Project: **Revenue Recognition**

Topic: **Uncertain consideration – existence of a right**

Purpose and summary of staff recommendation

1. This paper discusses the accounting for uncertain consideration; specifically it addresses some concerns raised by respondents to the Exposure Draft, *Revenue from Contracts with Customers*, about whether a right to an uncertain amount of consideration should exist before an entity would be required to measure that right.

2. The staff recommend that:

   (a) The final standard should clarify that a right to consideration must exist before an entity would be required to measure that right.

   (b) The Boards should address respondents' concerns about the pattern of revenue recognition in a royalty arrangement (and other similar arrangements) through the "reasonably estimated" constraint on the measurement of revenue. That constraint is discussed in Agenda Paper 10E / FASB Memo 140E *Uncertain Consideration – constraining revenue*.

3. This paper is organized as follows:

   (a) Proposals in the exposure draft (paragraph 4)

(b) Feedback on the proposals and staff analysis (paragraphs 5-15)

Proposals in the Exposure Draft

4. In accordance with the Exposure Draft (ED), if the amount of consideration is variable (uncertain) an entity would recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The ED stated that to reasonably estimate the transaction price, the following two conditions must be met:

   (a) The entity has experience with similar contracts; and

   (b) The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

Feedback on the proposals and staff analysis

5. Some respondents to the ED were concerned that they would be required to estimate uncertain consideration even if the entity does not yet have a right to that consideration. For example:

   (a) *Change orders*: some from the construction industry were concerned that they would need to estimate revenue from all future change orders before those change orders arise.

   (b) *Options*: some thought that an entity would be required to estimate additional consideration from the future exercise of options for additional goods or services (even though the customer may choose to not exercise those options).

6. The staff does not think it was the boards' intention to require an estimate of uncertain consideration for change orders and options (regardless of how 'reasonably estimable' those amounts might be). That is because an entity does not have a right to consideration until a future event occurs (for example, the customer and the entity agreeing to change the scope of the contract, or the customer choosing to exercise an option to purchase additional goods or

services). In other words, the uncertain consideration is a *recognition* issue rather than a *measurement* issue.

7. Hence, the staff thinks the final standard should clarify that a right to consideration must exist before an entity would be required to estimate an amount of uncertain consideration. The staff also thinks that the concern related to royalties needs to be specifically addressed.

Royalties

8. In some contracts, an entity may sell a product or license technology in exchange for the right to a stream of future payments (i.e. royalties) that are based on the occurrence of a future event (e.g. the customer's sales of products that incorporate the entity's technology or the entity's product).

9. Consider the following example:

> An entity licenses intellectual property to a customer for five years on a non-exclusive basis. The amount of consideration the customer pays the entity is 2% of the customer's future sales of the customer's products that utilize the entity's intellectual property.

10. Nearly all respondents are concerned that an entity would be required to recognize revenue in the above example when the license period begins in an amount based on the entity's estimate of future royalties to be received over five years. They think that:

    (a) recognizing revenue initially based on estimates of five years of royalties (or even some portion of those royalties that can be reasonably estimated), and

    (b) truing up those estimates throughout the five years

    would result in a pattern of revenue recognition that is less useful than recognizing revenue as the customer makes sales and becomes obliged to pay the royalties.

11. The following comment from a respondent illustrates those concerns:

> We understand that the Exposure Draft requires that if the transaction consideration is a variable fee and such fee can be reasonably estimated the consideration to be received must be estimated and

> recognized at the time of the completion of the performance obligation, even if the consideration is dependent on our customers subsequent generation of revenue and/or profits. We do not agree that variable transaction fees which are dependent on our customer's generation of revenues and/or profits should be estimated and recognized as revenue before such revenue is earned by the customer and there is a legal obligation to pay. [Comment Letter No. 350]

12. Some respondents think that royalties are similar to options because the customer is not obliged to make an additional payment until the customer performs a specific action. In other words, if the customer can avoid paying an additional amount of consideration (without breaching the contract), then the customer is not presently obliged to make that payment. Conversely, if the customer cannot avoid paying an additional amount of consideration (even if that amount is uncertain), then the entity has a right to consideration that must be included in the measurement of the transaction price.

13. The staff thinks the easiest way to deal with a usage-based royalty contract would be to account for the contract as a series of options to purchase additional goods or services, in which case an entity would have to determine it has a right to consideration before it could be measured.

14. However, in February 2011, the Boards discussed a similar issue in the Leases project in Agenda Paper 5A / FASB Memo 129 *Variable lease payments.* In that paper, the Boards considered which variable lease payments should be included in the lessee's liability to make lease payments and the lessor's right to receive lease payments. The Boards tentatively decided that the lessee has a liability for future sales-based payments and the lessor has a corresponding asset. The Boards decided that the uncertainty of the future payments is a *measurement* issue rather than a *recognition* issue.

Staff recommendation and question for the Boards

15. To be consistent with the Boards' recent decision in the Leases project, the staff recommends that the Boards address respondents' concerns about the pattern of revenue recognition in a royalty arrangement (and other similar arrangements) through the "reasonably estimated" constraint on the measurement of revenue. That constraint is discussed in Agenda Paper 10E / FASB Memo 140E *Uncertain Consideration – constraining revenue*.

Question for the Boards
Do the Boards agree with the staff recommendation?