

Straight away

IFRS bulletin from PricewaterhouseCoopers

IASB and FASB Propose Fundamental Changes to Revenue Recognition

What is the issue?

On June 24th, the IASB and FASB issued an exposure draft proposing a new revenue recognition model that could fundamentally alter the way entities across a variety of industries recognise revenue. The proposal is an output of the boards' joint efforts to develop a converged revenue recognition standard based on the same principles. A key objective is to increase the consistency of revenue recognition for similar contracts, regardless of industry. The proposed model requires a contract-based approach that focuses on the assets and liabilities that are created when an entity enters into and performs under a contract.

Performance Obligations:

Under the proposed model, revenue is recognized upon the satisfaction of an entity's obligations to its customer (performance obligations). The proposal defines a performance obligation as an enforceable promise in the contract that includes both explicit and implicit promises to transfer goods and/or services to a customer. Performance obligations are considered to be satisfied when control of a good or service transfers to the customer, which is when the customer is able to use, and receive benefits from, the good or service.

Identifying the performance obligations in a contract will be critical in applying the proposed model and will require significant judgment. This may be particularly challenging for service arrangements and long-term contracts. Also challenging will be determining when performance obligations should be combined and when they should be separated, which will be a key driver in determining the amount and timing of revenue recognition.

Transaction Price:

The boards are proposing that revenue be measured based on the transaction price, which is the amount the customer promises to pay in exchange for goods or services. The transaction price is usually easy to determine when it is a fixed amount of cash at the time of sale. However, it may be more difficult to determine if the consideration could vary in the future depending on the resolution of an uncertainty or when the transaction price is affected by the time value of money or involves non-cash consideration.

In what is a fundamental shift from most current practices, the transaction price will include variable or contingent consideration when such amounts can be reasonably estimated. In those cases, the transaction price is measured using a probability-weighted estimate of the consideration expected to be received. The transaction price should also reflect the customer's credit risk by recognizing only a probability-weighted estimate of the expected receipts and the impact of the time value of money, when material. The proposal will generally require greater use of estimates than under existing guidance.

The proposed model requires the transaction price to be allocated to performance obligations based on relative standalone selling prices. Other allocation methods used under existing guidance will not be allowed. The best evidence of the standalone selling price is the price of a good or service when the entity sells it separately. The selling price is estimated if a standalone selling price is not available.

After the inception of the contract, performance obligations are not re-measured unless the transaction price changes. For example, estimates of the transaction price could change particularly when there is variable consideration. The proposed model requires an on-going assessment, however, of the costs expected to satisfy outstanding performance obligations. If the direct costs exceed the allocated transaction price related to a performance obligation, a loss is recorded immediately.

Product warranties, rights of return, and licenses:

The proposal includes application guidance for some of the more common issues that arise in accounting for revenue, including product warranties, rights of return, and licenses. Product warranties will be accounted for differently than under current guidance, which may affect both the timing and measurement of revenue. The proposal also includes a model for customer return rights that is generally consistent with current practices. The timing of revenue recognition for licenses of intangible assets is based on whether the license is exclusive, and whether or not the license is for the entire economic life of the asset.

Disclosures:

The proposed model will require more extensive disclosures than are currently required under IFRS and US GAAP. The disclosures focus on qualitative and quantitative information, and the significant judgments and assumptions made in measuring and recognizing revenue.

Transition:

The boards are proposing that the new revenue recognition model be retrospectively applied upon adoption, meaning that an entity must apply the model to all contracts in existence in any of the periods presented in the financial statements (even for contracts completed before the year of adoption).

Am I affected?

The proposal will affect most entities whether they apply IFRS or US GAAP or would be applying *IFRS-converged Indian Accounting Standards* as per the IFRS roadmap issued by the Ministry of Corporate Affairs. Entities that have followed industry-specific guidance in the past may be more significantly affected. For example, the new model could cause pervasive change in a number of industries, including construction, pharmaceutical, aerospace and defense and technology.

The proposal applies to all entities, but certain types of revenue-generating arrangements are excluded from its scope. Arrangements excluded from the proposal are: lease contracts; insurance contracts; financial instrument contracts; guarantees (other than product warranties); and non-monetary exchanges whose purpose is to facilitate a sale to another party.

What do I need to do?

The comment letter period ends on 22 October 2010, and a final standard is expected in mid-2011. We will issue a Practical Guide shortly to provide a more comprehensive analysis of the proposal. Given the potential impact of the proposed changes, management should begin to assess the implications of the new model on their existing contracts and current business practices. Management should also consider commenting on the exposure draft to ensure their views on the proposed changes are considered.

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