1977

Accounting for service transactions; Exposure draft (American Institute of Certified Public Accountants), 1977, June 30

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

ACCOUNTING FOR

SERVICE TRANSACTIONS

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

This exposure draft has been prepared for public comment by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. It has been distributed to Members of Technical Executive Committees of the AICPA; State Society Presidents and Executive Directors; Chairmen of State Society Committees on Accounting Practices; and certain organizations outside the accounting profession. Copies are available to interested persons and organizations on request.

Comments should be sent in time to arrive not later than September 30, 1977 to

Paul Rosenfield, CPA
Director, Accounting Standards
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036

File Reference 4283

TABLE OF CONTENTS

INTRODUCTION

1. The number and variety of businesses that offer services to the public are increasing and the range of services offered is broadening. Personal services offered range from correspondence schools and health spas to retirement homes, cemetery associations, and perpetual care societies. Businesses may have their plants and products designed by engineering firms, their offices maintained by service and maintenance contractors, their products promoted by advertising agencies, or their records kept by computer service organizations. An all-inclusive list cannot be provided because the range of services is so wide. Variations in the pricing structure by type of service add to the complexity of a study of this area. For example, financial institutions have mortgage bankers or other institutions service certain mortgage loans for a fee based on outstanding principal; rights to the use of patented ideas are sold in exchange for advance or minimum royalties; transportation is provided for a charge based on distance and other factors.

2. Notwithstanding the wide range of services offered, all business entities that sell services must deal with these major accounting issues: the determination of the point or points at which revenue should be recognized as earned and costs should be recognized as expenses.

3. The fundamental standard for profit recognition is set forth in ARB No. 43, Chapter 1A, Rule 1: "Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sales price is not reasonably assured." APB Statement No. 4, which describes the basic concepts and accounting principles underlying financial statements of business enterprises, further explains the principles for profit recognition:

> Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place. (Paragraph 150)
>
> Revenue from services rendered is recognized... when services have been performed and are billable. Revenue from permitting others to use enterprise resources...is recognized as time passes or as the resources are used. (Paragraph 151)
>
> Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. (Paragraph 155)

> Since the point in time at which revenue and expenses are recognized is also the time at which changes in amounts of net assets are recognized, income determination is interrelated with asset valuation. (Paragraph 147)

4. Because of the wide variety of types of service transactions and the different characteristics of each type, diverse accounting methods have evolved to apply the fundamental principles to service revenues and costs. Furthermore, diverse accounting methods are used by entities engaging in similar transactions. The Division believes that the range of alternative accounting methods should be narrowed.

SCOPE OF STATEMENT OF POSITION

5. This Statement of Position applies to accounting for service transactions, including service transactions entered into by nonprofit organizations, that are reported in financial statements prepared in conformity with generally accepted accounting principles.[1]

---

[1] This Statement of Position does not specify the accounting for transactions that are in substance the receipt of contributions by a nonprofit organization such as a museum or alumni association; for example, if the services given or to be given in return are clearly not commensurate with the consideration received, the transaction should be treated as a contribution.

6. This Statement of Position is not intended to override or supersede existing accounting practices with respect to specified transactions or industries as set forth in AICPA Industry Accounting and Audit Guides and Statements of Position identified in Appendix A.

7. For purposes of this Statement of Position, a service transaction[2] is a transaction between a seller and a purchaser in which for a mutually agreed price the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use enterprise resources, that do not alone produce a tangible commodity or product[3] as the principal intended result (for example, services, not plans, are the principal intended result in a transaction between an architect and his customer).

---

2 According to Webster's New Collegiate Dictionary, the word "service" has twenty senses or subsenses. None of the various definitions comprehends all of the transactions contemplated by the definition in paragraph 7. Accordingly, it is difficult to define a "service transaction" with a high degree of precision and the definition in paragraph 7 must be applied in that light.

3 This Statement of Position does not deal with the determination of the cost of a facility the use of which is made available to purchasers, nor does it deal with the question of accounting for "start-up" costs, which is a broader problem found in a number of industries.

8. A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service. Illustrations of the application of the definition of service transaction to transactions that involve both services and product follow.

(a) If the seller offers both a service and a product in a single transaction and if any product involved is not separately stated in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the product, the sale of the product is either incidental or secondary or subordinate to the rendering of the service and the transaction is a service transaction that should be accounted for in accordance with the recommendations in this Statement of Position. For example, equipment maintenance contracts that include parts in their fixed price are service transactions, even though there may be individual contracts in which the value provided under the contract in the form of tangible product is ultimately greater than the value provided in the form of services. Conversely, if the seller offers both a product and a service in a single transaction and any service involved is incidental to the sale of the product and is provided or available to all purchasers (for example, express or implied warranties that are not sold separately), the transaction is a sale of product that should be accounted for as such, not as a service transaction.

(b) If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a sale of product that should be accounted for separately as such and a service transaction that should be accounted for in accordance with the recommendations in this Statement of Position. For example, equipment maintenance contracts that provide that certain or all parts will be charged for separately are service transactions except to the extent of any parts sold separately, which should be accounted for as sales of products.

9. In the following paragraphs the Division states its conclusions on:

(a) Revenue recognition for service transactions under three methods: specific performance, proportional performance, and completed service, with additional guidance on applying the proportional performance method.

(b) Classifying costs as initial costs, direct costs, and indirect costs and the accounting for each.

THE DIVISION'S CONCLUSIONS

Revenue Recognition

10. Revenue from service transactions should be recognized based on performance, because performance determines the extent to which the earnings process is complete or virtually complete. Performance is the execution of a defined act or acts or occurs with the passage of time, depending on the nature of the transaction. Accordingly, revenue from service transactions should be recognized as follows:

(a) Specific performance method - Performance consists of the execution of a single act and revenue should be recognized when that act takes place.

Initiation fees are sometimes charged to establish the customers' privilege to obtain subsequent services. Accounting for refundable initiation fees, which are not revenues, is beyond the scope of this Statement of Position. Nonrefundable initiation fees must be evaluated as to their substance. If they are, in substance, a means of advance collection for future services, they should not be accounted for as revenues at the time the fees are charged or collected but should be recognized as revenues as the services are performed.

(b) Proportional performance method - Performance consists of the execution of more than one act and revenue should be recognized based on measurement of the sales value of each act;[4] if performance consists of permitting others to use enterprise resources, revenue should be recognized based on measurement of the sales value allocable to each accounting period covered by the transaction as discussed more fully in paragraph 18.

---

4 Such measurements would need to be made only if the acts were performed in two or more accounting periods.

(i) In some cases, the sales value of each act is not specifically available. The relationship of direct costs incurred (see definition in paragraph 20) to the total estimated direct costs of providing the service may be an appropriate basis for measuring the sales value of each act or the sales value allocable to an accounting period, provided the total estimated direct costs can be reasonably estimated. (See paragraph 17.)

(ii) If measurement of sales value or direct costs is impractical, revenue should be recognized in a manner that reasonably relates revenue recognition to performance as discussed more fully in paragraphs 17(c) and 18.

(c) Completed service method - If services are performed in more than a single act, the proportion of services to be performed in the final act may be so significant in relation to the service transaction taken as a whole that performance cannot be deemed to have taken place until execution of that act. If services are to be provided in an indeterminate number of acts over an indeterminate period of time, there may be no basis for estimating the degree to which performance has taken place. In situations of either type, it may not be appropriate to recognize revenue except to the extent of initial costs (see paragraph 20) until completion of the final significant act of service.

11. In some situations, the degree of uncertainty surrounding realization of service revenue may be so significant that revenue should not be recognized until collection.[5]

12. The initial costs of a service transaction (see definition in paragraph 20) should be charged to expense as incurred and a portion of unearned revenues equal to the initial costs should be recognized as earned in the same period. Profit should not be recognized on such costs.

13. A minority in the Division believes that recognition of revenue in an amount equal to the initial costs of a service transaction is contradictory to the concept of revenue recognition expressed in paragraph 10, which provides that revenues should be recognized based on performance of the related services. The minority believes that incurring an initial cost is not equivalent to performing a service and should not be used as a basis for revenue recognition. In the view of the minority, the

---

5 Similar uncertainty concerning the collection of receivables is discussed in FASB Statement No. 5, appendix A, paragraph 23.

objective of associating or matching initial costs with revenue of the service transaction should be accomplished by deferring the initial costs and charging them to income during the period in which the revenues are recognized based on performance.

14. A purchaser may have the right to obtain a refund of a portion of the transaction price or an abatement of amounts he is otherwise obligated to pay, or it may be the seller's or industry practice to grant refunds or abatements. An adequate allowance for such refunds or abatements should be recorded as revenue reductions.

15. Service transactions that are part of a large, homogeneous group may be aggregated and considered as a group provided the recommendations in this Statement of Position can be substantially complied with.

Applying the Proportional Performance Method

16. If performance of services involves a specified number of identical or similar acts (for example, a coupon book sold by a car wash company), the revenue recognized for each act reasonably expected to be performed should be equal.[6]

17. If performance of services involves a specified number of defined but not identical or similar acts (for example, as

---

6 Nonrefundable amounts related to acts that are not expected to be performed and which do not escheat are therefore recognized as revenue over the number of acts expected to be performed.

to (b) or (c) below, a correspondence school that provides evaluation, lessons, examinations and grading, and so forth), the following guides for revenue recognition should be used, except for revenue recognized as earned in amounts equal to initial costs[7]:

(a) Revenue recognized for each act should be based on the ratio of (i) the sales value of each act at the amount at which each could be sold separately to (ii) the total of such individual sales values.

(b) If the measurements suggested in paragraph 17(a) are impractical or are not objectively determinable, revenue should be recognized based on the ratio of the seller's direct costs to perform each act expected to be performed to the total estimated direct costs of the transaction, if such costs can be reasonably estimated; all such revenue should be deemed to carry the same average gross margin rate.

(c) If the methods described in paragraphs 17(a) and (b) are not practical, revenue should be recognized on a systematic and rational basis over the estimated period during which the acts will be performed; the method selected

---

[7] See footnote 6.

should reasonably relate revenue recognition to performance. The straight-line method should be used to recognize revenue if no other systematic and rational basis is more representative of the pattern in which performance takes place.

18. If a service transaction involves an unspecified number of identical or similar acts with a fixed period for performance (for example, a maintenance contract on office equipment), revenue should be recognized on the straight-line method over the specified period during which the acts will be performed, unless evidence shows that some other method is more representative of the pattern in which performance takes place. Normal seasonality of service or prior experience as to the incidence of performance might constitute such evidence. If the seller agrees to provide facilities for a fixed period and the costs incurred by the seller are substantially the costs of holding a facility available for use (for example, a health spa or club), only the straight-line method should be used to recognize revenue. In this situation, performance is more closely related to the passage of time than to the incidence of use of the facility by the purchaser.

Cost Recognition

19. The principles set forth in the literature (see, for example, paragraph 155 of APB Statement No. 4) for recognizing

costs state, in general, that costs should be charged to expense in the period in which the revenue with which they are associated is recognized as earned. Costs are not deferred, however, unless they are expected to be recoverable from future revenues. Because of the wide range of service transactions and the variety of revenue recognition methods that may be appropriate in certain circumstances, the Division believes that more specific guidance is needed to implement those general principles. The following paragraphs are intended to provide that guidance.

Definitions

20. The following definitions related to costs have been adopted for purposes of this Statement of Position:

(a) Initial costs are incremental costs that have been incurred because of the negotiation and consummation of a specific service transaction, for example, commissions and installment paper processing fees.

(b) Direct costs are costs that have a clearly identifiable beneficial or causal relationship (i) to the service performed or (ii) to the level of services performed for a group of customers, for example, servicemen's labor and repair parts.

(c) Indirect costs are all costs other than direct costs and initial costs. They include provisions for uncollectible accounts, general and administrative expenses, general advertising expenses, and general selling expenses including salesmen's salaries. Indirect costs also include all allocations of facility costs (depreciation, rentals, maintenance, and other occupancy costs).

(d) Average gross margin rate is the ratio of (i) total revenues less initial costs less total direct costs to (ii) total revenues less initial costs. For example:

Total revenues	$1,000
Less initial costs	(200)
	800(ii)
Less direct costs	(400)
Gross margin	$ 400(i)

Gross margin rate:

(i) ÷ (ii) = 50%

Initial Costs and Indirect Costs

21. The initial costs to negotiate and consummate an agreement for a service transaction and the indirect costs of providing agreed services should be charged to expense as incurred.

Direct Costs

22. If revenues are recognized on a service transaction under the specific performance method as described in paragraph 10(a), all direct costs that do not exceed the amount of revenue expected to be realized on performance (see paragraph 29) should be charged to expense at the time revenues are recognized. Direct costs incurred before the service is performed should be deferred; however, deferred direct costs should not exceed the amount of revenue expected to be realized on performance of the service transaction reduced by estimated direct costs remaining to be incurred.

23. If revenues are recognized on a service transaction under the proportional performance method and revenue recognition is based on the relative sales value as described in paragraph 17(a) or on the incurrence of direct costs as described in paragraph 17(b), all direct costs should be charged to expense as incurred.

24. If revenues are recognized on a service transaction under the proportional performance method based on the passage of time or on another systematic and rational basis as described in paragraphs 17(c) and 18, direct costs, provided they can be reasonably estimated, should be recognized as expenses in a manner that results in the same average gross margin rate being attributed to all revenues recognized throughout the period during which the acts are performed, except revenues

recognized as earned in amounts equal to initial costs. This may require the deferral of costs or the accrual of costs. Deferred direct costs should not exceed the estimated amount of revenue remaining to be realized on the service transaction reduced by estimated direct costs remaining to be incurred. (See paragraph 29.)

25. The average gross margin rate should be calculated at least at each annual and interim reporting period and should be used in the determination of the cumulative revenues to be recognized as earned. The effect of any change in the rate should be recorded in accordance with APB Opinion No. 20, paragraphs 31 to 33.

26. If revenues are recognized on a service transaction under either the specific performance method or the proportional performance method and a reasonable estimate cannot be made of the maximum direct costs of performing all the services required to be performed under a given service transaction, all direct costs should be charged to expense as incurred. In these circumstances, furthermore, revenue should not be recognized as earned in a cumulative amount greater than the cumulative amount of costs incurred, because the ultimate profit on the service transaction cannot be reasonably estimated. If maximum total direct costs can be estimated with reasonable accuracy although direct costs could be less than that maximum, revenue and cost recognition

should be based on the minimum gross margin rate calculated using the maximum total direct costs.

27. If revenues are recognized on a service transaction under the completed service method as described in paragraph 10(c), all direct costs not in excess of estimated realizable revenues should be deferred until the revenues are recognized as earned. (See paragraph 29.)

28. If revenues on a service transaction are not recognized until they are collected because of uncertainties surrounding realization of service revenue, as described in paragraph 11, all direct costs should be charged to expense as incurred.

Other Matters

29. If a loss on a service transaction is indicated because initial costs plus current estimates of total direct costs of performance exceed current estimates of realizable revenue, provision should be made for the loss consisting of the excess of such costs over estimated total realizable revenue.

30. The notes to the financial statements should include an analysis of unearned revenue explaining the additions, amounts credited to earned revenues, and other significant changes, all presented in reasonable detail.

APPENDIX

PRONOUNCEMENTS RELATING TO ACCOUNTING FOR SERVICE TRANSACTIONS

- Statement of Financial Accounting Standards No. 13, Accounting for Leases

- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter II, Section A, "Cost-Plus-Fixed-Fee Contracts"

- Accounting Research Bulletin No. 45, Long-Term Construction-Type Contracts

- AICPA Industry Accounting Guides:

  Accounting for Franchise Fee Revenue
  Accounting for Motion Picture Films
  Accounting for Retail Land Sales
  Accounting for Profit Recognition on Sales of Real Estate

- AICPA Industry Audit Guides:

  Banks
  Brokers and Dealers in Securities
  Colleges and Universities
  Construction Contractors
  Finance Companies
  Fire and Casualty Insurance Companies
  Government Contractors
  Hospitals
  Investment Companies
  Medicare
  Savings and Loan Associations
  State and Local Governmental Units
  Stock Life Insurance Companies
  Voluntary Health and Welfare Organizations

- Statements of Position of the Accounting Standards Division of the AICPA

  Recognition of Profit on Sales of Receivables with Recourse (No. 74-6)
  Financial Accounting and Reporting by Face Amount Certificate Companies (No. 74-11)

Accrual of Revenue and Expenditures by State and Local Governmental Units (No. 75-3)
Accounting Practices in the Broadcasting Industry (No. 75-5)
Questions Concerning Profit Recognition on Sales of Real Estate (No. 75-6)
Accounting Practices in the Record and Music Industry (No. 76-1)
Accounting for Origination Costs and Loan and Commitment Fees in the Mortgage Banking Industry (No. 76-2)
Financial Accounting and Reporting by Investment Companies (No. 77-1)