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REVENUE RECOGNITION GUIDE

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Preface

Revenue recognition... The mere mention of the topic elicits thoughts of complex accounting and difficult judgments fraught with the potential for unfavorable high-profile financial statement restatements. Revenue is the top line in the income statement, and one of the most important indices of financial health to both preparers and users of financial statements. Reporting the correct amount of revenue on a timely basis is also one of the most difficult tasks in financial reporting.

Despite the importance of revenue recognition to the financial statements of virtually all companies, the accounting literature addressing revenue recognition is not as well-developed as the literature addressing many other areas of financial reporting. Although many accounting pronouncements directly or indirectly address revenue recognition, most of the guidance is extremely narrow in scope and addresses a particular issue or narrowly defined transaction. This lack of authoritative literature addressing certain issues and industries has resulted in the development of revenue recognition for some transactions on the basis of industry practice.

The lack of comprehensive guidance combined with the variety and complexity of revenue transactions has resulted in a large number of issues in revenue recognition, including many financial statement restatements and SEC enforcement cases. In fact, two reports issued by the SEC staff in 2003 illustrate that revenue recognition is an area prone to problems: (1) Report pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (the Section 704 Report) and (2) Summary by the Division of Corporate Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (the Fortune 500 Report). The Section 704 Report showed that improper revenue recognition was the area where the SEC brought the greatest number of enforcement actions during the report period and the Fortune 500 Report found that accounting policy disclosures related to revenue recognition was an area frequently questioned by the SEC's Division of Corporate Finance. These reports confirmed the findings from several other studies conducted in recent years.

In response to the growing number of problems in the area of revenue recognition, the SEC Staff issued Staff Accounting Bulletin No. 101 (SAB 101), *Revenue Recognition in Financial Statements,* in late 1999. SAB 101 summarized the existing revenue recognition guidance and the SEC Staff's views on the application of that guidance. In addition to causing a number of companies to change their revenue recognition policies, SAB 101 also helped to focus the attention of nearly every public company, as well as analysts and other financial statement users, on revenue recognition.

As a result of these developments, many accounting standard-setters around the world have begun a number of new projects on revenue recognition. Although many of these projects are limited in scope and address very specific revenue recognition issues, the ultimate goal of one project (the FASB's Revenue Recognition project) is to address revenue recognition on a comprehensive basis. However, until that project is completed, available revenue recognition guidance will remain incomplete and scattered throughout the accounting literature.

The principal objective of *Revenue Recognition Guide* is to fill this void. This book addresses the key issues faced in revenue recognition, identifies the appropriate accounting literature, explains both the required accounting and the reasons for that guidance, and often illustrates the application through recourse to disclosures and excerpts from the financial statements of publicly traded companies. For issues not addressed in the accounting literature, this book suggests accounting treatments that are consistent with general revenue recognition concepts and principles. This book also highlights the problem areas noted in the Section 704 and the Fortune 500 Reports.

The 2010 edition of the *Revenue Recognition Guide* incorporates changes in accounting literature and interpretive developments through May 2009. It also includes, in Chapter 13, "Future Expectations and Projects," a discussion of revenue-related projects on the standard-setters' agendas. A comprehensive discussion is provided of the most significant of these projects, the FASB's Revenue Recognition project. In addition, Chapter 13 includes discussion related to the following current EITF issues, which could affect revenue recognition guidance in the near future:

- EITF Issue No. 08-1, *Revenue Arrangements with Multiple Deliverables*
- EITF Issue No. 08-9, *Milestone Method of Revenue Recognition*
- EITF Issue No. 09-3, *Applicability of SOP 97-2 to Certain Arrangements That Include Software Elements*

Within the 13 chapters of the book, a number of Observations, Practice Pointers, and Practice Alerts highlight key consequences of the accounting guidance and identify issues to watch for when dealing with certain revenue transactions. SEC Registrant Alerts highlight issues that the SEC is particularly focused on, as well as additional guidance provided by the SEC beyond the guidance typically followed by non-public companies.

The book also includes a topical index as well as a cross-reference to the authoritative literature that indicates the chapters where specific pieces of authoritative literature are discussed. In addition, the text includes references to the paragraphs of the authoritative literature that address key points.

Abbreviations

The following abbreviations are used throughout the text to represent the various sources of authoritative literature discussed in this book:

AAG	AICPA Audit and Accounting Guide
AcSEC	AICPA Accounting Standards Executive Committee
AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board Opinion
ARB	Accounting Research Bulletin
ASC	FASB Accounting Standards Codification
CIRP	SEC Current Issues and Rulemaking Projects
CON	FASB Statement of Financial Accounting Concepts
EITF	Emerging Issues Task Force
FAS	FASB Statement of Financial Accounting Standards
FASB	Financial Accounting Standards Board
FSP	FASB Staff Position
FTB	FASB Technical Bulletin
IAS	IASB International Accounting Standard
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
REG S-X	SEC Regulation S-X
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SOP	AICPA Statement of Position
TPA	AICPA Technical Practice Aid

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About the Author

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Scott A. Taub is a Managing Director of Financial Reporting Advisors, LLC (FRA), which provides consulting services related to accounting and SEC reporting and litigation support services. FRA specializes in applying generally accepted accounting principles to complex business transactions and also provides litigation support and expert services. Mr. Taub is also a member of the IASB's International Financial Reporting Interpretations Committee.

Prior to writing the first edition of this book in 2002, Mr. Taub was a partner in Arthur Andersen's Professional Standards Group (PSG), where he consulted on complex financial reporting matters, helped to establish and disseminate Andersen's policies regarding financial reporting matters, and represented the firm before various standards setters, including the FASB, SEC, AICPA, and IASB. Mr. Taub also authored interpretive guidance for Andersen on a wide variety of accounting and reporting issues.

From September 2002 through January 2007, Mr. Taub was a Deputy Chief Accountant at the Securities and Exchange Commission (SEC) and twice served as Acting Chief Accountant for a total of 14 months. He played a key role in the SEC's implementation of the accounting reforms under the landmark Sarbanes-Oxley Act and was responsible for the day-to-day operations of the Office of the Chief Accountant. Mr. Taub represented the SEC in many venues, including the FASB and IASB's advisory committees, and served as the SEC Observer to the FASB's Emerging Issues Task Force (EITF) and as Chair of the Accounting and Disclosure committee of the International Organization of Securities Commissions (IOSCO).

Mr. Taub is a frequent speaker, having addressed numerous audiences sponsored by a variety of organizations, and writes a periodic column for *Compliance Week* on financial reporting developments. He is a licensed CPA in Michigan and Illinois and is a member of the American Institute of Certified Public Accountants.

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Value of the International Accounting Standards Board (IASB). From 2001–2003, he was a member of the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) and the Planning Subcommittee of the AcSEC. He has also been a member of the Global Financial Reporting Advocacy Committee and Chairman of the Financial Accounting Policy Committee of the CFA Institute.

Mr. Sondhi served on the FASB Task Force on Accounting for Impairments of Long-lived Assets and on the Steering Committee for the Statement of Cash Flows of the International Accounting Standards Committee. Mr. Sondhi was also an advisor to the FASB on its project comparing U.S. and International Financial Reporting Standards.

Mr. Sondhi received his Ph.D. in Accounting and Economics/ Management Science from New York University. He has taught at New York University, Columbia University, and Georgetown University. He has been a Visiting Professor at Stockholm University, Sweden, and Copenhagen Business School, Denmark. His research has been published in several accounting and finance journals.

In addition to co-authoring the 2006–2009 editions of CCH's *Revenue Recognition Guide*, Mr. Sondhi co-authored *The Analysis and Use of Financial Statements*, Third Edition, which is a recommended text for the Chartered Financial Analysts (CFA) program. Mr. Sondhi has also edited *Credit Analysis of Nontraditional Debt Securities*, co-authored *Impairments and Write-offs of Long-Lived Assets*, and co-edited *CFA Readings in Financial Statement Analysis*, and *Off-Balance Sheet Financing Techniques*.

Mr. Sondhi serves on the Board of Directors of an investment advisory services firm and one charitable foundation. He is also an advisor to several U.S. and foreign companies. His consulting activities include revenue recognition, valuation, and comparative analyses of financing and capital structure alternatives, creation and operation of finance, securitization, intellectual property, and investment subsidiaries, analyses of covenants, and the development of debt agreements. Mr. Sondhi has also served as an expert witness on many financial reporting issues.

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CHAPTER 1
INTRODUCTION

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OVERVIEW

Revenue is one of the most important indicators of a successful business. It is a key statistic used in the assessment of a company's financial health. The source, amount, and timing of reported revenue is relevant to all parties interested in financial data: company management, regulators, auditors, and users of financial statements. However, the determination of when and how much revenue to recognize remains difficult for accountants and industry professionals. The principal objective of *Revenue Recognition Guide* is to help all parties become more efficient and effective users of the revenue recognition and reporting literature. The *Guide* will also help its users develop more comprehensive revenue recognition policies.

The *Guide* comprehensively addresses the most important revenue reporting issues. It describes the appropriate accounting for each issue and explains the reason for that accounting. The *Guide* also provides practical examples and financial statement disclosures from public companies that illustrate the application of key concepts and judgments.

WHY A BOOK ON REVENUE RECOGNITION

Revenue Recognition Is Important to Financial Statement Users

Revenue-generating transactions are varied and can be extremely complicated. Because revenue reporting directly affects a company's results of operations and financial position, a thorough knowledge of the underlying concepts and practices is essential to the preparation and understanding of a company's financial statements.

The importance of revenue to the assessment of company performance has long been clear to the financial world. During the late 1990s, revenue was often viewed as the main driver of value for many companies, particularly those that were Internet-based. Small changes in revenue could often lead to huge changes in the market value of these companies. When the technology bubble burst in 2000, the steep stock price declines of many publicly traded Internet companies were attributed, in part, to the fact that their revenue numbers were not sustainable and, in some cases, misleading.

The Authoritative Literature Does Not Address All of the Issues

Despite the importance of revenue recognition to the financial statements of virtually all companies, the accounting literature on revenue recognition is neither comprehensive nor easy to apply. The revenue recognition guidance was originally published in over 200 separate documents by multiple standard-setters, including the Accounting Principles Board (APB), the Financial Accounting Standards Board (FASB), the Emerging Issues Task Force (EITF), and others. The introduction of the FASB Accounting Standards Codification (ASC) has significantly reduced the chances of being unable to identify relevant literature for a transaction, but other difficulties remain.

Most of the revenue recognition guidance is narrow in scope and only addresses specific issues or types of transactions. As a result, there is detailed guidance on some issues and little or no guidance on others. In addition, the development of revenue recognition guidance has occurred on an industry-by-industry basis, with the result that the models used by different industries are often inconsistent with one another.

Revenue Recognition Is a Leading Cause of Financial Reporting Errors

The lack of comprehensive guidance, combined with the variety and complexity of these transactions, has resulted in a large number of financial reporting errors. The staff of the Securities and Exchange Commission (SEC) issued two reports in early 2003 that highlighted revenue recognition as an area prone to problems: (1) Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (the Section 704 Report) and (2) Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (the Fortune 500 Report).

In developing the Section 704 Report, the SEC staff studied enforcement actions filed during the period July 31, 1997, through July 30, 2002. Improper revenue recognition was the area where the SEC brought the greatest number of enforcement actions during this period. The types of improprieties ranged from the improper timing of revenue recognition (e.g., improper recognition of revenue related to bill-and-hold sales and consignment sales) to fictitious revenue (e.g., falsification of sales documents, failure to consider side letter agreements) to improper valuation of revenue (e.g., failure to appropriately consider rights of return). Other revenue-related areas where the SEC brought a significant number of actions were nondisclosure of related party transactions and the accounting for nonmonetary and round-trip transactions.

The Fortune 500 Report resulted from the SEC's Division of Corporation Finance's (Corp Fin) review of all annual reports filed by Fortune 500 companies. This report provides insight into areas commonly questioned by Corp Fin during their reviews of annual reports. Revenue recognition accounting policy disclosures was an area frequently questioned by Corp Fin. In many cases, Corp Fin requested that companies significantly expand these disclosures. Industries where these requests were common included computer software, computer services, computer hardware, communications equipment, capital goods, semiconductor, electronic instruments and controls, energy, pharmaceutical, and retail. The revenue-related topics precipitating these requests included accounting for software, multiple-element arrangements, rights of return, price protection features, requirements for installation of equipment, customer acceptance provisions, and various types of sales incentive programs.

In addition, several other studies have shown that revenue recognition issues, more than any other issues, are the cause of the most financial statement restatements. Several high-profile revenue restatements over the last few years have reinforced the focus of regulators and the investing public on revenue recognition policy and disclosure.

The Authoritative Literature Is Changing

Largely in response to these problems, the SEC issued Staff Accounting Bulletin No. 101 (SAB 101), *Revenue Recognition in Financial Statements,* in late 1999, which explained the SEC staff's views on the application of the existing revenue recognition guidance. As a result, some companies were required to change their revenue recognition policies. The most significant impact of SAB 101, whose updated guidance is included in Topic 13, *Revenue Recognition,* of the Codification of Staff Accounting Bulletins, however, is that it focused the attention of most public companies on their revenue recognition policies and procedures. Even companies whose revenue recognition policies did not change as a result of the guidance in SAB Topic 13 have paid more attention to their revenue recognition policies and procedures since it was issued.

The FASB has made considerable progress on its project to provide comprehensive guidance on revenue recognition. This project may result in substantive changes to revenue reporting. See Chapter 13, "Future Expectations and Projects," for a discussion of this FASB project.

Tying the Literature Together

Because the revenue accounting literature is incomplete and was originally issued in many different pronouncements, it is often difficult to understand how it all fits together. This product makes it easier to identify the appropriate literature to follow (or analogize to) by: (a) addressing the issues in a topical manner, (b) providing references to the authoritative literature where appropriate, (c) providing guidance in areas that have not yet been addressed by standard-setters, and (d) providing explanations beyond those in the authoritative literature.

Seeing the Big Picture

The discussion above provides several good reasons why a product on revenue recognition is timely. This product addresses revenue recognition on a comprehensive basis, instead of issue-by-issue or transaction-by-transaction, making it easier to understand the fundamental principles and see common threads in the literature.

Focusing on the fundamental principles can also reveal the underlying logic that sometimes generates seemingly inconsistent conclusions. For example, although the same principles may be used to account for two different revenue transactions, the facts and circumstances related to each transaction will determine how to apply these principles and ultimately account for the transactions.

HOW THIS PRODUCT IS ORGANIZED

Introduction and Framework of Revenue Recognition

After an introduction and brief survey of the authoritative accounting literature in Chapter 2, Chapter 3, "General Principles," provides a detailed explanation of the FASB's conceptual framework on revenue recognition and a discussion of the criteria for revenue recognition that commonly appear in the revenue recognition literature and how these conditions are consistent with the conceptual framework. In addition, guidance is provided on how to evaluate satisfaction of these conditions.

Applying the Literature to Specific Transactions

The framework discussed in Chapter 3, "General Principles," is enhanced in Chapters 4–8, which discuss application of the general principles and criteria to specific types of transactions and issues. Chapter 4, "Multiple-Element Arrangements," addresses multiple-element transactions and explains when and how to account for separate deliverables. Chapters 5–7 discuss product, service, and intellectual property deliverables and explain how the general principles and criteria should be applied to these types of transactions. Chapter 8, "Miscellaneous Issues," addresses assorted issues that can affect revenue recognition in certain types of transactions. The discussion in these chapters is presented in the context of the conceptual framework.

Detailed Models in the Accounting Literature

Chapter 9, "Contract Accounting," and Chapter 10, "Software—A Complete Model," discuss two revenue recognition models that are comprehensively addressed in the accounting literature. Each model applies to a narrow group of transactions—accounting for certain long-term contracts (Chapter 9) and software revenue recognition (Chapter 10). Unlike the discussion of other issues in this product that is based, to a large extent, on analogy to common principles and concepts in revenue accounting, the guidance on contract accounting and software revenue recognition is taken directly from the accounting literature that was created to address these transactions. The recognition guidance in Chapters 5–8 generally does not apply to these transactions.

Financial Reporting

Chapter 11, "Presentation," and Chapter 12, "Disclosures," deal with issues that directly affect the financial statements. Chapter 11 focuses on an issue that is perhaps just as important as revenue recognition—the determination of what amounts should be reported on the revenue line of the financial statements as opposed to some other line. Chapter 12 discusses revenue recognition disclosures that are either required or desirable in the financial statements.

A Look Toward the Future

The product closes with a discussion of projects that have not yet been completed by the various accounting standard-setters. Given the ever-changing nature of the accounting literature on revenue recognition and the broad implications that certain projects-in-progress will have on revenue recognition, readers should closely monitor these projects.

CHAPTER 2
A BRIEF SURVEY OF REVENUE-RELATED LITERATURE

CONTENTS

BACKGROUND

Revenue recognition receives more attention than any other accounting topic. Despite this, standard-setters have never attempted to provide comprehensive, internally-consistent, and broadly applicable accounting standards for revenue. Instead, revenue recognition has been addressed on a fragmented basis, with various pieces of literature that deal with a wide range of topic- or industry-specific issues. Given the multitude of ways that companies earn revenue, it is not surprising that separate standards have been developed for specific types of transactions. For example, selling real estate is very different than selling software and leasing a product is different than originating loans. Accordingly, divergent