

Making sense of a complex world

Revenue recognition in contracts with customers

IASB/FASB discussion paper on revenue recognition in contracts with customers
Preliminary assessment of impact on the retail and consumer industries

April 2009



Introduction

On 19 December 2008 the IASB and FASB issued a discussion paper setting out a joint approach to revenue recognition. The changes could be significant – with companies currently reporting under US GAAP being the most impacted. Even so, the proposals are important for companies reporting under IFRS, as the IASB is seeking to replace both IAS 18, 'Revenue' and IAS 11, 'Construction contracts'. Comments on the discussion paper are due by 19 June 2009.

There is no proposed final release date for a standard, but it is not expected before 2011, with an effective date no earlier than 2012. Experience has shown that comments made by preparers and users of accounts at the discussion paper stage are more likely to result in modifications in areas of principle than comments made when the document is closer to final publication.

Summary of the proposals

The discussion paper covers many aspects of revenue recognition. The overall objective is to develop a single revenue model using recognition and measurement principles that can be applied to all transactions. The discussion paper takes a balance sheet view of revenue and proposes that it represents either an increase in a net contract asset or a reduction in a net contract liability. Revenue arises when an entity satisfies a promise (which may be explicit or implicit within a contract) to transfer an asset to a customer. For a good, the obligation literally represents a promise to transfer an asset; for a service the asset may be 'consumed' immediately as the customer receives the service; however, the same principles would be applied. At the same time, the contract conveys to the entity a right to receive payment. The combination of rights and obligations will result in a net contract asset (remaining rights exceed remaining obligations) or liability (remaining obligations exceed remaining rights). It should be noted that revenue is not recognised until there has been a transfer of control of the asset, so accounting for long-term contracts under a 'percentage of completion' method would not be permissible unless there is a continuous transfer of control of the assets to the customer as the contract progresses.

As far as measurement is concerned, the discussion paper proposes using customer consideration to measure a performance obligation. It tentatively rejects the view that performance obligations should be measured at fair value, though there remains the possibility of using a fair-value-like approach in some cases, such as certain insurance contracts. The discussion paper does not address measuring customer consideration; this will be discussed at a later date. Clearly, this is not an issue where consideration is in the form of a fixed amount of cash, as cash is cash, but is relevant where there is a degree of contingency or potential adjustment for rebates and discounts.

Where contracts provide for the delivery of a combination of several goods and services, the discussion paper proposes that the goods and services should each be identified and separated. The total consideration should then be allocated to each performance obligation in proportion to the stand-alone selling prices (actual

or estimated) of the individual goods and services. Alternative methods of allocating consideration between multiple deliverables which are currently in use, such as the 'residual' and 'reverse residual' methods, would be prohibited. It is acknowledged that this will involve a much greater degree of estimation (for example, cost-plus or market-based estimates), but the standard setters believe that the alternative (that is, not separating a particular element) "will result in an entity accounting for a satisfied performance obligation as if it was unsatisfied ... which would impair the depiction of an entity's financial position and performance in a contract with a customer".

The discussion paper does not consider the treatment of costs and, in fact, proposes that no cost accounting guidance be included in the final standard. However, it does propose that all costs should be expensed as incurred, unless they are eligible for capitalisation in accordance with other accounting standards and highlights this as one of the areas where existing practice may be impacted.

Impact on the retail and consumer industries

So what does this mean for companies in the retail and consumer industries? Many of the details which are key to this analysis are yet to be determined, but there are some underlying principles in the paper which highlight the major areas of debate.

Accounting for warranties

The discussion paper considers all types of warranties to be separate performance obligations. It would therefore be necessary to separate the revenue from sale of the good from the sale of the warranty. Under the current standard this is usually only performed for extensions to the minimum statutory warranty. The financial statement impact of this change may not be significant, but it is likely that detailed system changes would be required. There may also be a debate around whether or not the retailer is acting as agent for the sale of the manufacturers' warranty, resulting in reduced revenues for retailers.

Right-of-return

The board has proposed two views relating to the right of return – either the right of return is a performance obligation or it represents a failed sale.

In the performance obligation model, some portion of customer consideration would be deferred for this obligation and recognised as the 'return service' is provided. The actual return of the goods would be accounted for as an acquisition of inventory at the time of the return. This model would be a significant change to current practice.

Under the failed sale scenario, the arrangement can be rescinded without consequence and revenue would not be recognised until the return period has expired. Some proponents of this model believe that an entity with many homogeneous transactions that give it the ability to estimate the number of failed sales would be allowed to recognise revenue for the transactions it expects to complete – rather than waiting until the return right expires. If this exception is relatively narrow, then the failed sale approach may lead to a significant timing delay for the recognition of revenue.

Loyalty programme

As this is a joint project, a significant impact of the paper would be harmonising loyalty programme accounting towards the current IFRS/IFRIC 13 model.

This would be a major change for US GAAP preparers who are still using the accrued cost model. There would however also be a less significant change for those IFRS preparers who currently use the simpler residual method for loyalty programme accounting. The new standard would require the relative fair value to be used for the different performance obligations.

Promotional promises

The current paper discusses two possible approaches. The debate centres around whether a discount voucher supplied with a good at the time of sale is itself a performance obligation which requires an element of revenue to be allocated to it. Alternatively, the discount can be considered an element of a future as yet unsigned contract and therefore has no accounting impact until the new contract is executed.

Vendor allowances/marketing programmes

The current paper does not address linkage of contracts which drives the current revenue recognition approach for vendor/marketing allowances. We anticipate this to be one of the areas the Board will consider as they develop the exposure draft of the standard.

Next steps for industry participants

We encourage those involved in the industry as preparers, investors or advisers to review the discussion paper and consider the 13 questions posed by the Boards. As a reminder, the deadline for comments to be submitted is 19 June 2009.

If you would like to discuss the contents of this briefing or any matter relating to accounting and reporting in the retail and consumer industry, please contact your local PwC service team or any member of the PwC Retail & Consumer Industry Accounting Group.

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