CHANGES ARE COMING

It's time to pay close attention to a new revenue accounting standard proposed by the FASB and the IASB.

By Bruce Pounder, CMA, CFM

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are developing a new standard that will profoundly change the way reporting entities in nearly every industry account for revenue under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). As a result, accounting professionals throughout the world will need to completely relearn the fundamentals of accounting for revenue, including recognition, measurement, presentation, and disclosure. Because many accounting professionals are unaware of the challenges and business implications that await, I'll summarize the standard that the Boards have proposed, explain why it's "a big deal," and encourage you to begin familiarizing yourself with the proposal now.

Table 1: Types of Contracts Excluded from the Scope of the Proposed Standard

TYPE OF CONTRACT	U.S. GAAP REFERENCE (ASC TOPIC NUMBER)	IFRS/IAS REFERENCE
Debt and equity securities	320	IFRS 9
Debt in general	470	IFRS 9
Derivatives and hedging	815	IFRS 9
Extinguishments of liabilities	405	IFRS 9
Financial instruments	825	IFRS 9
Guarantees other than product warranties	460	N/A
Insurance contracts	944	IFRS 4
Lease contracts	840	IAS 17
Receivables in general	310	IFRS 9
Transfers and servicing (of financial assets)	860	IFRS 9
Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (e.g., an exchange of oil to fulfill demand on a timely basis in a specified location)	N/A	N/A

Background

In 2002, the FASB and the IASB began working together on a long-term project to improve and converge the revenue-accounting standards of U.S. GAAP and IFRS. The project is often referred to as the "revenue recognition" project, but it actually encompasses more issues than just whether revenue should or shouldn't be recognized in a particular situation. Additional aspects of revenue accounting that are within the project's scope include:

- How recognized revenue should be measured,
- How revenue and related costs should be presented in the financial statements, and
- Additional disclosures that reporting entities should make regarding revenue.

In developing a common, improved standard, the Boards have attempted to:

- Clarify the principles for recognizing and measuring revenue;
- Remove inconsistencies and weaknesses in existing revenue accounting standards and practices;
- Provide a more robust framework for addressing revenue accounting issues;
- Improve the comparability of revenue accounting practices across entities, industries, jurisdictions, and capital markets;
- Provide more useful information to users of financial statements through improved disclosure requirements; and
- Simplify the preparation of financial statements by reducing the number of requirements to which entities must refer.

After working together for six years, the FASB and the IASB reached the first major milestone of their joint project—the publication in December 2008 of the discussion paper (DP) titled *Preliminary Views on Revenue Recognition in Contracts with Customers*. It described a unified model for recognizing and measuring revenue that was unlike any of the multiple models found in U.S. GAAP or IFRS at the time. Although the DP reflected the significant progress the Boards had made toward the project's goals, it wasn't a proposal of specific changes to existing standards.

The FASB and the IASB achieved their next major milestone in June 2010 when each Board published an Exposure Draft (ED) that formally proposed a specific accounting model on which the revenue provisions of U.S. GAAP and IFRS would be based. They had agreed on a single converged model, but each one issued its own ED because of editorial, stylistic, and procedural differences in how the Boards planned to implement changes to their respective standards. Both EDs were titled *Revenue from Contracts with Customers*. It's interesting that the word "Recognition," which was included in the DP title, was dropped from the title of the EDs, thus reflecting the broader range of accounting and reporting issues that the Boards had been addressing.

After reviewing nearly 1,000 comment letters received in response to the June 2010 EDs, the FASB and the IASB redeliberated several issues. They remained in agreement as they modified their previously proposed revenue accounting model. On November 14, 2011, they issued revised EDs. Those EDs, like the Boards' original drafts, were formal proposals of changes to U.S. GAAP and IFRS. But the revised versions differed from the originals as a result of the Boards reaching different conclusions on certain issues during their redeliberations.

The IASB's November 2011 ED, like the one that preceded it, detailed a complete standard intended to replace existing International Accounting Standard (IAS) 18, *Revenue*, and IAS 11, *Construction Contracts*. In contrast, the FASB's June 2010 and November 2011 EDs described proposed changes to U.S. GAAP in essentially the same language as the IASB's EDs but didn't detail specific changes that would be made to the text of the FASB *Accounting Standards Codification®* (ASC). On January 4, 2012, the FASB issued a 239-page "companion" ED that *did* describe the specific changes to the ASC flowing from the Board's November 2011 ED. Shortly thereafter, the FASB issued a "combined" ED incorporating both the November 2011 and January 2012 EDs into a single document.

Summary of Proposed Standard

I'm not going to include a detailed explanation of the specific provisions of the joint proposal. Instead, I'm offering a high-level summary that will give you enough context to understand the significance of the proposal and the profound impact it's likely to have on reporting entities of all kinds if finalized as proposed.

In general, the proposed revenue standard would apply to any entity that:

- Enters into contracts to provide goods or services that are an output of the entity's ordinary activities (unless covered by other standards) and/or
- Sells certain nonfinancial assets that aren't an output of the entity's ordinary activities.

The proposed standard would apply to all contracts with customers except those listed in Table 1. The table also indicates where guidance on accounting for those types of contracts is addressed in existing U.S. GAAP and IFRS. This list of scope exclusions may seem extensive, but what remains in the scope of the proposed standard is quite substantial.

The proposed standard is rooted in this core principle of revenue recognition: "An entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services." Reporting entities would be required to apply the core principle by following a five-step procedure:

1. Identify contracts with customers.
2. Identify separate performance obligations within each contract.
3. Determine the transaction price of each contract.
4. For each contract, allocate the transaction price to the separate performance obligations.
5. Recognize revenue when (or as) the entity satisfies each performance obligation.

The proposed standard also addresses onerous performance obligations, contract costs, and various revenue-related disclosures. Additionally, extensive implementation guidance and illustrations are provided.

Impact on U.S. GAAP

With a high-level understanding of what has been proposed, let's examine the impact that the FASB's January 2012 ED would have on U.S. GAAP if the Board were to finalize its proposal.

The core principle of revenue recognition under U.S. GAAP would change significantly. The current core principle, found in ASC paragraph 605-10-25-1, is that revenue is to be recognized when it is (1) earned *and* (2) either realized or realizable. In contrast, as explained above, the proposed core principle abandons the notions that revenue must be "earned" and "realized or realizable." Not surprisingly, the proposed five-step procedure for applying the core principle is also entirely new.

Table 2 provides a quantitative summary of proposed changes to the ASC. To put Table 2's figures into perspective, the ASC currently contains 90 topics and approximately 485 unique subtopics (where a subtopic's content is duplicated in another subtopic—e.g., Subtopic 985-605's content is duplicated in Subtopic 605-985—it's counted once, not twice). Observe that the

Table 2: Quantitative Summary of Changes to the ASC

	TO BE SUPERSEDED	TO BE ADDED	TO BE AMENDED
ASC Topics	1	0	0
ASC Subtopics	38	3	107
ASC Glossary Terms	104	6	3

proposed standard would supersede (i.e., delete) or amend 30% of the unique subtopics in the ASC (38 plus 107 out of 485).

The proposed standard's qualitative impact on the ASC would likewise be profound. The proposed standard would *eliminate* industry-specific revenue guidance for entities in the industries listed in Table 3 and *significantly change* industry-specific revenue guidance for entities in the industries listed in Table 4. As a result, with regard to revenue, U.S. GAAP would become far less industry-specific than it is today.

Impact on IFRS

Now let's examine the impact that the IASB's November 2011 ED would have on IFRS if finalized as proposed.

The core principle of revenue recognition under IFRS would change significantly. The current core principle, as stated in the "Objective" section of IAS 18, is that "Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably." The proposed core principle completely abandons the notions of "future economic benefits," probability, and reliability of measurement. And as with U.S. GAAP, the proposed five-step procedure for applying the core principle would be entirely new to IFRS.

The substantive content of IAS 18 runs just over eight pages. The proposed standard contains 33 pages of substantive content plus a page of terms and definitions. Thus, *the proposed standard would more than quadruple the quantity of substantive guidance on revenue within IFRS.* As a result, the new guidance can be characterized as *significantly more prescriptive* than existing guidance. At the same time, the sole significant instance of industry-specific revenue guidance in IFRS (i.e., IAS 11) would be eliminated.

As noted earlier, two standards would be replaced, and 18 primary standards and four interpretive standards would be amended, but the amendments are relatively minor.

Business Implications

For many contracts with customers, the proposed standard would have little, if any, effect on the amounts and timing of recognized revenue. This would be especially true for typical retail transactions. In other cases, however, the proposed guidance would change revenue recognition and measurement significantly. Table 5 lists several examples.

In every case, the "how" of revenue accounting and reporting would change profoundly. This has significant implications for the preparation of financial statements and for internal control over financial reporting (ICFR) and external auditing of financial statements. Financial managers would have to develop, document, and implement new accounting and reporting policies and procedures and then demonstrate to internal and external auditors that they are following those policies and procedures.

Companies under the jurisdiction of the U.S. Securities & Exchange Commission (SEC) would face even more consequences if the proposed standard were finalized. Such companies would have to contend with extensive changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). As often discussed in *Strategic Finance*, the UGT is the "dictionary" of electronic "labels" that SEC registrants must use when submitting required filings to the Commission in XBRL (eXtensible Business Reporting Language) format. The FASB's January 2012 ED stated that the Board would soon expose for public comment the changes to the UGT that would be required if the provisions of the ED are finalized as proposed. But those

Table 3: Industries for which Guidance Would Be Eliminated

Airlines
Construction Contractors
Federal-Government Contractors
Development-Stage Entities
Certain Entertainment Entities (Broadcasters, Films, and Music)
Oil and Gas
Certain Financial-Services Entities (Brokers/Dealers, Depository and Lending, Mortgage Banking)
General Real Estate
Retail Land
Real Estate Time-Sharing Activities
Software

Table 4: Industries for which Guidance Would Be Changed Significantly

Agriculture
Certain Entertainment Entities (Cable Television, Casinos)
Investment Companies
Franchisors
Healthcare Entities
Not-for-Profit Entities
Real Estate Investment Trusts
Regulated Operations

Table 5: Examples of Potential Impact on Revenue Recognition and Measurement

In contrast to some existing standards and practices, the effect of a customer's credit risk (i.e., collectibility) would not affect the amounts or timing of recognized revenue.
In determining the transaction price and allocating it to separate performance obligations, an entity would be required to use estimates (e.g., standalone selling prices for each separate performance obligation) more extensively than when applying existing standards. Contracts having variable-consideration provisions could be particularly challenging in this regard.
Contracts for the development of an asset (for example, construction, manufacturing, and customized software) would result in continuous revenue recognition only if the customer controls the asset as it's developed. This isn't necessarily the same as current practice, nor would earlier transfer of control to customers necessarily be seen as desirable by the parties to long-term construction contracts.
An entity would be required to evaluate whether a license to use its intellectual property (for less than the property's economic life) is granted on an exclusive or nonexclusive basis. If a license is granted on an exclusive basis, an entity would be required to recognize revenue over the term of the license. That pattern of revenue recognition might differ from current practice.
Certain contract-acquisition costs would be capitalized and expensed over time rather than expensed as incurred.

changes hadn't been published at the time this article went to press.

Transition Planning

The Boards haven't decided on an effective date for the proposed standard. But they have decided that the standard won't be effective sooner than for annual reporting periods beginning on or after January 1, 2015. Additionally, the FASB plans to make the effective date for nonpublic entities at least one year later than the effective date for public entities.

Does this mean that accounting professionals can simply ignore the forthcoming changes to U.S. GAAP and IFRS for the next three years? No. There are three compelling reasons to devote significant attention to understanding what the FASB and the IASB have proposed for the future—*starting now*.

First, reporting entities would be required to apply the new standard *retrospectively* starting on the final standard's effective date. This means that, as of the effective date, entities would be required to adjust previously reported financial information that's presented on a comparative basis in conjunction with current-period information. Making the required adjustments would result in the comparative-period information being presented as *if the new standard had always been in effect*. Many entities would be required to adjust at least two years of comparative information (as required by SEC rules, for example) and possibly a far greater number of comparative years (as is common in practice). As a long-time financial-statement preparer myself, and as a consultant to many other preparers, I can assure you that waiting until the effective date that a standard is to be applied retrospectively before taking action is a recipe for maximum disruption, maximum effort, and maximum cost. Determining the correct adjustments after the fact for comparative-period numbers is much harder than determining the adjustments at the same time the numbers are reported initially. Thus, you have an opportunity to spend the years between the issuance of the final revenue standard and its effective date very productively.

Second, you'll have the benefit of knowing how contracts that you negotiate today will impact your financial statements in the future. This became very apparent to participants in professional-education seminars I conducted on the proposed standard in December 2011. Participants identified numerous, diverse examples of how they would *immediately* begin to negotiate different terms and conditions in contracts with customers.

Third, early application of the new standard would be permitted under IFRS although not under U.S. GAAP. Some entities might find it desirable to adopt early. And any entity that does so will force internal and external stakeholders to deal with the impact sooner rather than later.

As always, the EDs that the FASB and the IASB have issued are freely available in electronic format at the Boards' websites (www.fasb.org and www.ifrs.org). I encourage you to review the relevant ED(s) now in order to ensure an orderly, cost-effective transition to new standards in the future. And if you want to provide feedback to the Boards on what they've proposed, you can do so until the comment period ends March 13, 2012. **SF**

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