

How will your company respond to the proposed changes in revenue recognition?*

The FASB/IASB discussion paper and its potential impact on the technology industry



Table of contents

Introduction	2
Executive summary	3
Summary of the proposed model	7
The principle	7
Scope	8
How might the proposed model work in practice?	8
What areas have not been addressed by the boards?	13
Potential impact on the technology industry	15
Focus on the transfer of control of assets	15
Identification and satisfaction of performance obligations	19
Determination of stand-alone selling prices	22
Onerous contracts	25
Other measurement considerations	26
Sales incentives and discounting	27
Contract costs	28
Other practical considerations	28
Changes and challenges to consider	29
Next steps	32

This publication refers to issues specific to the technology industry.
For IFRS issues that cut across all industries, please refer to:
www.pwc.com/usifrs/publications

Introduction

A joint proposal by the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) may change the timing and amount of revenue recognition for technology companies. No change comes without challenge. The proposal, designed to improve consistency and comparability in financial reporting across international borders, may have implications for people, processes, and systems. However, the proposal also presents an opportunity to influence the development of a new converged revenue recognition standard. Companies may strategically seek out ways not only to simplify current revenue recognition accounting but also take advantage of future contract changes or negotiations to ensure that they are aligned with the proposal.

This publication is designed to help executives understand the potential impacts of the proposal on their businesses, identify challenges and opportunities, and encourage active participation in the standard-setting process by responding to the boards' proposal. PricewaterhouseCoopers (PwC) is currently formulating its global response and is planning to submit a comment letter on the proposal.

The proposal is described in a discussion paper (DP) titled *Preliminary Views on Revenue Recognition in Contracts with Customers*. The two standard setting bodies have taken a step toward a converged standard for revenue recognition that focuses on a single, contract-based, asset-and-liability model in which companies would recognize revenue based on increases in a contract asset or decreases in a contract liability resulting from satisfying performance obligations. This potentially represents a major shift for some technology companies—software companies in particular—that often follow industry specific guidance in recognizing revenue based on Generally Accepted Accounting Principles in the United States (US GAAP).

Companies should begin evaluating the changes and challenges now. A DP is usually followed by an exposure draft and our experience has shown that comments made by preparers and users during the DP stage are more likely to lead to changes than comment letters submitted during the exposure draft stage. Accordingly, companies will have the greatest impact in shaping the new model if they act now and submit a comment letter. The deadline to comment on the DP is June 19, 2009. By commenting, companies can make sure their voices are heard in defining a new converged revenue recognition standard. PwC can help companies further explore the proposed model, potential impacts, and examples discussed in this publication.

Executive summary

What are the biggest proposed changes? The DP is based on the principle that revenue is recognized when a contract asset increases or a contract liability decreases as a result of satisfying an obligation to deliver goods or services to a customer. A contract with a customer includes rights to receive promised consideration and obligations to provide goods or perform services. Revenue is recognized on the basis of increases in a company's net position in a contract with a customer.

In contrast to the DP's approach, US GAAP uses a rules-based approach with numerous standards and extensive accounting guidance for specific industries, notably software. International Financial Reporting Standards (IFRS), on the other hand, is more principles based with only a few standards on revenue recognition. The proposed model shares similarities with the principles of revenue recognition existing in both frameworks and may not have a significant effect on many transactions. However, there are a number of proposed changes to existing practice which are discussed further in this publication. The following are some of the more noteworthy changes proposed by the DP:

Change proposed by the DP	What it may mean for your company
A single revenue model for all contracts	Companies will no longer have to evaluate and comply with multiple standards for different classes of transactions or industries. All revenue transactions within the scope of the DP will be accounted for using a single model. For certain companies this will provide an opportunity to consolidate and perhaps streamline current processes for revenue recognition accounting and reporting functions.
US GAAP and IFRS will have a converged model	Companies will no longer be burdened by, or required to, track the impact of differences between US GAAP and IFRS. This allows resources to focus on other matters such as streamlining financial reporting processes and reducing compliance costs. Companies may also have opportunities to obtain greater comparability with global competitors, easier access to the capital markets, and cheaper capital.
Revenue will be recognized when performance obligations are satisfied by transferring the promised asset(s) to customers	Revenue will be recognized when performance obligations (i.e., an enforceable explicit or implicit promise to transfer an asset to a customer) are satisfied by transferring assets (goods or services) to customers (evidenced by when the customer controls the promised asset). The result may be different from the current concept of realization of an earnings process. This change may require that companies not only re-evaluate existing contracts, but it may provide opportunities to more effectively negotiate new contracts. The proposal is designed to eliminate current inconsistencies surrounding the notion and definition of the earnings process.

Change proposed by the DP	What it may mean for your company
The transfer of control of assets will drive revenue recognition	<p>The focus on the transfer of assets via control may change many existing revenue models. Current revenue standards consider other criteria, such as when risks and rewards are transferred to the customer or when collectibility is reasonably assured. The proposed model could have a considerable impact on the amount and timing of revenue recognition if control of an asset transfers at a different time than the transfer of risks and rewards. Collectibility could potentially impact the measurement of the contractual rights, but may not by itself preclude revenue recognition. In some cases, the transfer of control of an asset coincides with the transfer of risks and rewards of owning an asset, but in other cases it may not. This proposal may present challenges for companies that currently do not determine the satisfaction of a performance obligation by evaluating the transfer of control of assets to customers.</p>
Companies may no longer use the percentage-of-completion method as a separate revenue recognition model	<p>This proposed model may have a fundamental impact on accounting for some construction and other long-term contracts, including certain service arrangements. The percentage-of-completion method may no longer exist as a separate and distinct revenue recognition model. A company may only recognize revenue for its activities (consistent with current percentage-of-completion methods) when those activities concurrently satisfy performance obligations through the transfer of assets to the customer (e.g., the customer controls the in-process work product or there is a continuous transfer of assets to the customer).</p>
Performance obligations must be identified and separated	<p>The definition of a performance obligation is similar to the current concepts of “deliverable,” “component,” or “element,” but is broader. For example, a warranty or a customary business practice, such as a guarantee or a right of return, may be identified as separate performance obligations using the proposed model. The separation criteria in existing standards will no longer be relevant. Companies will separate the performance obligations in a contract whenever a company transfers the promised assets to a customer at different times.</p>
The transaction price will be allocated to separate performance obligations such as a warranty or a right of return	<p>Current practices of accruing warranty costs at the time of revenue recognition may be eliminated. Instead, a warranty may be considered a performance obligation to which a portion of the total consideration will have to be allocated and then recognized as revenue as the warranty obligation is satisfied. The satisfaction of the warranty obligation may not necessarily occur evenly over the contract life.</p> <p>Rights of return are currently accounted for using an estimated failed sale model, where, if certain conditions are met, revenue is reduced to reflect estimated returns. The boards continue to deliberate whether rights of return should be treated as either a performance obligation to provide a service pursuant to the contract, or a failed sale, as the customer has not accepted the terms of the sale since the arrangement can be rescinded without consequence.</p>

Change proposed by the DP	What it may mean for your company
Companies will be required to use estimates to reflect stand-alone selling prices	In the absence of observable stand-alone selling prices, the proposed model relies on the use of estimates to determine selling prices and to allocate the transaction price to performance obligations on a relative basis. As no estimation method is prescribed, a company will have flexibility to determine a method of estimation as long as it maximizes the use of observable inputs that result in the best estimate of the stand-alone selling price. Examples of estimation methods may include an expected cost-plus-reasonable-margin or a price that a customer in that market would be willing to pay. Companies may be able to allocate margins more appropriately and better reflect the economic realities of their transactions. Companies may be less constrained by some of the existing separation requirements for revenue recognition purposes.
Companies may have to change existing allocation and estimation methods	<p>The increased ability to separate multiple deliverable arrangements into performance obligations and allocate the transaction price using estimates may give some companies the flexibility to go to market with more bundled product and service offerings.</p> <p>Companies will be precluded from using the residual method. The proposal would permit allocation of consideration only on the basis of relative stand-alone selling prices. Recently proposed changes in US GAAP may also eliminate the use of the residual method in the near future.</p> <p>Deferral of revenue due to an inability to estimate selling price or due to restrictions imposed by existing standards—such as Vendor Specific Objective Evidence (VSOE) or Vendor Objective Evidence (VOE) of fair value—may no longer be appropriate. Companies currently challenged by difficulties in obtaining fair value will be provided with significantly more flexibility to demonstrate stand-alone selling prices using estimates, increasing the likelihood of revenue being recognized when goods and services are transferred to customers.</p>
Certain sales incentives may be treated as performance obligations	Revenue may be deferred until performance obligations are satisfied, such as when a customer redeems loyalty points. The proposed model does not currently address situations surrounding the measurement of consideration where cash is paid to customers or sales incentives are offered.
Certain contract costs may no longer be capitalized	The proposal does not include cost recognition guidance. However, in discussing the various models, the proposal does reiterate that contract costs should be expensed as incurred unless they meet the definition of an asset in another standard such as inventory, fixed assets or intangible assets. This may present a challenge for some companies that may have capitalized certain costs to acquire contracts or customers, such as sales commissions, that may not necessarily meet the definition of an asset.

Change proposed by the DP	What it may mean for your company
Performance obligations may need to be remeasured over the life of an arrangement	<p>The current proposal only requires remeasurement where performance obligations are determined to be onerous. A performance obligation is onerous when the expected cost to satisfy a performance obligation exceeds that performance obligation's carrying amount.</p> <p>The DP is silent to the impact of contract renewals, cancellations, and contingent consideration. Estimation of anticipated performance may be integral to companies with long-term contracts or contracts with significant variability in outcome.</p>

Although the DP does not present the complete revenue recognition model that the boards will propose in the exposure draft, it does provide the boards' preliminary views toward certain aspects of the model. The impact on companies may vary based on the nature and extent of industry-specific guidance currently used in practice. Companies should analyze the potential effects of the proposed model on their current business activities, including those surrounding contract negotiations, budgeting/forecasting, systems changes, taxes, and other related revenue recognition processes. This publication is designed to help companies identify opportunities to improve business processes in advance of these changes so that companies can make strategic decisions about revenue recognition that align with their overall business strategy. Through obtaining a deeper understanding of the impact of the key changes, companies will be able to provide vital feedback to the boards, either individually or collectively through an industry association.

Summary of the proposed model

The following summary is designed to help companies evaluate the proposed model with the understanding that the model will continue to evolve as the boards deliberate and update the proposed model for the exposure draft.

The principle

The principle in the proposed model is that revenue is recognized when a contract asset increases or a contract liability decreases as a result of satisfying a performance obligation. A contract with a customer includes both rights to receive promised consideration and obligations to provide goods or perform services. Contract rights are measured based upon the transaction price at the outset of the arrangement. Performance obligations are measured based on estimated selling price and are recorded at an allocated amount based on the total customer consideration. As a company performs its obligations in a contract, where the rights exceed the obligations, the company has a (net) contract asset. Conversely, where the obligations exceed the rights, the company has a (net) contract liability. A company would not recognize any revenue at contract inception since obligations are equal to the rights at the outset of an arrangement. Accordingly, a company's net position at contract inception is zero.

A company's net asset or net liability in a contract can change for a variety of reasons. When a customer pays cash, the company's contract asset decreases because its right to receive payments has diminished. Conversely, when a company satisfies an obligation, such as through the delivery of goods or services, its contract liability decreases because it is no longer required to provide those goods or services. The potential impact on the net contract position—and the impact if that net contract position is a contract asset or a contract liability—is illustrated in the following table:

	Net contract position	If net contract position is:	
		Contract asset	Contract liability
Customer pays (reduces remaining rights)	Decreases	Decreases	Increases
Company provides goods and services (reduces remaining obligations)	Increases	Increases (company recognizes revenue)	Decreases (company recognizes revenue)

Source: IASB's Discussion Paper - *Preliminary Views on Revenue Recognition in Contracts with Customers*, 2.32

In summary, revenue will be recognized as performance obligations are satisfied and control of the asset is transferred to a customer. Control of a good typically transfers when the customer takes physical possession. Control of a service generally transfers when or as the service is performed since the service either enhances a customer's existing asset or represents a benefit that the customer consumes immediately.

Scope

The proposed model applies to a company's contracts with its customers. A contract is defined as "an agreement between two or more parties that creates enforceable obligations." A customer is defined as "a party that has contracted with a company to obtain an asset that represents an output of the company's ordinary activities." A contract can be written, verbal, or otherwise evidenced, potentially resulting in both explicit and implicit obligations. The definition suggests that if an enforceable obligation is created, a contract exists. Industry-specific contracts are not excluded from the proposed model. The boards have asked whether the proposed model would provide decision-useful information for certain types of contracts such as:

- Contracts for financial and some non-financial instruments
- Insurance contracts
- Leasing contracts

How might the proposed model work in practice?

The DP does not explicitly provide guidance on implementing the proposed model so the following steps are designed to illustrate a possible alternative in evaluating contracts with customers. There may be other equally acceptable alternatives. After ensuring that a contract is within the scope of the DP, the following steps summarize how a company may evaluate a contract:

- Identify and separate performance obligations
- Determine the transaction price (including the measurement of contract rights)
- Allocate the transaction price to the performance obligations on a relative stand-alone selling price basis—that is, the company's selling price of the goods and services underlying the performance obligations
- Recognize revenue when performance obligations are satisfied as control of assets are transferred to the customer
- Remeasure performance obligations when deemed onerous

Each of these steps is discussed in greater detail below:

Identify and separate performance obligations

The proposal defines a performance obligation as “an explicit or implicit promise to transfer an asset (either goods or services)” to a customer. A performance obligation is similar to the concept of a “deliverable,” “component,” or “element,” but may have a much broader definition. Items that are not currently viewed as deliverables such as warranties or rights of return may be viewed as performance obligations in the proposal. As the separation criteria in existing standards will no longer be relevant, there may be an increase in the number of separately identifiable performance obligations identified in an arrangement.

Companies will separate the performance obligations in a contract whenever the company transfers the promised assets to a customer at different times. Companies will be required to unbundle all their contracts—not just what they may currently view as being multiple deliverable arrangements—into separate performance obligations when the customer receives the promised assets at different times. If a company promises to deliver a bundle of goods and services at the same time, then the company may account for those promised assets as a single performance obligation. While companies will need to initially identify all performance obligations, they may be able to group certain performance obligations together by evaluating the timing of the transfer of assets, thus reducing the total number of performance obligations that may have to be tracked and monitored separately.

Determine the transaction price, including the measurement of contract rights

The original transaction price is the consideration the customer promises at inception in exchange for the promised goods and services. The transaction price reflects the amount a company requires in exchange for taking on the related performance obligations. Performance obligations are initially recorded based upon an allocated portion of the original transaction price. A preliminary view on how a company would measure a contract right—specifically, an asset—has not been provided. Since it is anticipated that both contract rights and performance obligations will be based on the transaction price, a company’s net position in a contract is zero at the outset of an arrangement. Accordingly, no revenue is recognized at contract inception as no performance obligations have been satisfied.

Other measurement considerations, such as the time value of money and contract uncertainties, are currently being deliberated by the boards. The tentative view, based on recent board discussions, is that companies may have to record a separate financing component to reflect the time value of money (in situations where that effect would be material). Furthermore, uncertainties could potentially be reflected in the transaction price at contract inception based upon a probability weighted estimate that a company expects to receive from the customer. That estimate may then be updated over the life of the contract with corresponding adjustments made to the performance obligations. The DP and the boards' recent discussions have also not addressed the impact on the original transaction price of contract renewals, cancellation clauses, or other consideration provided to a customer.

Allocate the transaction price to performance obligations on a relative stand-alone selling price basis

Once determined, the original transaction price is allocated to performance obligations on the basis of relative stand-alone selling prices. This allocation reflects the company's selling price (i.e., the price to its customer) of the goods and services underlying the performance obligations rather than the fair value of the performance obligations themselves. (The fair value of the performance obligations would reflect the price that the company would have to pay another company for it to assume responsibility for satisfying those performance obligations, rather than the price the company charges its customers.)

The proposal precludes the use of other allocation methods, such as the residual method. In the current residual method, the amount of consideration allocated to the delivered item(s) equals the total arrangement consideration, less the aggregate fair value of the undelivered item(s). The inability to use the residual method in cases where there is evidence of stand-alone selling prices of undelivered items, but no such evidence for the delivered items, may be a significant change in practice for many technology companies. Recent US GAAP proposals to eliminate use of the residual method may force companies to evaluate both the implications and challenges of such a change sooner than expected.

Where observable stand-alone selling prices are not available, estimation is required. Consistent with existing concepts in IFRS and proposed amendments to certain transactions in US GAAP, the estimate of stand-alone selling prices could be based upon a cost-plus-reasonable-margin calculation or upon the estimated amount a customer in that market would be willing to pay for the goods or services underlying a performance obligation. Accordingly, deferral of revenue due to the inability to estimate the selling price or the restrictions imposed by current standards, such as VSOE or VOE of fair value, may no longer be appropriate.

Recognize revenue when performance obligations are satisfied as control of assets are transferred to the customer

Revenue recognition in the proposed model is driven by the transfer of control of the assets. Performance obligations are satisfied—and thus, revenue recognized—when control of a promised asset such as a good or a service is transferred to the customer. The boards are continuing to deliberate on a specific definition of control. However, transfer of control, as described in the DP, is generally presumed to occur when the customer controls the resource underlying the promised asset. This view of control is consistent with the boards' discussions on the definition of an asset in their joint conceptual framework project.

For companies currently utilizing a percentage-of-completion method for revenue recognition, the proposed model may significantly impact the amount and timing of revenue recognition. If control, such as ownership or lien rights to construction in progress, passes during the period of construction or service, revenue recognition is likely to be unchanged. However, where control does not transfer continuously, revenue may not be recognized until the customer takes control of the asset. In some cases, the transfer of control of an asset coincides with the transfer of risks and rewards of owning an asset, but in other cases it may not. The proposal might present challenges for companies that currently do not determine the satisfaction of a performance obligation by evaluating the transfer of control of assets to customers. The potential shift in mindset from a focus on transfer of risks and rewards to transfer of control of assets may be significant for some companies.

Other factors that are relevant today in determining the transfer of risks and rewards, such as customer acceptance, customer intent, or payment terms, may indicate the transfer of control, but may not be individually conclusive evidence of the transfer of control. Accordingly, the inability of a customer to use an asset that has been received may not affect revenue recognition unless the parties agree that control has not been transferred. Similarly, the pattern of customer payments only impact revenue recognition to the extent it is an indicator that transfer of control has occurred. The determination of whether collectibility is probable or reasonably assured may not impact recognition criteria in the proposed model, but the boards are expected to have additional deliberations on the measurement of the transaction price which will consider the impact of collectibility. The uncertainty surrounding customer payment could potentially be incorporated as a component of the measurement of rights in a contract where expected cash flows are reduced by an appropriate rate to reflect the credit risk associated with a transaction.

Remeasure performance obligations when deemed onerous

In the proposal, measurement of the performance obligation is only reassessed where obligations are determined to be onerous. A performance obligation is defined as onerous when the expected cost to satisfy a performance obligation exceeds that performance obligation's carrying amount. The boards have presented two models for consideration surrounding measurement of obligations as follows:

	Cost test	Current price test
Remeasurement trigger	When the company's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation	When the measurement of the performance obligation at a current price (e.g., in accordance with IAS 37*) exceeds the carrying amount of the performance obligation
Remeasurement	Remeasure the performance obligation to the company's expected cost of satisfying the performance obligation	Remeasure the performance obligation to the current price (e.g., the amount in accordance with IAS 37)

Source: IASB's Discussion Paper - *Preliminary Views on Revenue Recognition in Contracts with Customers*, 5.81

*International Accounting Standard 37 *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37)

The boards' preliminary views support the cost test; however, there is still debate over whether performance obligations should be remeasured only when they are onerous. In particular, there are concerns that useful information will not be provided to investors in situations where outcomes are highly variable because of volatile prices or where significant changes in circumstances are likely, such as certain insurance contracts. There is an inherent risk that the initially determined measurement may not provide decision-useful information about the company's performance obligations at each financial statement date since significant changes in circumstances are likely in these types of arrangements.

The proposal only outlines initial views on when an obligation becomes onerous and the subsequent implications on remeasurement. All practical aspects of accounting for onerous obligations have not yet been fully explored and there may be additional changes proposed in this area.

What areas have not been addressed by the boards?

The following table summarizes some areas not fully addressed by the boards and highlights other areas where application guidance may be needed. This is not a comprehensive list of areas to be deliberated by the boards.

Areas not addressed	
Measurement of rights	<ul style="list-style-type: none">• Time value of money• Uncertainty (including credit risk and contingent consideration)• Non-cash consideration
Contracts with customers	<ul style="list-style-type: none">• Contract renewal and cancellation options (including return rights)• Contract aggregation or disaggregation• Changes in the contract's terms and conditions after contract inception
Presentation	<ul style="list-style-type: none">• Gross or net presentation of the rights and obligations in the contract• Gross or net presentation of contract liabilities and contract assets• Display of remeasurements in the statement of comprehensive income• Gross versus net presentation of revenue
Consequential amendments	<ul style="list-style-type: none">• The effect of proposed model on existing revenue recognition standards and cost recognition guidance
Areas addressed without preliminary views	
Scope of a general revenue recognition standard	<ul style="list-style-type: none">• Decide whether any particular types of transactions should be excluded from the scope of the standard, such as financial instruments, insurance contracts, or leasing arrangements.
Alternative measurement approach	<ul style="list-style-type: none">• If the boards conclude that a different measurement approach is required for some contracts, they will consider the criteria for determining when that approach is required and the measurement basis for that approach.

Areas addressed but application guidance needed

Identification of performance obligations	<ul style="list-style-type: none">• Guidance to help companies identify performance obligations consistently
Satisfaction of performance obligations	<ul style="list-style-type: none">• Guidance to help companies assess when performance obligations are satisfied
Measurement of performance obligations	<ul style="list-style-type: none">• Guidance on how a company should determine stand-alone selling prices for the purpose of allocating the transaction price to separate performance obligations

Additional considerations

Onerous contracts	<ul style="list-style-type: none">• Which costs should be included in the onerous test and in the remeasurement of an onerous performance obligation?• At what unit of account should the onerous test operate — a single performance obligation, the remaining performance obligations in a contract, or a portfolio of homogeneous performance obligations?
Disclosure	<ul style="list-style-type: none">• Disclosures required to improve the decision-usefulness of information provided to users of financial statements
Transition and effective date	<ul style="list-style-type: none">• The effective date of the general revenue recognition standard and the transition guidance required

Potential impact on the technology industry

The DP represents a step toward moving US GAAP and IFRS to a single, contract-based revenue recognition model. The proposed model is designed to reduce complexity in guidance and provide a principles based approach that will increase consistency and comparability between companies. As the DP introduces an incomplete model, the discussion, examples, and assumptions used in this publication may change as the boards continue their deliberations. This section is designed to help companies think through the potential impact of both the proposed model and some areas that have yet to be addressed by the boards. There may be other equally valid interpretations of the proposed DP, US GAAP, or IFRS models based upon assumptions or specific facts and circumstances.

Focus on the transfer of control of assets

The focus on transfer of control of assets in determining when revenue is recognized may be a significant change to existing models. Although the boards have not completed their deliberations on what constitutes control, the DP does provide examples indicating when control of an asset may transfer. Some indicators of the transfer of control discussed include physical possession, non-refundable cash payments, or customer acceptance. Recognizing revenue when assets are transferred to a customer is consistent with many existing standards. However, identifying that transfer on the basis of control of an asset may differ from existing standards that identify the transfer on the basis of the risks and rewards of ownership.

Example 1: Transfer of goods in connection with a service

Situation: A company agrees to build and install a local area network for a customer. The network hardware is delivered to the customer in advance of the installation. Should the company recognize revenue for the hardware when it is delivered, or once the installation is completed?

Discussion: The DP acknowledges that it may be difficult to determine when an asset is transferred if it is used in satisfying a future performance obligation. Accordingly, it is presumed that an asset used in satisfying a future performance obligation is not considered to be transferred to the customer until used. However, this rebuttable presumption may be overcome if other factors such as the contract terms or local law clearly indicate the asset has been transferred to the customer before being used to satisfy other obligations.

Given the facts in this example, it is unclear whether the customer controls the hardware when delivered. The presumption may be that the hardware has not transferred to the customer until the hardware is used in satisfying the performance obligations of the building out services and the installation services. This presumption may be rebutted if the terms of the contract clearly indicate that the hardware has been transferred to the customer before it is used in satisfying the other performance obligations. If this were the case then the performance obligations may include the promise to transfer the hardware, the building out services, and the installation services. In either case, a company should evaluate if there are any other performance obligations, such as a warranty or a right of return, that may need to be identified and accounted for separately.

This example highlights the complexities surrounding the determination of the transfer of control and how fundamental it is to the timing of revenue recognition. There are additional indicators such as customer acceptance; payment and intent that may help determine when a performance obligation is satisfied, as follows:

- Contract terms may specify that payment is only due once the asset is formally accepted by a customer. However, where goods have been delivered to the customer in accordance with contract specifications, written acceptance may only be a formality and may not preclude revenue from being recognized upon delivery.
- Customer payment terms and the customer's ability to recover those payments may help to determine whether an asset has been transferred. If a company enters into a service contract that requires non-refundable progress payments during the contract, this may indicate that the partially completed asset transfers to the customer as the contract progresses.
- Customer intent alone does not affect when a performance obligation is satisfied. However, contract negotiations may reflect the customer's intent by specifying when control transfers and thus when performance obligations will be satisfied.

Consider the following example:

Example 2: Ability of a customer to use an asset

Situation: Customer buys a hard drive, keyboard and monitor from Vendor, who delivers the hard drive only to Customer in the first week. Vendor ships the keyboard and monitor to Customer two months later.

Discussion: In the proposed model, Vendor’s performance obligations—the promises to transfer the hard drive, keyboard, and monitor—are satisfied when Customer obtains control of each promised asset. Customer takes control of the hard drive in the first week and the monitor and keyboard two months later. Even though the customer may not intend to use the individual products on a stand-alone basis, they are delivered separately and revenue may be recognized for each product upon delivery as each performance obligation has been satisfied, as control of each asset is transferred. This may be a departure from existing standards, where the transaction may be viewed from Customer’s perspective—that is, if Customer views the purchase as one bundled product due to an “essential to functionality” point of view or lack of stand-alone value, or where the Vendor is unable to separate the bundled product due to a lack of fair value. In either scenario, all of the revenue may be recognized upon delivery of the last item using existing standards. However, in the proposed model, if the contract terms were such that control over all products does not transfer until the last item is delivered, revenue may also not be recognized until control of the last item is transferred to Customer.

As illustrated in this example, the inability of a customer to use an asset that has been received may not affect revenue recognition unless the parties agree that control has not transferred. Similarly, the pattern of customer payments or requirement for acceptance by a customer may only impact revenue recognition to the extent it may be an indicator that transfer of control over an asset has occurred, such as when non-refundable payments are made or acceptance is determined to be substantive.

The proposed model may also fundamentally change accounting for certain construction and other long-term contracts, including service arrangements, as the percentage-of-completion method will no longer exist as a separate revenue recognition model. A company may only recognize revenue for activities completed in a contract when those activities concurrently satisfy performance obligations through the transfer of assets and control to the customer. Technology companies with contracts currently in the scope of Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-*

Type Contracts (SoP 81-1), such as those providing complex electronic equipment or those providing significant software customization using Statement of Position 97-2 *Software Revenue Recognition*, may need to re-evaluate whether control transfers to the customer during the construction period or only at the end of the project. The proposed model may be less of a change for companies utilizing the approach of International Financial Reporting Interpretation Committee's IFRIC 15 *Agreements for the Construction of Real Estate* which addresses continuous transfer in International Accounting Standard 18 *Revenue*. Where companies cannot demonstrate a continuous transfer of assets, revenue may not be recognized until the customer takes control of the asset.

Example 3: Continuous transfer of assets

Situation: Customer hires Vendor to design and construct a customized system (the build) and then to host the software and system and process transactions (the run). Customer will make non-refundable progress payments based upon the stage of completion of work. The system will be subject to written acceptance from Customer at completion of the build.

Discussion: Using the proposed model, revenue is recognized for the build when control of the asset is transferred to Customer. The challenge is to determine how and when control is obtained by the Customer. In these types of scenarios, all facts and circumstances, such as non-refundable payments and written acceptance, should be evaluated to determine when control of the asset transfers. Further, the nature of the contract will have to be understood to determine whether Customer has an ownership claim to the work in process or lien rights to take over the work in process. This determination will rely heavily upon management judgment and the legal contract terms. However, where construction activities do not result in a transfer of control of the asset to Customer, Vendor's net position in the contract may not increase as it completes the work and revenue may not be recognized until completion, delivery, and acceptance of the build.

This example illustrates that in the proposed model revenue reflects the transfer of promised goods or services to customers and not necessarily the activities of the company in producing those goods or services. Activities undertaken by a company to fulfill a contract results in revenue at the time of those activities only if they simultaneously satisfy a performance obligation by transferring an asset to the customer.

Companies within the software industry may also have to re-evaluate when control of assets transfer to a customer. Certain perpetual software licenses only permit the right to use intellectual property. Does this constitute transfer of control of asset or is this more akin to a right to use or a lease that is currently being viewed as outside the scope of the proposed model? Companies will need to follow the boards' deliberations to see if leases of certain assets may be included in the scope of the proposal. What about term license agreements, hosting arrangements or subscription sales models—do these constitute a service or has there been transfer of control of the license? Similarly, if a software license is delivered upfront electronically but the customer typically also requests a physical copy, which is delivered at a later date—does control transfer on electronic or physical delivery, or after both have occurred, or are there really two performance obligations? Companies will need to determine how many performance obligations exist and when each performance obligation is satisfied in the proposed model. The definition of control or indicators of control that may be provided by the boards in the future may require companies to reconsider their contract structure if they wish to preserve their current revenue model.

Identification and satisfaction of performance obligations

Companies should start to consider not only when control of assets transfer in arrangements, but also what performance obligations may exist. The DP may well result in the identification of more performance obligations that may need to be accounted for separately in multiple deliverable arrangements. For example, legal requirements, such as implied or explicit warranties, could be performance obligations, as could customary business practices, such as rights of return and guarantees. However, extended warranties may in substance be insurance contracts, so should insurance contracts be viewed as included in the scope of the proposed model?

The current practice of accruing standard warranty costs at the time of revenue recognition may be eliminated. Rather, warranties may be considered performance obligations for which a portion of the total consideration will be allocated at inception and then recognized as the warranty obligation is satisfied. The warranty may not necessarily be satisfied on a ratable basis, so companies will need to determine the most appropriate recognition pattern. The increase in identification and separation of performance obligations may require a greater use of estimates than is the case in current practice.

Example 4: Warranty

Situation: Using Example 2, in which Vendor sells a hard drive, keyboard, and monitor to Customer, assume there is an additional obligation to service a standard 12-month warranty and based upon historical experience, 90 percent of warranty claims occur within the first three months of the obligation.

Discussion: In the proposed model, Vendor’s performance obligations—the promises to transfer the hard drive, keyboard, monitor, and warranty—are satisfied when Customer obtains control of each promised asset. As the warranty represents a performance obligation, a portion of the transaction price is allocated to the warranty and may be recognized as revenue as the warranty obligation is satisfied. Revenue recognition may not be ratable as the majority of the warranty claims occur within the first three months of use. This may be a departure from existing standards where standard warranty costs are simply accrued at the time of revenue recognition.

This example illustrates that companies will have to assess if additional performance obligations exist for any types of legal or statutory requirements such as implied warranties or return rights. The boards continue to deliberate whether rights of return should be viewed as:

- A performance obligation to provide a service in the contract, resulting in some revenue being deferred at contract inception and subsequently recognized as revenue as obligation are satisfied or when the return right expires; or,
- A failed sale, as the customer has not accepted the terms of the sale since the arrangement can be rescinded without consequence.

Consider the following example:

Example 5: Right of return

Situation: Vendor sells and ships on the same day 10,000 gaming systems to Customer, a reseller. Customer may return the gaming systems to Vendor within 12 months of purchase. Historically, Vendor has experienced a 10 percent return rate from Customer.

Discussion: The DP identifies two possible approaches to address rights of return, but other approaches may also develop as the boards continue their deliberations:

Approach 1—treatment as a performance obligation: The performance obligations may include the promises to transfer the gaming systems and the related rights of return. Since neither Vendor nor any competitors sell similar gaming systems without a right of return or separately sell a right of return, the stand-alone selling prices for both have to be estimated. After allocating the transaction price on a relative basis using estimates for stand-alone selling prices, revenue may be recognized as each performance obligation is satisfied by transferring the promised asset. The inventory associated with the systems may be derecognized as control over the inventory is transferred to the customer.

The right of return is a service that may be transferred over time or may only be fulfilled upon expiration of the right or upon a failed sale. Generally, expiration of the right should be based upon contractual terms; however, companies should evaluate customary business practices and historical experience to assess whether revenue related to the right could be recognized over the period of the right of return.

Approach 2—treatment as a failed sale: The performance obligations in this approach may only include the gaming systems. Vendor may record a contract liability representing 10 percent of the total systems or 1,000 systems and may not derecognize the associated inventory. The remainder of the transaction price may be attributed to the 9,000 systems where a failed sale was not anticipated. This performance obligation would be satisfied when Customer obtains control of the promised assets. The contract liability and associated inventory may not be extinguished or derecognized until expiration of the right or upon failed sale.

Both approaches create application questions that will need to be addressed by the boards. Failed-sale treatment could result in use of historical experience to defer anticipated returns, broadly consistent with current accounting. However, this approach could be seen as inconsistent with the concept of control since a company may continue to recognize inventory or other assets even though control has been transferred to the customer. If treated as a performance obligation, the focus may shift from the ability to estimate the level of returns to the ability to estimate stand-alone selling prices for the right of return.

There are additional practice issues that are not currently addressed within the DP. In US GAAP and IFRS, when an obligation is fulfilled by a number of indeterminate acts, ratable recognition is generally permitted. However, there is no similar accommodation permitted in the DP. Revenue is recognized consistent with the pattern that the underlying performance obligations are satisfied. Consequently, a warranty obligation or postcontract customer support (PCS) obligation is recognized as revenue based upon the pattern of the transfer of the underlying goods or services. Depending on the relevant product, the stage in the

product lifecycle, and history, the pattern of revenue recognition could differ significantly for every product, perhaps even during different time periods. However, this method of recognition may be more reflective of the underlying economics of the arrangement where future services are provided based upon varying patterns of delivery.

The broad definition of performance obligations may not only require additional processes, but may increase the level of management estimates inherent in a company's revenue model. This could create challenges for finance and accounting teams, and potentially require valuation resources and the development of new skills. Companies will need to understand the impact of the proposed model on their current systems and processes, identify potential data gaps, and determine effective solutions. Companies that currently have robust estimation processes may view the proposed model as a welcome change.

Determination of stand-alone selling prices

Companies will need to allocate the original transaction price—the customer's promised consideration—to the identified performance obligations on the basis of relative stand-alone selling prices. The best evidence of stand-alone selling price is the price charged by the company for selling the good or service separately. The proposal requires a price to be estimated when stand-alone selling prices are not available. Deferral of revenue solely due to an inability to estimate selling price or due to restrictions imposed by existing standards (such as VSOE or VOE of fair value) may no longer be appropriate. The proposed model's increased use of estimates in determining stand-alone selling prices may provide some flexibility to companies that wish to bring more bundled product and service offerings to market.

Example 6: Determination of stand-alone selling prices

Situation: Vendor sells Customer a perpetual software license (version 2.0) and postcontract customer support (PCS) services consisting of telephone support for a period of five years once the software is activated. Vendor also provides a product roadmap to Customer which describes the future features, functionality, and expected release date of version 3.0 in two years. None of the goods and services underlying the performance obligations are sold on a stand-alone basis.

Discussion: In the proposed model, the performance obligations in the arrangement may include the promises to transfer version 2.0, a specified upgrade right for version 3.0 and telephone support. Other performance obligations such as any implied warranties, guarantees or rights of return may also exist. Assuming that none of the goods and services underlying the performance obligations are sold separately, stand-alone selling prices would be estimated. Estimation could be made using a cost-plus-reasonable-margin approach or any other reasonable and reliable method that is consistent with stand-alone selling prices that maximize observable inputs. For example, quoted competitor prices may be adjusted to reflect a company's own costs and margins.

Example 6 demonstrates that the proposed model may provide relief from current fair value thresholds utilized particularly in US GAAP. Companies using the software revenue recognition guidance may find more flexibility in the proposed model as it allows the determination of stand-alone selling prices using estimates. Elimination of the use of the residual method may cause problems for certain technology companies and potentially increase compliance and systems costs. Given the nature of the product, software licenses are rarely sold on a stand-alone basis. Some companies have historically used a residual method approach to allocate the consideration between the software license and other deliverables. Companies will now need to determine an estimate of stand-alone selling prices and perform a relative allocation of the transaction price. Companies may be required to use more estimates if they choose to use a cost-plus-reasonable-margin approach. Accordingly, companies should consider the strengths and weaknesses of their current estimation processes. What challenges will the inability to use the residual method present? How would existing internal controls surrounding estimates have to be modified to ensure compliance with Sarbanes-Oxley or other regulations?

The DP contains an example in which the selling price for a software license is developed using a cost-plus-reasonable-margin estimate. The example uses the labor hours allocated to the project and a suggested margin. In practice, the feasibility and practicality of this approach may present challenges, given the length of time between development and end-of-lifecycle of a software product and the inherent unpredictability of market acceptance of a product. The requirement to estimate stand-alone selling prices may create challenges for software companies. How should companies apply a cost-plus-reasonable-margin approach to a license? What costs are attributable to each individual license? How should development efforts be apportioned to individual licenses? What is a reasonable margin for stand-alone software?

Software companies may face a similar issue with PCS, which may consist of services such as telephone support and software updates/upgrades that may incorporate enhancements, added features, or bug fixes. The development costs of these types of services may not, by their very nature, be identified, or determined upfront for each product sale. Another challenge is the level at which performance obligations should be identified. For example, for a company providing PCS, should each bug fix or each individual feature be considered a performance obligation, as they will be delivered at different times? Consider a PCS obligation that includes updates, upgrades, and telephone support. All have different performance parameters and are delivered to the customer at different times with different levels of frequency over the contractual period. Is PCS a single obligation, or does it consist of multiple separate performance obligations to the customer? The level at which a performance obligation is determined may have a significant impact on the level of effort and cost tracking that management may have to perform using the proposed model.

The impacts and challenges are not just limited to software companies. Hardware companies or any technology company bundling goods and services may also be affected. Generally, hardware products are bundled with other rights such as when-and-if available upgrades, price protection or other guarantees, which are often delivered over different periods of time. The proposed model may make it easier to separate performance obligations (relative to existing separation guidance on units of accounting or components) but the challenge for some companies may be the need to determine the stand-alone selling prices for the underlying goods and services of performance obligations that are never sold separately. Since some of these bundled rights are generally not sold on a stand-alone basis, the stand-alone selling prices attributable to these rights may have to be estimated through use of either a cost-plus-reasonable-margin approach or using an adjusted market assessment approach (e.g., adjusting a competitor's quoted prices for a company's own costs and margins or using a price a customer in that market would be willing to pay for those goods or services). Application of these approaches may be challenging in practice for certain items where there are no established valuation techniques. Further, since the associated hardware product is generally not sold without these rights, the stand-alone selling prices attributable to hardware products may also have to be estimated through use of a cost-plus-reasonable-margin approach or an adjusted market assessment approach.

The use of current fair value measures such as VSOE of fair value, particularly for software companies, may no longer be the only acceptable way to demonstrate stand-alone selling prices as companies may use estimates or other approaches to determine stand-alone selling prices for the goods and services underlying the performance obligations. This may increase the level of complexity associated with determining stand-alone selling prices and may create challenges for companies that may have historically defaulted to using VSOE or VOE of fair value for an entire arrangement. This could further decrease the use of market measures in estimating selling price and place more reliance on the importance of management estimates surrounding the valuation of the goods and services underlying the performance obligations. The inherent subjectivity around the estimation process may create divergence in practice and potentially make comparability between industry peers difficult. However, companies should keep in mind that using estimates may allow them to recognize revenue using the proposed model in scenarios where revenue recognition may currently be precluded.

Onerous contracts

Where the expected cost to satisfy a performance obligation exceeds that performance obligation's carrying amount, the performance obligation is deemed to be onerous. IFRS allows a similar approach; however, the ability to record an onerous contract provision may be a change for US GAAP companies with contracts outside the scope of SoP 81-1.

Example 7: Determination of an onerous contract

Situation: Using Example 3, in which Vendor will build and run a system, now assume that the Vendor completes the build, receives written customer acceptance, and commences the run services at the end of the eighth month. Assume that in the ninth month, it becomes apparent that anticipated cost savings will not be realized by Vendor and performance in the remainder of the contract will be onerous.

Discussion: At the end of the ninth month, Vendor would remeasure the remaining performance obligations in order to reflect the adverse changes in circumstances and record a loss on remeasurement. The remeasured obligation would effectively result in additional recognition of costs in the current period and would not result in an increase in overall total contract revenue recognized.

While broadly consistent with the existing IFRS model, the concept of onerous contracts may be a change for others. The practical aspects of accounting for onerous obligations have not yet been fully deliberated by the boards. Accordingly, there may be additional changes to the proposed model in the future.

Other measurement considerations

Other measurement considerations, such as the time value of money, credit risk, non-cash consideration, and contract uncertainties, are currently being deliberated by the boards. There is a presumption in the DP that an obligation to be fulfilled in the future, all else being equal, is less arduous than an obligation to be fulfilled immediately. Accordingly, two identical obligations may have different values if they are fulfilled at different times. Incorporating the time value of money in the measurement of consideration may have a significant impact upon companies entering into long term contracts. Recent discussions by the boards preliminarily indicate that the net contract position should reflect the time value of money (whenever that effect would be material) and that the effect of financing should be presented separately from revenue. This may result in changes compared to current practice in both US GAAP and IFRS.

The boards are also considering how a company should determine the transaction price when the promised customer consideration amount is uncertain for reasons other than the customer's credit risk and modifications of the contract. For example, should the transaction price at contract inception represent the expected amount of customer consideration—the probability-weighted estimate of customer consideration?

With respect to non-cash consideration, the boards have tentatively agreed that a company should measure non-cash consideration at its fair value. If a company cannot reliably estimate the fair value of non-cash consideration, it should measure the consideration indirectly by reference to the fair value of the promised goods and services.

The impact of these items on the measurement of rights in a contract continues to evolve. However, given the proposed departure from existing practice as illustrated by the boards' recent tentative views, any changes in the measurement of consideration may require companies to further analyze and evaluate their revenue recognition models.

Sales incentives and discounting

The DP proposes a change in accounting for certain sales incentives. Free products, services, and customer loyalty programs, which may have been treated as a marketing expense in certain circumstances, may be considered performance obligations. As such, revenue may not be recognized until the obligations are satisfied, such as when a customer redeems loyalty points. This change may align existing practice with the guidance for customer loyalty programs in IFRS.

Example 8: Free services

Situation: Using Example 5, where Vendor sells gaming systems to Customer, assume that the end user receives five free months of an online gaming service upon activation.

Discussion: In the proposed model, Vendor's performance obligations—the promises to transfer the gaming systems, future free services, and the right of return—are satisfied when Customer obtains control of each promised asset. The stand-alone selling price for the free services is readily identifiable as the services are sold separately by Vendor. A portion of the transaction price is allocated to the free services based upon relative stand-alone selling prices of the identified performance obligations. The free services are recognized as provided over a five-month period from the activation date.

Consider an alternative scenario for this example where future free services are not provided, but an incentive of equal value was offered in the form of either a discount on a future purchase, or as cash consideration. Would a discount on a future purchase be a performance obligation in the existing contract? Or would the obligation relate to a future contract? Does payment of cash consideration constitute a performance obligation? Or is it a reduction of the original transaction price, or simply a financial liability? Although the form of the transaction differs in each case, the substance is consistent. As these are areas that are yet to be deliberated by the boards, companies should consider the impacts of these types of scenarios as they comment on the proposal.

Contract costs

Certain contract costs will be expensed as incurred and no longer capitalized, unless they meet the definition of an asset using another standard—for example, inventory, fixed assets, or intangible assets. Sales commissions paid for obtaining a customer may not be deferred if they do not create a corresponding asset that qualifies for recognition. Using existing standards, certain costs may be capitalized if they are recoverable, such as in the construction industry. Some of these types of currently capitalized costs may have to be expensed. The proposed model does not provide any explicit cost recognition guidance, but through discussion and examples it reiterates the importance of contract costs meeting the definition of an asset in order to be eligible for capitalization. The boards will deliberate cost recognition in the context of consequential amendments to existing cost recognition guidance that may be required as a result of the proposed model.

Other practical considerations

Companies should evaluate impacts to existing contracts, systems, and processes around revenue recognition. The proposed model may present new challenges for some companies as they focus on determining how and when control of an asset transfers. Companies may choose to modify or amend existing contractual arrangements. Other process changes may be required to identify and separate performance obligations and to develop robust estimates in establishing and monitoring stand-alone selling prices. Companies should also consider training that may be required for finance and other staff involved in evaluating and negotiating future contracts once the proposed model becomes a final standard. This training may need to extend externally as companies start to think about how to educate the investor and user community. Companies may need to consider engaging external specialists to assist during the transition from existing standards to the proposed model.

As revenue recognition models change, technology companies should also consider the impact on compensation and incentive programs as well as current controls in place for the sales force. Operational and implementation assessments, particularly those related to sales force behaviors and incentives, should be considered while forming a point of view on the DP.

From a tax perspective, any eventual changes in revenue recognition will need to be evaluated to determine their conformity with local tax rules and associated tax accounting method changes. These changes could affect a company's transfer pricing, state and local income tax apportionment factors, and directly affect cash and deferred income taxes.

Changes and challenges to consider

As the boards continue to deliberate and develop the model, companies should continue to follow the debate and submit their views as part of the DP comment process. The following list is designed to help companies think through some of the changes and challenges presented by the proposed model on their businesses:

Control

- What factors provide the best evidence of the transfer of control?
- Would a list of indicators or factors supporting the transfer of control provide useful guidance?
- Should transfer of control focus on legal control, physical control or both?
- In industries where the use of the percentage-of-completion method is currently prevalent, does the proposed model's focus on the transfer of assets (evidenced by the transfer of control) provide useful information for investors?
- How should the existing principal versus agent literature with its focus on risk and rewards be modified to be incorporated into a model that focuses on control?

Performance obligations

- Should the proposed model provide explicit criteria for identification and separation of performance obligations or at a minimum provide a list of factors for consideration?
- Will the proposed definition of a performance obligation help companies consistently identify the separate obligations of a contract?
- Should the concept of “inconsequential or perfunctory” obligations be evaluated when identifying or separating performance obligations?
- Should the proposed model provide more examples and guidance of what items would be considered performance obligations? For example, which of the following would meet the performance obligation definition as currently proposed: promises to defend rights (such as patents); conditional promises (such as when-and-if available upgrades); constructive promises (such as bug fixes and patches); guarantees and stand-ready obligations (such as price protection or future price concessions)?
- Should sales incentives such as future discounts, customer loyalty programs, free products, and cash consideration give rise to performance obligations in a contract?

- Does recognizing a standard warranty as a separate performance obligation provide decision-useful information for investors?
- What operational changes would need to occur to allow companies to measure and track the satisfaction of performance obligations?
- How should cash incentives be measured: as separate performance obligations, or a reduction of the original transaction price?
- How would implicit performance obligations be identified consistently?

Measurement and remeasurement

- Should the customer's perspective influence the determination of the stand-alone selling price of an asset?
- Should an expected outcome approach be used in measuring the customer's consideration?
- What are the operational challenges to measuring and remeasuring the customer's consideration for the time value of money or other changes in credit risk or variable outcomes?
- Should a performance obligation be deemed onerous and remeasured where the cost exceeds the carrying amount of the performance obligation?
- Where in the financial statements should remeasurements relating to onerous contracts be presented?
- Should remeasurements be limited to onerous contracts only?

Stand-alone selling prices

- Where a company does not sell a good or service separately, should the stand-alone selling price of that good or service always be estimated for purposes of allocating the transaction price?
- How should companies measure stand-alone selling prices for newly developed software?
- What happens when a company is truly unable to establish reasonable and supportable estimates of selling prices? Should the proposed model provide any guidance in situations where a company is unable to establish stand-alone selling prices?
- Do companies have a robust process and system to track and monitor the increased use of estimates for stand-alone selling prices?

- Should the proposed model contain a hierarchy for using observable stand-alone selling price versus other models such as an estimated cost-plus-reasonable-margin to ensure consistent application?
- Should companies be permitted to develop their own hierarchy for establishing stand-alone selling prices absent any guidance in the proposed model?

Allocation of customer consideration

- Should discounts be allocated using a relative selling price basis or should other allocation models like allocating majority of discount to the earlier performance obligations be evaluated?
- Should the residual method be allowed in certain limited circumstances (such as when management is unable to support any reasonable estimates) to ease implementation?

Presentation and disclosure

- How should contract assets and liabilities be presented in the balance sheet: gross or net?
- What specific disclosures could improve the decision-usefulness of information provided to users of financial statements?
- What should the transition provisions and disclosures be for the proposed model?

Practical considerations

- What level of investment in systems and incremental resources—e.g., people, training, use of specialists—will be required to both track and value incremental performance obligations in the proposed model?
- How many company resources could be freed up by moving to a single revenue model globally?
- How will companies address the challenges of using more estimates in light of Sarbanes-Oxley or other regulations?
- Are there opportunities to look for synergies and cost savings by evaluating shared service centers or other systems implementation projects as companies start to think through the potential effects of the proposed model?

Next steps

The proposed model may impact current revenue recognition practices for technology companies reporting under US GAAP or IFRS. Each industry within the scope of the DP will be affected to some degree; however, companies that have historically followed industry-specific guidance may see the most pervasive changes. As the DP does not present a complete model, there are areas that are still to be addressed by the boards that may impact how the DP model evolves. Companies should carefully analyze the impact of the proposed model on current business activities and projects, especially surrounding contract negotiations, budgeting, tax strategies, information technology, and other business initiatives. While the proposed model may change current revenue models and present new challenges, companies should view the changes as an opportunity to rethink how they go to market with their products or service offerings and to evaluate and streamline processes related to revenue recognition.

A DP is the first step toward the development of an exposure draft of a proposed standard. The boards will use the feedback received during the DP public comment period in their development of the exposure draft. Unlike a DP, an exposure draft sets out a specific proposal for accounting standards. After the exposure draft is released, there will be a comment period. Once this feedback is received, the boards will consider the comments to evaluate and validate the proposed model. After resolving the issues identified in the exposure draft, the boards will determine if there is a need for re-exposure using a second exposure draft. Once the boards have reached conclusions on all of the issues raised during the exposure process, the boards' staff will draft the final standard, which will then be voted on by the boards.

It is expected that the boards will issue the exposure draft for this project in the first half of 2010 and the new revenue recognition standard by the first half of 2011. The timeline for the final standard, the effective date, and the transition requirements are all items that companies may wish to comment on during the exposure process. US companies may be required to apply the boards' converged revenue recognition standard in advance of any potential adoption of IFRS in the US. Additionally, US companies will need to consider the impact of recently proposed US GAAP revenue recognition changes for certain transactions as a component of their transition to the DP's model. All companies will need to think strategically on how best to navigate through the potential changes, consequences, and opportunities of the pending changes to revenue recognition.

Our experience has shown that comments made by preparers and users during the DP stage are more likely to result in changes than comment letters submitted during the exposure draft stage. Evaluate the potential impact of the DP on your company and engage in the debate with the standard setters. PwC will participate in the process by submitting a comment letter that will respond to the DP's questions and provide our global point of view on the proposed model. The deadline to comment on the DP is June 19, 2009. Companies should not miss this opportunity to provide input that may potentially better align accounting standards with the underlying economics of transactions and business practices.

PwC is committed to helping technology companies with the challenges resulting from changes in both US GAAP and IFRS. The following IFRS and technology industry leaders are dedicated to this effort within our firm:

John Barry
US IFRS Leader
john.j.barry@us.pwc.com
646.471.7476

Rob Gittings
Technology Sector Leader
robert.gittings@us.pwc.com
408.817.3730

Cory Starr
Technology Sector Leader,
Assurance
cory.j.starr@us.pwc.com
408.817.1215

Farhad Zaman
IFRS and Subject Matter Specialist
farhad.zaman@us.pwc.com
646.471.5376

Srijit Banerjee
IFRS and Subject Matter Specialist
srijit.banerjee@us.pwc.com
415.498.5203