

2010–14

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# Revenue Recognition...Change Is Closer Than You Think

## A Joint FASB/IASB Project Update

### What's inside:

Overview .....	1
At a glance.....	1
The main details.....	1
Key provisions .....	2
Asset and liability model.....	2
Scope .....	2
Identify the contract with the customer .....	3
Identify and separate performance obligations in the contract .....	4
Determine and allocate the transaction price.....	5
Recognize revenue when performance obligations are satisfied.....	7
Subsequent measurement .....	8
Disclosure .....	9
Transition.....	9
Other considerations .....	9
Principal and agent .....	10
Options to acquire goods or services .....	10
Licenses and rights to use.....	11
Rights of return .....	11
Product warranties and product liabilities .....	12
Contract costs.....	12
What's next.....	13
Where to go for more information.....	13
Questions .....	13

### Overview

#### At a glance

- The FASB and IASB released a discussion paper in December 2008 to outline a new revenue recognition model that could significantly change the way entities recognize revenue.
- The new revenue recognition model is a single, contract-based, asset and liability model in which revenue is recognized upon the satisfaction of performance obligations, which occurs when control of an asset (whether a good or service) transfers to the customer.
- The boards have made substantial progress in their continued deliberations with only a few aspects of the model remaining to be discussed. The boards expect to issue an exposure draft in mid-2010 and a final standard in 2011.
- Management should continue to evaluate how the model might change current business activities, including contract negotiations, key metrics (including debt covenants), budgeting, controls and processes, information technology requirements, and accounting.

#### The main details

.1 The objective of the converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry. Existing guidance under U.S. generally accepted accounting principles (U.S. GAAP) may in some cases provide different revenue recognition models for contracts with similar characteristics. Existing International Financial Reporting Standards (IFRS) guidance can be difficult to apply beyond simple transactions, leading to diversity in practice.

.2 The comment period for the discussion paper ended June 19, 2009. More than 220 constituents from more than 20 countries provided feedback. Responses differed in tone and detail, but a majority supported the boards' overall objective of creating a single, comprehensive revenue recognition model.

.3 Since the boards issued the discussion paper, they have reached tentative decisions regarding scope, transition, measurement of contract consideration, contract combination and segmentation, principal versus agent considerations, and the accounting for options, licenses, return rights, and warranties.

.4 The boards also have made substantive clarifications to certain principles proposed in the discussion paper, in particular the principle for when revenue should be recognized and the accounting for arrangements that contain more than one deliverable.

.5 This DataLine explores the model as summarized for the February 2010 joint FASB/IASB board meeting. While aspects of the model will continue to evolve, we believe the tentative decisions reached to date reflect the key principles that we expect to be included in the final exposure draft.

.6 The boards' conclusions are tentative and subject to change until issuance of a final standard. The boards' decisions noted are based on commentary from recent board meetings and project updates published by the FASB and IASB. We encourage management to continue to monitor the boards' progress toward a final standard.

**PwC Observation:** Additional board meetings are scheduled for the coming months, leading up to the expected issuance of an exposure draft for public comment in mid-2010. The most significant items that remain to be decided are the effective date, disclosures, certain aspects of scope, and accounting for contract costs. The tentative board decisions are subject to change, but the most significant aspects of the model appear ready for public comment in the upcoming exposure draft.

## Key provisions

### Asset and liability model

.7 The revenue recognition model employs an asset and liability approach, the cornerstone of the FASB's and IASB's conceptual frameworks. Current revenue guidance focuses on an "earnings process," but difficulties often arise in determining when revenue is earned. The boards believe a more consistent application can be attained by using a single, contract-based model where revenue recognition is based on changes in contract assets and liabilities.

.8 A contract with a customer includes rights to receive consideration and obligations to provide goods or perform services. When the rights exceed the obligations, the entity has a net contract asset. When the obligations exceed the rights, the entity has a net contract liability. If no consideration is received at inception of the contract, the net contract position would be zero (i.e., no entry would be recorded).

.9 The underlying principle in the model is that revenue is recognized when a contract asset increases or a contract liability decreases as a result of the satisfaction of a performance obligation. An entity's net asset or net liability in a contract can change for a variety of reasons. For example, when consideration is received from a customer, the entity's gross contract asset decreases because its right to receive payment has decreased. Conversely, when an entity satisfies an obligation, such as through the delivery of goods or services, its gross contract liability decreases.

### Scope

.10 The model focuses on an entity's contracts with customers. A contract is defined as "an agreement between two or more parties that creates enforceable rights and obligations." A contract can be written, verbal, or implied.

.11 The standard is expected to apply to an entity's contracts with customers, except for:

- Lease contracts
- Insurance contracts
- Financial instrument contracts
- Guarantees (other than product warranties) within the scope of other standards

**PwC Observation:** The scope of the model does not focus on a specific industry; rather, the focus is on contracts with customers across all industries. Entities that currently follow industry-specific guidance will be required to apply the same model as all other entities.

We expect that most transactions accounted for under existing revenue standards will be within the scope of the revenue model. Transactions in industries where revenue is recognized absent a contract with a customer (e.g., certain biological, agricultural, or extractive industries) may not be in scope.

Entities with multiple-element arrangements may face challenges when some performance obligations are within the scope of the revenue model and other performance obligations are within the scope of other projects or accounting standards. The revenue model utilizes relative selling price to allocate consideration to performance obligations, while certain other standards utilize fair value or other measures that may require mark-to-market accounting or other reassessments. We expect the boards to continue to discuss this topic as they develop an exposure draft.

.12 The boards have proposed that an entity follow a four-step process in applying the model:

- Identify the contract with the customer
- Identify and separate performance obligations in the contract
- Determine and, if applicable, allocate the transaction price
- Recognize revenue when performance obligations are satisfied

### Identify the contract with the customer

.13 The model applies only to contracts with customers. There are a wide array of common business practices and legal requirements associated with customer contracts, across geographical and business boundaries. Customary practices should be considered in determining whether a contract exists.

.14 Under the model, a contract must:

- Have commercial substance
- Specify the goods or services to be transferred (i.e., define the performance obligations)
- Specify the amount of consideration to be paid by the customer
- Specify the manner and terms of settlement

There must also be an expectation that parties to the contract will satisfy their respective obligations (i.e., the entity's obligation to perform and the customer's obligation to pay).

.15 An entity may need to combine two or more contracts, or segment (i.e., divide) one contract into two or more contracts, to properly reflect the economics of the underlying transaction.

.16 An entity should combine two or more contracts into one contract if the prices of those contracts are interdependent. Contracts generally have interdependent pricing if they are:

- Entered into at or near the same time
- Negotiated as a package with a single commercial objective
- Performed concurrently or continuously

.17 An entity should segment one contract into two or more contracts if certain goods or services within the contract are priced independently from other goods or services in that same contract. Contracts have goods or services with independent pricing if:

- The entity, or another entity, regularly sells the goods or services on a standalone basis, and
- The price for all goods or services in the contract approximate the sum of the standalone selling price for each good or service (i.e., there is not an inherent discount for the purchase of bundled goods/services).

.18 The boards have suggested that a contract modification should be combined with the original contract if the prices of the original contract and the modification are interdependent (i.e., treat the modification and original contract as one contract). Management would first consider the factors in paragraph .14 above to determine whether a contract modification exists. Management would then consider the factors in paragraph .16 (as applicable) to determine whether the price of a modification is interdependent with the pricing of the original contract.

**PwC Observation:** Contract modifications come in a variety of forms. A modification can be a change in the scope of work, a change in pricing, or both. It is unclear how certain modifications will be accounted for under the model. For example, it is common in certain industries (such as aerospace and defense, and engineering and construction) for the parties to agree upon a modification to the scope of work, but agree on pricing at a later date (i.e., unpriced change orders).

### Identify and separate performance obligations in the contract

.19 A performance obligation is a promise to transfer an asset (either goods or services) to a customer. A contract may explicitly state performance obligations, but they may also arise in other ways. Legal or statutory requirements may create performance obligations even though such obligations are not explicit in the contract. A performance obligation may also be created through customary business practices, such as an entity's practice of providing customer support. An enforceable promise to transfer an asset to a customer, whether explicit or implicit, is therefore a performance obligation. Performance obligations do not include amounts paid to the customer in the form of cash, credit, or other items that the customer can apply against amounts owed to the entity.

**PwC Observation:** It is unclear how an entity would account for situations where a customer can receive either cash or require specific performance in the satisfaction of an obligation (e.g., cash settled warranty).

.20 The objective of identifying and separating performance obligations is to ensure that an entity's revenue is recognized when such obligations are satisfied (i.e., goods and services are transferred to the customer). Contracts should be evaluated carefully to ensure all performance obligations are identified.

.21 It is not necessary to account for performance obligations separately if all performance obligations are satisfied at the same time. An entity may need to account for performance obligations separately if the entity transfers the promised goods or services at different times (or continuously).

.22 Performance obligations that are "distinct" from other goods or services promised in the contract are accounted for separately.

.23 A good or service is distinct, and should be accounted for separately, if the entity, or another entity, sells an identical or similar good or service separately in the customer's market. In cases where the good or service is not sold separately either by the entity, or another entity, the following factors should be considered in determining whether a good or service is distinct:

- Is the good or service identified separately in the contract?
- Does the good or service have a distinct profit margin?
- Does the good or service have a distinct function?
- Is the good or service transferred to the customer at a different time?

.24 Performance obligations that are not distinct should be combined with other performance obligations until there are groupings of performance obligations that are distinct.

**PwC Observation:** Separation of performance obligations may be necessary in other situations, even if not required for recognition purposes. For example, a single contract that provides for the concurrent transfer of goods or provision of services may need to be separated for income statement presentation or segment disclosures.

## Determine and allocate the transaction price

### Determine the transaction price

.25 The transaction price in a contract reflects the consideration the customer promises to pay in exchange for goods or services.

.26 The transaction price is readily determinable in some contracts because the customer promises to pay a fixed amount of cash, due when the entity transfers the promised goods or services. In other contracts, management will need to consider the effects of the following when determining the transaction price:

- Variable consideration
- Collectibility
- Time value of money
- Noncash consideration

*Variable consideration*

.27 When consideration is not fixed, the transaction price is the probability-weighted estimate of consideration to be received. Such an estimate requires management to assess the probability of each possible outcome.

.28 An estimate of variable consideration is only included in the transaction price if it can be estimated reliably. The boards have indicated that an estimate is reliable only if an entity:

- Has experience with identical or similar types of contracts
- Does not expect circumstances surrounding those types of contracts to change significantly

.29 Management should consider several factors in assessing whether circumstances may change significantly, including:

- The impact of external factors
- The time until the uncertainty is expected to be resolved
- The extent of experience
- The variability in the range of possible outcomes

.30 An entity should refer to the experience of other entities if it has no experience of its own.

**PwC Observation:** Some industries and entities could experience a significant change in the timing of revenue recognition based on the model for variable consideration. Revenue may be recognized earlier than under the existing guidance if an entity can reliably estimate variable consideration. Management will need to assess the variable consideration to be included in the total transaction price at contract inception. This could result in increased volatility as estimates change, including a reduction of revenue for estimates adjusted downward.

*Collectibility*

.31 Collectibility refers to the customer's ability to pay the contractual consideration. The transaction price should be adjusted to reflect the customer's credit risk by recognizing the consideration expected to be collected on a probability-weighted basis.

**PwC Observation:** Existing literature requires that payment be reasonably assured (or probable) for revenue to be recognized. Therefore, the model may result in revenue being recognized sooner than currently permitted.

Assessing collectibility will require significant judgment in determining the potential consideration to be received. It is currently unclear whether the model will require subsequent changes in collectibility to be reflected as changes in revenue or an expense.

*Time value of money*

.32 The transaction price should reflect the time value of money whenever the effect is material. Management should use a discount rate that reflects a financing transaction between the entity and its customer that does not involve the provision of other goods or services.

**PwC Observation:** It is unclear how the time value of money principle would be applied in practice, but it may be complex. For example, should the principle be applied at the contract level or performance obligation level? This may be clarified as the boards continue their deliberations.

#### *Noncash consideration*

.33 Noncash consideration received for satisfying a performance obligation should be measured at its fair value. When fair value cannot be estimated reliably, the entity should measure the noncash consideration indirectly by reference to the standalone selling price of the goods or services transferred in exchange for the consideration.

#### Allocating the transaction price to performance obligations

.34 Contract consideration should be allocated to separate performance obligations in a contract based on relative standalone selling prices.

**PwC Observation:** The model will significantly affect entities that currently use the residual method to allocate arrangement consideration, as this method will no longer be permitted. Management will need to make an estimate of selling price for each separate performance obligation when standalone selling price is not available.

#### *Estimating standalone selling prices*

.35 The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. The selling price is estimated if a standalone selling price is not available. The use of observable inputs should be maximized in estimating the standalone selling price. Some possible estimation methods include:

- Cost plus a reasonable margin
- Evaluation of standalone sales prices of the same or similar products, if available
- Cash flow models or other valuation techniques

**PwC Observation:** Estimating the standalone selling price of performance obligations is a key aspect of applying the model. The model should result in a better reflection of the economics of the transaction, but it may create challenges in developing, documenting, and supporting the estimated standalone selling price. In addition to considering the impact the model will have on the financial statements, it is important that management consider whether new internal systems and processes (and related internal controls) are required to support the process of developing estimates. This will be particularly relevant for those entities not within the scope of the new U.S. GAAP guidance on multiple-element arrangements (EITF Issue 08-1, *Revenue Recognition with Multiple Deliverables*, which is codified in ASC 605-25, *Multiple-Element Arrangements*).

#### **Recognize revenue when performance obligations are satisfied**

.36 Revenue should be recognized when a promised good or service is transferred to the customer. An entity transfers a promised good or service and satisfies a performance obligation when the customer obtains control of that good or service.

.37 Performance obligations can be satisfied at a point in time or continuously over time. The transfer of control should be assessed for each separate performance obligation in a contract. Judgment will be needed in making this assessment. Indicators that may be considered in determining whether the customer has obtained control of the good or service include:

- The customer has an unconditional obligation to pay
- The customer has legal title
- The customer has physical possession
- The customer specifies the design or function of the good or service

**PwC Observation:** These indicators are not a checklist nor are they all-inclusive. All relevant facts and circumstances should be considered to determine whether the customer has obtained control of the good or service.

#### Continuous transfer of goods and services

.38 Management must determine when to recognize revenue when control is transferred continuously. The method that best depicts the transfer of goods or services to the customer should be applied consistently throughout the contract and to similar contracts with customers.

.39 The boards have identified the following as examples of methods for recognizing revenue when continuous transfer of control occurs:

- Output methods that recognize revenue on the basis of units produced, units delivered, contract milestones, or surveys of work performed
- Input methods that recognize revenue on the basis of costs incurred, labor hours expended, or machine hours used
- Methods based on the passage of time

.40 Revenue can be recognized on a straight-line basis when the pattern of transfer of goods or services over a specified period of time is indeterminate.

#### Subsequent measurement

.41 Performance obligations should not be remeasured after contract inception unless those obligations become onerous. A performance obligation is onerous when the direct costs to satisfy a performance obligation exceed the consideration allocated to it. The excess should be recognized as a contract loss with a corresponding liability that is remeasured at each reporting period.

**PwC Observation:** The boards continue to clarify the definition of "direct costs." Our understanding is that such costs would encompass: direct materials, direct labor, indirect costs that are either specifically attributable to the contract or specifically reimbursable under the terms of the contract, and those costs that are incurred only because the entity entered into the contract.

This proposal may represent a significant change for many U.S. entities as the recognition of onerous contracts is not currently permitted in U.S. GAAP outside of certain specific guidance (e.g., construction contract guidance). The onerous assessment is performed at the performance obligation level and not the contract level, so a loss may be recorded for performance obligations that are onerous even though the overall contract is profitable.

.42 The measurement of the contract asset should be updated each reporting period, or as circumstances change, to reflect changes in the transaction price. These changes should be allocated to the recognized performance obligations. The effects of those changes on satisfied performance obligations would be recognized as revenue in the period of change.

## Disclosure

.43 The boards continue to discuss disclosure requirements for revenue transactions. The FASB and IASB staff have proposed the following disclosures:

- Qualitative and quantitative information about performance obligations, rights to consideration, and onerous performance obligations to help users understand the characteristics of their contracts with customers.
- Significant judgments, and changes in judgments, to communicate the effect of those judgments on the timing and amount of revenue recognition in contracts with customers. Such disclosures should include (a) the effect on the amount of revenue recognized in the current period and (b) an indication of the expected effect on the timing and amount of revenue recognition in future periods.

**PwC Observation:** The boards have not yet decided on disclosure requirements for the exposure draft. Staff members are expected to present a revised disclosure package to the boards at the next joint meeting. The disclosure requirements proposed by the staff appear more detailed than is currently required under either framework. Management should closely follow the boards' decisions on this topic.

## Transition

.44 The boards have proposed full retrospective application of the model, including for those contracts that do not affect current or future periods, but affect reported historical periods.

.45 The FASB tentatively decided to prohibit early adoption of the proposed model, whereas the IASB will discuss the possibility of early adoption at a future meeting. The IASB, however, decided to permit early adoption by first-time adopters of IFRS.

**PwC Observation:** The effective date for the standard has yet to be decided, but the boards discussed a possible effective date no earlier than 2014 to provide management adequate time to prepare for and implement the standard.

We expect the model to require full retrospective application. The transition requirements may have a significant impact on entities, given the level of effort expected to be required and the anticipated costs of implementation.

The transition requirements may affect some entities more than others, depending on the number of reporting periods to be included in their regulatory filings.

## Other considerations

.46 The boards also considered the impact the following may have on the accounting for performance obligations in a contract:

- Principal and agent
- Options to acquire additional goods or services
- Licenses and rights to use
- Rights of return
- Product warranties and product liabilities

## Principal and agent

.47 Management will need to consider whether they are acting as a principal or an agent in a contract. Revenue should be recognized on a gross basis if the entity is the principal and on a net basis if the entity is acting as an agent. Management should consider whether its performance obligation is to provide the goods or services or to arrange for another party to provide those goods or services in determining whether it is the principal or the agent.

.48 Consideration should be given to the following factors in determining whether the entity is acting in a principal or an agent capacity:

- Which party has primary responsibility for fulfillment of the contract (i.e., primary obligor)
- Which party has inventory risk
- Which party has discretion in establishing prices
- Who bears customer credit risk
- Whether the consideration paid between parties is a commission

**PwC Observation:** This proposed principle and list of indicators is consistent with current revenue guidance under U.S. GAAP and IFRS. We do not anticipate a significant change in this area upon adoption of a new standard.

## Options to acquire additional goods or services

.49 An entity may grant a customer the option to acquire additional goods or services. That promise gives rise to a performance obligation if the option provides for a material right to the customer that the customer would not receive without entering into the contract. The entity recognizes revenue allocated to the option when the option expires or when the additional goods or services are transferred to the customer.

.50 The estimate of a standalone selling price for a customer's option to acquire additional goods or services should reflect the discount the customer would obtain when exercising the option. The estimated selling price should then be adjusted for the following:

- The discount that the customer would receive without exercising the option
- The likelihood that the option will be exercised

.51 A contract may include cancellation and renewal options (i.e., an option for goods or services similar to the original goods or services). An entity may allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.

**PwC Observation:** Options come in a variety of forms. The proposed accounting for these options as separate performance obligations may be a significant change from existing guidance. Furthermore, it is not clear whether there is, or should be, a difference in the accounting for options to acquire similar goods or services and options to acquire dissimilar goods or services. This is an area that would require further consideration by the boards.

## Licenses and rights to use

.52 The recognition of revenue for the license of intellectual property will depend on whether the customer obtains control of the asset. The contract is considered a sale (rather than a license or a lease) of intellectual property if the customer obtains control of the entire licensed intellectual property (e.g., the exclusive right to use the license for its economic life). If determined to be a sale, revenue is generally recognized when control transfers.

.53 If the customer licenses intellectual property on an exclusive basis but does not obtain control for the entire economic life of the property, the performance obligation is satisfied over the term of the license. In this case, revenue generally would be recognized over the term of the license.

.54 A contract that provides a nonexclusive license for intellectual property (e.g., off-the-shelf software) contains a single performance obligation. Revenue is recognized when the customer is able to use the license and benefit from it (i.e., when control transfers).

**PwC Observation:** The recognition model to be applied to a contract that includes intellectual property will depend on a number of factors, including:

- Whether control of the underlying asset transfers to the customer or merely gives the customer a right to use the asset
- Whether the license is exclusive or nonexclusive
- Whether the term of an exclusive license covers the duration of the economic life of the intellectual property

Due to the significance the model places on "exclusivity," we believe it will be necessary for the boards to clarify the definition of this term. A license might be exclusive for a number of reasons, such as for a specific territory (versus worldwide) or for a certain period of time.

## Rights of return

.55 The boards decided that the sale of goods with a right of return should be accounted for as follows:

- Revenue should not be recognized for goods expected to be returned; rather a liability should be recognized for the expected amount of refunds to customers using a probability-weighted approach
- The refund liability should be updated for changes in expected refunds
- An asset and corresponding adjustment to cost of sales should be recognized for the right to recover goods from customers on settling the refund liability, with the asset initially measured at the original cost of the goods (that is, the former carrying amount in inventory)

**PwC Observation:** The model for accounting for return rights is similar to today's failed sale model (i.e., revenue should not be recognized for goods expected to be returned). The model will require the full derecognition of inventory that has been sold and the corresponding recognition of an asset for the entity's right to recover goods from the customer. The return right (i.e., the asset) should be assessed for realizability in accordance with existing standards.

## Product warranties and product liabilities

.56 The boards' current proposal draws a distinction between quality assurance warranties and insurance warranties. A quality assurance warranty provides a customer with coverage for latent defects (i.e., those that exist when the asset is transferred to the customer but which are not yet apparent). This warranty does not give rise to a separate performance obligation but acknowledges the possibility that the entity has not satisfied its performance obligation. Management will need to determine the likelihood and extent of defects in the products it has sold to customers at each reporting period to determine the extent of unsatisfied performance obligations. No revenue should be recognized at the time of sale for defective products that will be replaced in their entirety. However, warranties that require replacement or repair of components of an item result in revenue being deferred for only the portion of revenue attributable to the components that will be repaired or replaced.

.57 An insurance warranty provides a customer with coverage for faults that arise after the product is transferred to the customer (e.g., normal "wear and tear"). These insurance warranties give rise to a separate performance obligation. A portion of the transaction price is allocated to that separate performance obligation at contract inception.

.58 Product liability obligations (e.g., when an entity is legally obligated to pay consideration if its products cause harm or damage), are not performance obligations. Such liabilities should be accounted for in accordance with ASC 450-20, *Loss Contingencies*, or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

**PwC Observation:** Management will need to use significant judgment to determine whether a defect is latent or has arisen subsequent to a sale. It may also be difficult to apply the guidance for quality assurance warranties when only a component of the asset sold will be repaired or replaced. For example, the contract may have only one performance obligation (e.g., the sale of a car) but the entity may be required to determine the amount of consideration associated with individual components of the performance obligation (e.g., the seats or the brakes) that are expected to be defective and subsequently repaired.

The model proposed for quality assurance warranties will represent a significant change from current practice. Currently, these warranties are recorded as a liability for the costs expected to repair defective products based on experience with similar contracts. Under the new model, revenue would not be recognized for defects that exist at the time of the original sale.

## Contract costs

.59 The boards tentatively decided not to include guidance on accounting for contract costs in the final revenue standard. Accordingly, an entity would recognize all contract costs as expenses when incurred unless they were eligible for capitalization in accordance with other standards (e.g., inventory, intangibles, property, plant, or equipment).

**PwC Observation:** The boards have resumed their deliberations on the accounting for contract costs. Existing revenue literature includes cost recognition guidance in a number of instances (in particular within U.S. GAAP). All existing revenue guidance will be superseded by the new standard, so the FASB is concerned that eliminating existing cost guidance may lead to diversity in practice. The FASB is therefore considering developing guidance on accounting for the costs of setting up and fulfilling a contract and will further discuss this topic at the March 2010 joint FASB/IASB board meeting. Whether and how guidance for contract costs will be provided remains to be seen. We encourage management to closely monitor the boards' decisions on this topic.

## What's next?

.60 There are several areas that need to be addressed prior to the issuance of an exposure draft. Some of the more significant areas that remain open are:

- Effective date
- Scope considerations for when a contract includes some performance obligations in the scope of the revenue recognition project and some performance obligations in other standards
- Disclosures
- Guidance on the accounting for contract costs

## Where to go for more information

.61 A summary of all tentative decisions reached by the boards relating to this project can be found at [http://www.fasb.org/revenue\\_recognition.shtml](http://www.fasb.org/revenue_recognition.shtml).

## Questions

.62 PwC clients that have questions about this DataLine should contact their engagement partner. Engagement teams that have questions should contact members of the Revenue team in the National Professional Services Group (1-973-236-4377 or 1-973-236-7804).

# DataLine

## 2010-14

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