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Convergence: How the revenue recognition exposure draft might impact your company

Whether you are reporting under U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), the forthcoming revenue recognition standards will likely impact your company, either through minor adjustments to your current policy or through potentially significant changes to the way you record, track, and report revenue information.

The exposure draft issued last year proposes to supersede both IAS 11, *Construction Contracts*, and IAS 18, *Revenue*, and most of the extensive U.S. GAAP guidance, including multiple element arrangements (EITF 08-01 which replaced EITF 00-21), construction accounting (SOP 81-1), and software revenue recognition (SOP 97-2) under the pre-codification references currently codified in ASC 605.

The proposed transition guidance would require companies to apply the proposed requirements retrospectively, which, depending on the effective date, may result in certain arrangements in existence today being accounted for under the new guidance upon adoption. The timing of adoption has not been determined. However, the FASB and the IASB recently indicated that the effective date would not be before January 1, 2013.

Will your policy require some adjustments?

While most revenue arrangements should fit nicely into the new approach, others could result in changes to your existing recognition practices. Some examples — based on the proposals in the exposure draft — include:

- **Percent of completion:** Companies may need to change the method utilized to recognize revenue to a model that reflects the manner in which transfer of control has occurred (i.e., proportional performance, cost-to-cost, output method, etc.).
- **Sell through-type arrangements:** Under the proposed approach, a company may be allowed to recognize revenue when the product has been sold to the reseller (if the reseller controls the product (as defined)), the company has completed its performance obligation, and the company can reliably estimate the amount of revenue (i.e., estimate the number of returns expected from the reseller).
- **Contingent consideration:** Revenue may be recognized at time of delivery even if the amount of consideration is uncertain.

- **Variable consideration and royalties:** Companies may be required to develop complex estimates at contract inception and update this estimate throughout the arrangement in order to determine the total transaction price. Royalty arrangements often result in variable consideration. Companies may need to estimate the total amount of royalties expected to be received upon contract inception.
- **Modifications:** Contract modifications not deemed separate contracts (as defined in the proposed guidance) would be accounted for by recalculating the total transaction price and allocating the resulting amount to all performance obligations. The adjustment allocated to performance obligations that have already been satisfied, and included in prior periods, would be recorded at the time of the modification.

The exposure draft proposes a five-step process for recognizing revenue:

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price to performance obligations.
5. Recognize allocated revenue as each separate performance obligation is satisfied.

Additional disclosure requirements

The exposure draft would require companies to disclose more information than currently required by either IFRS or U.S. GAAP. For starters, the exposure draft would require companies to provide a reconciliation of their contracts with customers similar to a fixed asset roll forward. The reconciliation would, at a minimum, show each of the following, if applicable: amounts recognized from performance obligations satisfied, changes in the transaction price to performance obligations satisfied in previous reporting periods, interest income and expense, the effect of changes in foreign exchange rates, cash received, amounts transferred to receivables, noncash consideration received, and contracts acquired in business combinations and contracts disposed.

In addition to the comprehensive roll forward, entities would need to disclose the amount of the transaction price allocated to performance obligations expected to be satisfied in periods subsequent to year-end: one year, two years, three years, and later than three years (similar to the type of disclosure associated with debt maturities).

Next step: an assessment

The first part of the evaluation process is to assess the impact the proposals could have on your current accounting policies, followed by an evaluation of the potential impacts changes may have on your existing systems, processes, people, and resources. Unlike certain accounting changes which may be confined to a certain area of your business, modifications to revenue will likely have a broad impact.

An assessment of your current revenue recognition policies and processes should compare them against the current requirements and the proposals in the exposure draft. For example:

- Review your current revenue recognition policy.
- Review your typical contract terms and conditions.
- Identify arrangements that may be accounted for differently under the exposure draft.
- Analyze significant revenue arrangements focusing on your obligations to perform and the value provided to the customer.
- Evaluate the impact of the new standard on income tax accounting methods for revenue recognition.
- Obtain an understanding of your current system and process infrastructure.
- Identify and prioritize potential people, process, and technology changes which may impact your organization.
- Develop recommendations to manage organizational changes, enhance existing processes, and manage technology changes for a sustainable solution.
- Evaluate new go-to-market approaches under both the current guidance and the exposure draft.
- Prepare or enhance your current policy documentation.
- Develop a roadmap detailing the people, process, and technology activities and workstreams necessary to implement the expected accounting changes.

The assessment may identify gaps in your current policy as well as potential changes that may be necessary due to the exposure draft. Understanding these differences and changes may help your organization improve its current processes or documentation and gauge the significance of the exposure draft on the organization.

Boards issue additional guidance on impairment proposals

On January 31, 2011, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) (collectively, the Boards) issued a supplementary document (the Supplement) to the Boards' previous exposure drafts (EDs) related to impairment.[1] The proposals in the Supplement seek to address the feedback received from comment letters on each of their respective EDs. Additionally, the IASB's version includes an appendix which proposes separate presentation and disclosure requirements.

The Supplement proposes to replace the incurred loss impairment models in International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) with an expected loss impairment model. However, the proposals in the Supplement address only open portfolios of assets (i.e., portfolios which are constantly changing), which the Boards consider most challenging when applying an impairment model. The Supplement requests feedback from constituents on potential issues in applying the proposals to individual items or closed portfolios. The Boards will then consider these responses when they address closed portfolios and individual assets.

What is being supplemented?

The incurred loss impairment models in IFRS and U.S. GAAP were criticized during the financial crisis for delaying recognition of losses and not incorporating more forward-looking information. To address these concerns, the Boards issued separate EDs on impairment.

Under the proposals in the IASB's ED, the amortized cost of a financial asset would be the present value of the future expected cash flows from the asset, including consideration of future credit losses. Credit losses expected at initial recognition would be recognized by reducing the effective interest rate of the asset over its life. In contrast, subsequent changes to the estimate of future credit losses would be immediately recognized in earnings. The different treatments of initial estimates and subsequent changes in estimates of expected credit losses are supported by the view that credit risk was a key input into the pricing of the asset, and, therefore, initial estimates of future credit losses should be a component of interest revenue recognition. Accordingly, subsequent changes in credit risk that were not part of the consideration in the pricing of the asset should be recognized as profit or loss immediately.

The FASB's ED focused on ensuring the allowance account was sufficiently reserved for all lifetime estimated credit losses. To accomplish this, entities would be required to recognize impairment expense during the period the estimated loss estimate was made. This effectively results in immediate recognition of lifetime expected credit losses in earnings. However, the FASB's ED limited the amount of forward-looking information that could be used in the analysis.

The Supplement

Many comment letters acknowledged the conceptual merits of the proposals in the IASB's ED, but voiced significant operational concerns. Similarly, many of the FASB's comment letters applauded the removal of the "probable" loss recognition threshold, but did not agree with limiting the use of forward-looking information. More broadly, many constituents expressed concerns over the lack of convergence between the Boards' respective EDs. The Boards seek to resolve these issues through the proposals in the Supplement.

Expected credit loss estimates

In the Supplement, the Boards clarified that the lifetime expected credit loss estimate should consider all information available including internal and external information. This would include historical data and current economic conditions as well as supportable forecasts of future events and future economic indicators. This represents a convergence of the Boards' views from their initial EDs.

Presentation and disclosure

The appendix to the Supplement proposes presentation and disclosure requirements related to the proposals in the Supplement, and includes requirements for disaggregation and sets forth the goals of the required disclosures. A key change in the Supplement from the IASB's ED is the proposal that impairment losses be presented as a separate expense line item in profit or loss. Under the IASB's ED, interest income would be presented net of impairments.

Next steps

As noted above, the Boards are seeking feedback from constituents on the Supplement. In the interim, the Boards plan to continue deliberations related to issues identified in their original EDs. The IASB and the FASB expect to issue final credit impairment standards in June 2011 and during 2011, respectively.

[1] ED/2009/12 *Financial Instruments: Amortized Cost and Impairment*, and Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, issued by the IASB and FASB, respectively.

Industry corner: FASB proposes a softer fair value proposal

In December 2010 and January 2011, the U.S. Financial Accounting Standards Board (FASB or the Board) continued its redeliberation on the classification and measurement component of its project for financial instruments and made a number of significant decisions related to financial assets. These discussions are part of the FASB's redeliberation efforts on the joint project with the International Accounting Standards Board (IASB) on financial instrument accounting.

In contrast to the existing exposure draft (ED) issued in May 2010, under the accounting model tentatively approved by the FASB on January 25, 2011, an entity will be able to continue measuring some of its financial assets (e.g., loans) at amortized costs instead of measuring such instruments at fair value as originally proposed. The FASB's decision is tentative and therefore subject to change, as the Board has not yet concluded its deliberations or issued a final standard.

The FASB received 2,814 comment letters[2] on the ED and its January decision was intended to address the concerns expressed by the vast majority of those respondents. That proposal calls for financial instruments to be measured at fair value with changes in fair value recognized in net income, unless an instrument qualifies and an entity elects to have fair value changes recognized in other comprehensive income (i.e., a separate component of equity). Many respondents[3] raised concerns about the requirement for loans to be measured at fair value and suggested that carrying loans at fair value would increase the subjectivity of financial statements. In addition, many users believed that amortized cost is a better starting point for financial analysis when supplemented by information about the assets' quality and risk exposures. The banking industry[4], in particular, raised major concerns against the original proposal amid concerns that it would indirectly increase borrowing costs for consumers and potentially hurt an already fragile economy.

[2] The comment period for the Exposure Draft ended on September 30, 2010. 2,814 comment letters were received and posted on the FASB's website — www.fasb.org.

[3] Read the summary of feedback received on the classification and measurement model in the proposed ED at the FASB Accounting for Financial Instruments Project Update webpage.

[4] Of the preparer respondent group, 2,199 letters, or 95% of that group, represent comment letters submitted by banking institutions.

The FASB, in its redeliberation efforts, has decided to create three categories of financial assets, each to be measured and recorded in financial statements on a different basis. The three categories reflect the differences in how entities manage their assets, such as whether the assets are meant to be sold or held for the collection of the underlying cash flows.

1. For financial assets where an entity is holding assets for sale and actively trading them, the FASB will require entities to measure them at fair value and record any changes through net income.
2. For financial assets that are considered investments with a focus on minimizing risk and maximizing return, the assets would be measured at fair value with any changes recorded through other comprehensive income.
3. For financial assets where an entity plans to manage the asset and collect the cash flow it generates, such as loans that are not securitized but instead are held to maturity, the assets would be measured at amortized cost. This is a significant change from the FASB's original proposal in which this category was only available to financial assets that are short-term receivables.

This limited cost approach brings the FASB's model one step closer to the IASB's model in IFRS 9 and to the recommendations made by the AICPA's Accounting Standards Executive Committee (AcSEC), now known as the Financial Reporting Executive Committee (FinREC). The IASB — in its issued proposal that becomes effective in 2013 — already included a provision for loans that would permit such instruments to be carried at amortized cost as held to maturity.

The FASB's decision on valuing loans is part of a wide-ranging change in rules governing how companies account for financial instruments and is expected to be completed by June 2011. Financial instrument accounting is one of several high-priority projects that the FASB and the IASB are focusing on as part of their convergence efforts. We expect a revised ED to be issued in the future by the FASB.

IFRS resources

If you're looking to learn more about IFRS, join us for two days of IFRS executive training in San Jose, CA on May 17–18. Check our Website for more details and registration information. If you are unable to attend a classroom session, please consider our IFRS e-learning program which provides CPE credit.

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