

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

Executive summary



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.

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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.

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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>

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Companies will be required to use estimates to reflect stand-alone selling prices	<p>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.</p>
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	<p>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.</p>
Certain contract costs may no longer be capitalized	<p>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.</p>

Performance obligations may need to be remeasured over the life of an arrangement

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.

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.

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.

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:

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