 5 paragraph 63). The IASB's *Framework* similarly states that an element of the financial statements should be recognized only if it can be measured with reliability.

49. Under Alternative 4, the boards could then consider carrying forward some material from existing standards on the information an entity could use to make

reliable estimates. That information might be derived from an entity's past practice, industry practice, market data, etc.

50. Sometimes an entity simply does not have information on which to base an estimate. That might occur because an entity is selling a new product in a new market and whether any consideration is received is based largely on speculative efforts (Example 6 on page 14). If it is impracticable for an entity to determine a reliable estimate because there is no information on which to base an estimate, the staff thinks an entity should exclude an uncertain consideration amount from the transaction price until it is practicable or until the uncertainty is resolved.

STAFF ANALYSIS AND RECOMMENDATION

51. The staff recommends Alternative 4. In considering the alternatives, the staff focused on the information needs of users of financial statements with regard to contracts with uncertain consideration amounts. In the staff's view, the following information would be useful to users:

- the amount of promised goods and services that an entity has provided to a customer during the reporting period,
- management's estimate of the customer consideration to be received in exchange for those goods and services,
- the nature and extent of any uncertainty that would affect those estimates.

52. The above information could be provided to users through various configurations of revenue recognition, measurement, and disclosure. If revenue recognition is constrained to consideration that is certain, then entities still should disclose information about how much consideration they expect to receive (and how uncertainties could affect that estimate). If revenue is recognized on the basis of estimated consideration amounts without constraint, then an entity should disclose how it determined those estimates and how uncertainties could affect them.

53. The staff thinks that regardless of whether revenue is constrained, entities will need to communicate similar information about uncertain consideration. Consequently, the staff thinks that the principle in the proposed model should be as simple and clear as possible—and that principle is to recognize revenue based on expected consideration.

54. However, in some circumstances it might be impracticable for an entity to reliably estimate a consideration amount because of a lack of information on which to base an estimate. In those circumstances, the staff thinks it would be more relevant to disclose information about the uncertainty and why some amounts could not be reliably estimated than to require an entity to recognize amounts that cannot be measured reliably. Such a measurement would introduce unnecessary subjectivity in revenue and is likely to result in users demanding detailed disclosures to understand recognized amounts.

55. The boards will consider disclosures at a future board meeting. However, the staff has included some disclosure considerations in Appendix A to this paper.

Question for the Boards

Do the boards agree that the expected consideration approach should be constrained only if it is impracticable for an entity to reliably estimate a consideration amount?

Appendix A: Disclosures

Disclosures about uncertainty, estimates, and management judgment are already required by IAS 1 (125-133) and in U.S. GAAP by APB Opinion No. 22 (12-14). In addition to those general requirements, the proposed model could require disclosures of the following information (where material):

- The nature and extent of uncertainties affecting the amount of consideration due from customers
- Significant assumptions and methodologies that an entity uses in the estimation process
- The sensitivity of estimates to changes in assumptions
- The extent of contracts for which it is impracticable to estimate uncertain consideration amounts reliably
- Reasons why it is impracticable for an entity to reliably estimate a consideration amount

Appendix B: Existing standards relating to uncertain consideration

Topic	IFRS	U.S. GAAP
Revenue (general)	Revenue is recognised only when it is **probable that the future economic benefits** associated with the transaction will flow to the entity. In some cases, this many not be probable until the consideration is received or until an uncertainty is removed. (IAS 18, paragraph 18)	Revenue is recognized when it is **realized or realizable**, and earned. (CON 5, paragraph 83) To be realized or realizable, the seller's price to the buyer must be **fixed or determinable** and collectibility must be reasonably assured. (SAB 104)
Contingencies	**Contingent assets are not recognised** in financial statements since this may result in the recognition of income that may never be realised. However, **when the realisation of income is virtually certain, then the related asset is not a contingent asset** and its recognition is appropriate. (IAS 37, paragraph 33)	**Contingencies that might result in gains usually are not reflected** in the accounts since to do so might be to recognize revenue prior to its realization. (FAS 5, paragraph 17)
Construction contracts	Contract **revenue includes uncertain consideration amounts** to the extent that they are probable and are capable of being reliably measured. (IAS 11, paragraph 11)	The estimated **revenue is the total amount that a contractor expects to realize** from the contract. The contract price may be highly variable and subject to a great deal of uncertainty. Thus, the determination of total estimated revenue requires careful consideration and the exercise of judgment in assessing the probabilities of future outcomes. (SOP 81-1, paragraph 55)
Return rights	Revenue is recognised at the time of sale of a good with a return right if the seller can **reliably estimate future returns**. (IAS 18, paragraph 17)	Revenue is recognized upon delivery of a product with a right of return if various criteria are met, including the ability of the seller to **reasonably estimate the amount of future returns**. (FAS 48, paragraph 6)

Uncertain consideration for intellectual property	In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, **revenue is recognised only when it is probable that the fee or royalty will be received**, which is normally when the event has occurred. (IAS 18 Appendix, paragraph 20)	*Software:* Some fixed fee license arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy up to the total amount of the fixed fee. Although the price per copy is fixed at the inception of the arrangement, **an allocation of the arrangement fee to the individual products generally cannot be made**, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. (SOP 97-2, paragraph .43) *Films*: For producers or distributors of films, the arrangement fee may be based on a percentage or share of a customer's revenue from the exhibition or other exploitation of a film. In such instances, the entity should **recognize revenue as the customer exhibits or exploits the film.** (SOP 00-2, paragraph 18)
Insurance		*Short-duration contracts*: If premiums are subject to adjustment, premium revenue shall be recognized as follows: a. If, as is usually the case, **the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract.** The estimated ultimate premium shall be revised to reflect current

		experience.
Contingent rent	In May 2006, the IFRIC considered adding the issue to its agenda but decided not to after concluding that there was no evidence of diversity in practice, which was to **exclude contingent rent from the estimate of total lease payments/ income.**	**SAB 104 4c** Contingent Rental Income "The staff does not believe that it is appropriate to recognize revenue based upon the probability of a factor being achieved. **The contingent revenue should be recorded in the period on which the contingency is resolved**."
Real estate/talent/insurance agents		The staff advised the registrants that **the portion of revenue subject to customer cancellation and refund must be deferred until no longer subject to that contingency because the registrants did not have an ability to make reliable estimates of customer cancellations due to the lack of a large pool of homogeneous transactions** In the case of the insurance agent, however, the particular registrant demonstrated that **it had a sufficient history of homogeneous transactions with the same characteristics from which to reliably estimate contract cancellations** and satisfy all the criteria specified in the previous question. 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. (SAB 104 4a Question #2)