Latest Developments for Revenue Recognition and IFRS in the United States

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How America's Participation in International Financial Reporting Standards Was Lost

By Chris Cox

Former SEC Chairman

"Today, I come to bury IFRS, not to praise them.

The fact is, far too much time has gone by with no meaningful progress. I think we have to fairly conclude that the moment has passed. Full-scale adoption of IFRS in the United States might once have been possible, but it is no longer. This is not a prognosis. It's just a statement of fact."

End of the Road for IFRS/US GAAP Convergence?

- Joint release by the FASB and the IASB of the new standard, Revenue from Contracts with Customers, in May 2014, was a triumph for international cooperation

- However, not so successful as it relates to convergence to IFRS

- Ian Mackintosh, Vice Chairman of the IASB, accused the FASB of “turning back the clock.” He characterized the current FASB approached as “remarkably similar” to the pre-IASB effort that after 25 years, “failed miserably.”

End of the Road for IFRS/US GAAP Convergence?

- Thomas Linsmeier, FASB Member, points out an issue in the utilities industry that strikes to the very core of the overall difficulty with brining IFRS and US GAAP into sync
  - US GAAP has a well worked out set of industry-specific rules for utilities to follow, while IFRS does not
  - IFRS is principles based, while USD GAAP is rules based
- At the height of the US enthusiasm for moving to IFRS, the country was reeling from the Enron and related financial disasters, enabled by unscrupulous exploitation of the "bright lines" of US GAAP rules
- That caused suspicion which clouded all of US GAAP, evoking calls to move to a more principles based set of standards, where judgment would replace form with substance

The Split Over Convergence

10/16/14 | CFO Magazine

- Failure in coming to terms on common standards for two major topics – **leases and financial instruments**

The recent divergence "requires us to recognize that differences in the cultural, business, legal, and regulatory environments in different jurisdictions inevitably will result in some differences in those standards."

Russell Golden, FASB Chairman

- Hoogervorst cites, "the structural fault with convergence, that **two independent boards with different imperatives have a nasty habit of reaching different conclusions.**"

ASU No. 2014-09 –
Revenue from Contracts with Customers

Overview

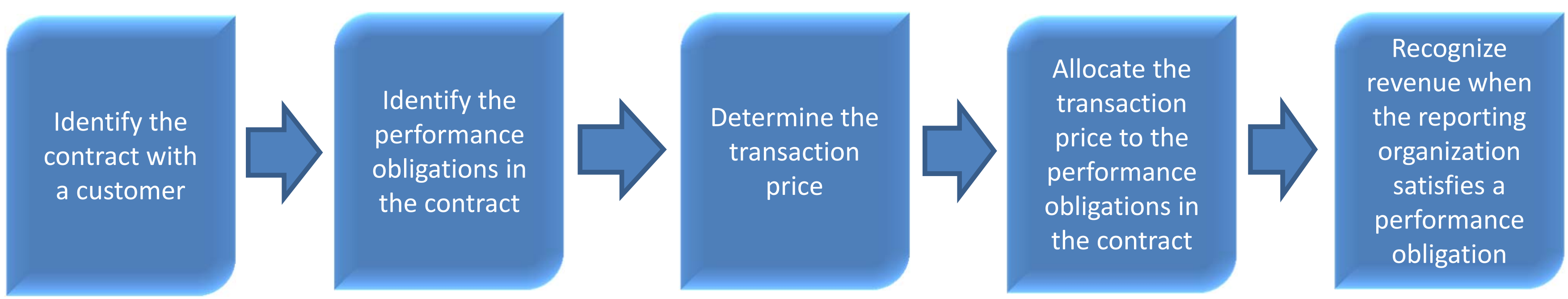
- May 28, 2014 - FASB and IASB issued converged guidance
- Will replace numerous, industry specific GAAP revenue recognition requirements
  - *Removes inconsistencies*
  - *Improves comparability across entities and industries*
- Effective for annual periods beginning after December 15, 2016 (public entities) or after December 15, 2017 (non-public entities)
  - *Early adoption is only permitted under IFRS*

Sources: fasb.org / aicpa.org / iasplus.com

Core Principle

- Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to.

5 Step Model to Achieve Core Principle



Sources: fasb.org / aicpa.org / iasplus.com

Step 1 – Identify the Contract with a Customer

- Must meet the following criteria:
  - Approval and commitment of the parties
  - Identification of rights of the parties
  - Identification of payment terms
  - Has commercial substance
  - Probable that consideration will be collected in exchange for goods or services

1

Sources: fasb.org / aicpa.org / iasplus.com

Step 2 – Identify the Performance Obligations in the Contract

- Contracts include promises to transfer goods/services
- When goods/services are distinct, the promises, or performance obligations, are accounted for separately
  - *Distinct goods/services can have benefits on their own or together with other readily available resources*
  - *Seller's promise to transfer goods/services is separately identifiable from other promises*

2

Sources: fasb.org / aicpa.org / iasplus.com

Step 3 – Determine Transaction Price

- Transaction price is the amount of consideration the entity expects to be entitled to
- May be fixed or variable amount
  - *If variable, an estimated amount of consideration should be made*
  - *Only to extent that it is probable that a significant reversal will not occur*
- Should be adjusted for TVM if contract includes a significant financing component

3

Sources: fasb.org / aicpa.org / iasplus.com

Step 4 – Allocation of the Transaction Price to Performance Obligations

- Typically allocate transaction price based on relative standalone selling price of each distinct good/service
  - *Use estimate if standalone selling price is not observable*
- Specific guidance applies when allocating a discount or variable consideration to one or more performance obligations

4

Sources: fasb.org / aicpa.org / iasplus.com

Step 4 – Allocation of the Transaction Price to Performance Obligations

How to estimate stand alone

non- observable selling price?

- Adjusted market assessment approach (what customer would pay)
- Expected cost plus a margin approach, or
- If price is highly variable or uncertain, a residual approach – total transaction price ($1,800 in the example) less sum of observable selling prices of the other goods or services

4

Sources: fasb.org / aicpa.org / iasplus.com

Step 5 – Recognize Revenue when the Reporting Organization Satisfies Performance Obligations

- Recognize revenue when customer obtains control of good/service
- Recognize amount allocated to distinct performance obligation
- Performance obligation may be satisfied at:
  - *Point in time (usually when transferring goods)*
  - *Over time (usually when transferring services)*
    - *Use appropriate method for measuring progress towards completion (output or input methods)*

5

Sources: fasb.org / aicpa.org / iasplus.com

Specific Industries Likely to be Affected

Step 1 – Identifying the contract with a customer
Aerospace, defense, healthcare, life sciences, real estate

Step 2 – Identifying the performance obligations
Licensors, real estate, software, telecommunications

Step 3 – Determining the transaction price
Aerospace, defense, asset management, construction, healthcare

Step 4 – Allocating the transaction price to performance obligations
Software, telecommunications

Step 5 – Recognizing revenue when performance obligation is satisfied
Aerospace, defense, construction, contract manufacturers, licensors, real estate, software

Sources: fasb.org / aicpa.org / iasplus.com

Other Areas of Guidance

- Incremental costs of obtaining a contract
  - *Recognize incremental costs to obtain a contract that the entity expects to recover, as an asset*
- Costs to fulfill a contract
  - *Recognize as an asset if:*
    1. *Relate directly to a contract*
    2. *Generate or enhance resources that will be used in satisfying performance obligations*
    3. *Expected to be recovered*

Sources: fasb.org / aicpa.org / iasplus.com

Disclosures

- Revenue from Contracts with Customers:
  - *Breakout of revenue into appropriate categories*
  - *Contract balances, including opening and closing balances of receivables, and contract assets/liabilities*
  - *Performance obligations and when typically satisfied*
  - *Transaction price allocated to remaining performance obligations*
  - *Significant judgments and changes in judgments*

Sources: fasb.org / aicpa.org / iasplus.com

Current GAAP vs. New Guidance

Current GAAP	New Guidance
Numerous requirements for recognizing revenue.	Consistent principles for recognizing revenue regardless of industry/geography.
Other than segment reporting, there is limited information disclosed about revenue contracts.	Disclosure requirements will provide financial statement users useful information about an organization's contracts with customers.
Many goods/services are overlooked as non distinct revenue generating transactions when in fact they may represent separate obligations.	Required to identify each good/service, determine if they represent a performance obligation, and recognize revenue when obligation is satisfied.
Transaction price can only be allocated to the extent that it is not contingent on delivery of future goods/services.	Transaction price is allocated among performance obligations based on standalone selling price, except when a discount or variable amount relates entirely to one or more performance obligation.
Accounting for variable consideration is inconsistent across industries.	Provides a single model for variable consideration, including rebates, discounts, and bonuses.

Implementation

- In 2013, FASB and IASB formed a group of 15-20 auditors, regulators, users, and other stakeholders to promote effective implementation and transition to the converged standard
- Accounting processes and internal controls may need revisions
- Sales and contracting processes may need to be reconsidered
- Tax planning revisions

Sources: fasb.org / aicpa.org / iasplus.com

Investor Impact

- More reliance on estimates and judgment when recognizing revenue
- Revenue could be recognized much sooner than when cash is actually received
- Investor may need to rely on operating cash flow more than before

Sources: fasb.org / aicpa.org / iasplus.com

Effective Date

- Public companies:
  – Annual reporting periods beginning 1/1/17 for calendar Y/E's
- Early application not permitted (but OK for IASB)
- Nonpublic companies:
  – Annual periods beginning 1/1/18 or 1/1/17 (same as public companies) but not earlier

Sources: fasb.org / aicpa.org / iasplus.com