

10Minutes

on the future of revenue recognition



July 2011

The far-reaching implications of a new revenue model

Highlights

Management should evaluate existing business practices under the new model, including how product or service offerings are bundled and priced, and begin assessing the need to negotiate revised contract terms.

Industry-specific accounting guidance will be eliminated under the new model and “industry practice” will need to be re-evaluated.

Estimates that are required to apply the new model will often require the use of greater judgment and may necessitate process or system changes.

Companies should begin assessing the impact of the changes and the adequacy of their resources, systems, and processes to address the new requirements.

Revenue, or the “top line,” is one of the most closely-monitored measures in financial statements. However, the accounting rules for revenue can be difficult to decipher. US revenue guidance today is a tangled web of special rules and exceptions created to address unique transactions, industries, and business models.

The FASB and IASB are in the process of replacing this labyrinth of revenue guidance with a new global accounting standard that will apply a single set of principles to all revenue transactions, regardless of industry. Their proposed standard, issued in June 2010, received extensive feedback, which the boards have discussed at length during the first half of 2011.

Now that they’ve completed their initial redeliberations and decided to re-expose their revenue proposal, it’s time to take stock of the effects. Understanding the impact now will inform your response to the revised proposal and limit surprises down the road.

This 10Minutes provides a preview of the proposed changes and their implications. We expect the FASB and IASB to issue a revised exposure draft in August or September 2011 and a final standard in the September 2012 timeframe. Keep in mind that some aspects of the guidance could change before a final standard is issued.

What it means for your company:

1. Revenue is a key metric subject to considerable focus by investors and other stakeholders. The impact of changes to the revenue model will affect key financial measures and ratios. Early communication to stakeholders will be critical.
2. Companies may need to change information technology systems to capture different information and develop new processes for estimates that aren’t required today.
3. The resulting need for increased judgment will require thoughtful documentation and dialogue with those charged with governance.
4. It may be necessary to modify contract terms to maintain the original intent of arrangements or better align reported revenue with business objectives.
5. Adopting the new guidance will entail adjusting prior period financial statements. Successful implementation of the standard will require upfront planning.
6. The FASB and IASB have decided to re-expose their proposed revenue standard. Companies should take advantage of this opportunity to participate in the standard-setting process and provide input to the boards.

At a glance

A principles-based approach...

The proposed model is easy to understand on its surface, but its application could result in significant changes from existing practice. A few highlights of the revenue proposal¹ include:

- Revenue is recognized when control is transferred to the customer, a new model that requires judgment for many transactions.
- Revenue reflects a more extensive use of estimates (for example, contingent fees), and bad debt estimates offset gross revenue.
- Revenue from licenses of intellectual property is recognized when the customer obtains control of the rights, which could result in fewer license fees recognized ratably over the license period.
- Direct costs of obtaining and fulfilling contracts are capitalized as assets if they meet certain criteria, bringing consistency to an area of mixed practice today.

...with potential for big implications

The implications will vary by company and by industry. But at a minimum, companies will need to consider the following:

- Industry practices that have developed over time are now off the table. It may take time for interpretations to develop and practices to evolve for some aspects of the new model.
- Most companies will see some impact on margins and other key financial measures. Changes that affect a broad base of companies include offsetting bad debt expense against revenue and changes in the timing of recognizing certain costs.
- Changes in how contract terms affect reported revenue, such as contingent fees and prepayments or extended payment terms, could influence how companies and their customers negotiate these terms.
- Any change to revenue is likely to affect a wide range of arrangements that are linked to financial measures, including compensation and bonus plans, earnout arrangements, and covenants in financial agreements.
- Changes to revenue might also have tax implications and could affect the timing of cash tax payments if, for example, revenue recognition is accelerated.

¹ The discussion of the proposed guidance throughout this document is based on the proposals in the June 2010 exposure draft and tentative decisions reached during redeliberations as of June 30, 2011. Certain provisions may change before the final standard is issued.

01

No more special treatment

Industry-specific US revenue guidance will be largely eliminated including:

Financial services

- Brokers and dealers
- Depository and lending
- Investment companies
- Mortgage banking

Entertainment

- Broadcasters
- Cable television
- Casinos
- Films
- Music

Other industries

- Airlines
- Contractors
- Extractive activities-oil and gas
- Franchisors
- Health care entities
- Real estate
- Software

A primary goal of the standard setters is to create a single, principles-based approach that's applied across all industries. So, companies that previously followed industry-specific guidance or established industry practices will likely feel the greatest impact. Assessing this impact now may reveal potential longer-term strategic matters to consider even before the standard is finalized. The examples below represent only a small sample of affected industries.

Software

The detailed rules in today's software guidance were designed with an anti-abuse bias and often delay revenue recognition. Software companies have shaped their business models to address the strict requirements; for example, by including renewal rates in contracts, putting limits on discounts offered to customers, and avoiding promises for future technology. The less rigid approach in the new model may eliminate the need for these restrictions and may cause software companies to rethink their current practices. As a result, some may change how they sell their products and services, and how they negotiate with customers.

Real estate

Industry-specific guidance for real estate includes prescriptive requirements in areas such as the continuing involvement of the seller and evidence of the buyer's commitment to pay for a property. The new model takes more of a principles-based approach that eliminates these "bright lines." Thus, companies may decide to modify arrangements

that were previously structured to meet bright-line requirements to better align with their business objectives.

Contractors

Those in the engineering and construction, and aerospace and defense industries, among others, currently apply specific guidance on long-term contracts. This guidance includes rules for recognizing revenue (usually on a percent-complete basis), recording contract costs, and accounting for change orders. The new model has similar concepts but there are nuances that could catch some by surprise. For example, there could be differences in the costs that are capitalized or how progress to completion is measured. At the extreme, some arrangements might not result in revenue until the project is complete. Each company will have to assess its own specific facts under the new model.

Can one size fit all?

The standard setters have encountered some bumps in the road over the course of the revenue project. It hasn't been easy to craft a principles-based approach that functions as intended for all industries. The FASB and IASB plan to issue a revised exposure draft in August or September 2011, with a 120-day comment period. Companies with concerns about unintended consequences of the model should take advantage of this opportunity to influence the standard-setting process.

02

Navigating areas of judgment

Examples of estimates required by the revenue standard

Bad debts/ credit risk

- Record estimated bad debts as an offset to gross revenue
- Updates to estimates also affect net revenue

Performance bonuses

- Estimate the amount the company expects to receive
- Generally recognize if reasonably assured based on experience and other factors

Royalties and other variable fees

- Estimate the amount the company expects to receive
- Generally do not recognize if sales-based royalties or no predictive experience

Time value of money

- Only record impact if significant and greater than one year
- Could affect contracts with prepayments or extended payment terms

Loss contracts

- Record upfront loss if remaining costs exceed revenue for service obligations
- Update assessment throughout the life of the contract

A principles-based approach, by design, requires more judgment than applying a set of rules. While the standard setters have agreed to add more guidelines and indicators in some areas, accounting for revenue will likely require a greater use of estimates and judgment than it does today. We highlight just a few areas requiring estimates or judgments and the related process implications below.

New estimates of variable fees

Revenue under the new model is based on the total fees a company expects to receive. This includes estimates of variable fees, such as performance bonuses, royalties, and other contingent fees. Recognition of revenue for fees with these types of uncertainties is often deferred today. Under the new model, there are still some constraints on recording revenue, particularly for contingencies outside the company's control. But some fees might be recognized earlier than today, and potentially adjusted along the way, requiring new processes to estimate these amounts.

A new model for credit risk

A change affecting almost all companies is the treatment of bad debts. Today, a company defers all of the revenue from a contract when it can't be assured of collecting from the customer at the onset of the arrangement. Under the new model, this hurdle has been removed. Also, estimates of uncollectible amounts will offset gross revenue, instead of being recorded as bad debt expense. In addition to affecting margins, these changes require recording a "day one" estimate of customer credit losses for all transactions.

Loss leaders in service contracts

Today, contract losses are generally not recorded until incurred, except when applying certain industry guidance. A loss could be recorded upfront under the new model, however, when estimated costs to fulfill a service obligation exceed remaining revenue. For example, a service provider might sign a one-year contract with a customer that is unprofitable, anticipating that the customer will renew for future years. A loss will likely be recorded at contract inception in this scenario. The new model will require forecasting costs and updating estimates on an ongoing basis to identify potential losses. Because it's an ongoing assessment, a loss could be triggered part way through a contract if costs begin to climb.

System and process implications

Revenue estimates will be based on the probability-weighted or most likely amount of cash flows. New systems and processes may be needed to collect and analyze data for developing and continuously reassessing these estimates. Companies will also likely need new processes for other areas of judgment, including allocating revenue to performance obligations, tracking customer credit risk, identifying loss contracts, and analyzing capitalized costs.

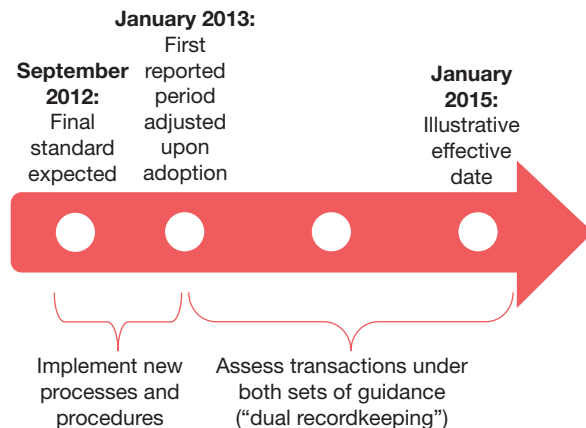
The judgment required when applying a principles-based approach continues to raise concerns. A common concern is that judgments and estimates can be challenged by others in hindsight. That's why it's essential to establish good processes, thoughtfully document estimates on a contemporaneous basis, and ensure they are subject to the appropriate oversight.

03

Assessing the impact on the past, present, and future

Illustrative timeline for implementing the new standard

The boards have yet to decide on the effective date of the final standard; however, the FASB recently announced that the effective date would be no earlier than annual periods beginning on or after January 1, 2015. The below timeline illustrates key timing considerations, including the transition period, if the effective date is January 1, 2015.



A fresh look at contract terms

Applying the new model is almost like starting with a clean sheet of paper. This fresh look could prompt changes to contract terms or other business strategies. Now that the standard setters are about to release a revised exposure draft, it's time to start thinking ahead about potential strategic changes. An important first step is analyzing existing sales transactions and modeling the impact of the proposed guidance. This could reveal areas where changes are warranted.

Management should also reassess business practices that have been influenced by the existing revenue rules. For example, some may bundle or price their offerings in a way to achieve, or avoid, deferral of revenue. Similarly, some may structure arrangements to comply with bright-line requirements. These strategies might not be necessary under the new model, or consistent with broader business objectives. Because changes to business practices can't be implemented overnight, companies should think through these issues well in advance of adopting the new standard.

Other affected arrangements

Due to the pervasive impact of revenue on the financial statements, other arrangements linked to financial measures could be affected. These arrangements might include compensation and bonus plans, earnout arrangements, and covenants in financing agreements, among others. Companies should inventory affected arrangements and assess the impact of changes to the relevant financial measures. In some instances, it may be necessary to modify the terms of these arrangements to maintain their original intent.

Adopting the new standard

Companies will adopt the new standard by adjusting prior period financial statements as if the guidance had always been applied, with a few practical exceptions provided to reduce the burden. Most agree this approach is conceptually superior as it provides consistency across reporting periods. Gathering data on historical transactions, however, could be challenging, particularly for companies with multi-year contracts. Getting an early start will be key to overcoming these challenges.

Managing the transition period

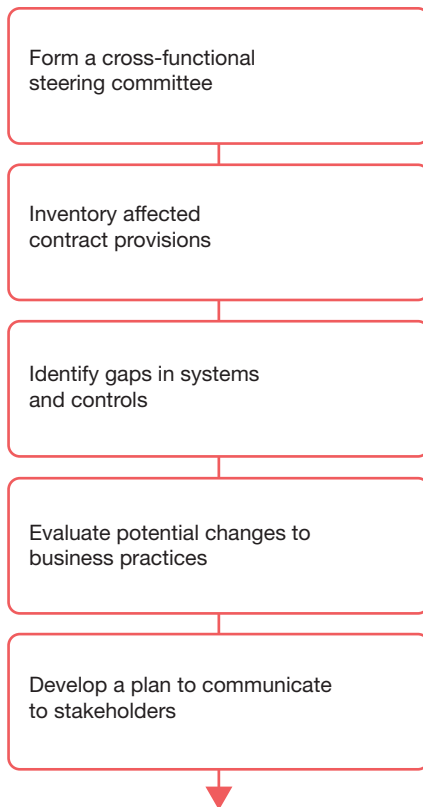
For a period of time prior to the effective date, most companies will need to implement some form of parallel or dual tracking of transactions under both the current and new guidance. This analysis will be needed to adjust prior periods on the effective date, but it is also important information for communicating the impact of the new standard to stakeholders.

Another challenge during the transition period is planning the timing of strategic changes, such as changes to contract terms. Prior to the effective date of the new standard, reported revenue will continue to reflect existing guidance. However, these same transactions will be reported under the new guidance when prior periods are adjusted upon adoption. The contract's terms in a given arrangement will dictate how it is accounted for under both sets of guidance. Some companies may decide to delay changes to contract terms until they have adopted the new guidance. Regardless of the approach taken, communicating these decisions and their implications to stakeholders will be critical to avoid surprises.

04

What should your company be doing now?

Preparing for the change



While the standard's effective date is still a few years away, its successful implementation will require planning ahead and keeping stakeholders well-informed of the changes to come. Key steps in the process include:

Rally the people who need to act

- Assemble a steering committee. Include resources from legal, tax, operations, information technology, human resources, sales and marketing, and investor relations.
- Educate business leaders in the company about the changes and business implications.
- Inform the audit committee and others charged with governance and oversight responsibilities.
- Develop a point of view on the revised exposure draft (when issued) and provide input to the boards during the comment letter period.

Assess the potential impact early

- Review existing revenue arrangements and contracts to identify provisions that will be affected.
- Model the impact on significant sales transactions or a sample of transaction types.
- Assess the potential impact on other arrangements linked to key financial measures, such as compensation plans or debt covenants.
- Assess the potential tax implications, as the timing of cash tax payments could be affected, and consider the need to pursue approval for changes to existing methods of accounting used for tax purposes.

Consider new systems and controls

- Assess whether current systems can capture and process the data needed to develop and monitor new required estimates, and track potential differences in revenue for book and tax purposes.
- Develop a plan to implement “dual recordkeeping” of transactions during the transition period.
- Consider the need for new systems and the time requirements to implement and test them.
- Identify processes and controls that need to be designed or modified, documented, and implemented.

Conduct strategic reviews

- Utilize forecasting models to assess expected changes in reported revenue, gross margin, and other key financial measures.
- Evaluate potential changes to business practices, including whether to modify existing contract terms.
- Assess when strategic changes should be enacted (i.e., before or after the standard's effective date).
- Educate the sales force about the changes and assess how the changes will affect negotiations with customers; consider whether any controls related to the sales process need to be modified or put in place.

Communicate in advance with stakeholders

- Develop a plan to limit surprises by communicating the expected impact to investors and other stakeholders.

Upcoming 10Minutes topics

Workplace flexibility

Flexibility over time and place has long been one of the best incentives companies can offer to improve retention. Yet these options are now almost standard practice among top US companies. 10Minutes addresses the question “how can businesses make over flexibility approaches to better attract and engage employees?”

Leading an innovative company

Operational efficiency is necessary to running the business today, but it’s not enough to build the business of tomorrow. CEOs recognize they need to innovate to sustain share and target new growth trajectories. 10Minutes discusses important organizational and cultural attributes to consider that can make or break the best idea.

Next-generation business intelligence

The business information companies collect has changed radically in recent years, with more unstructured data available through the Web, email, blogs and other multimedia sources. Tried-and-true methods for managing traditional data are no longer up to the task. 10Minutes explores how leading companies are treating different types of data differently, to gain greater insight into their operations, customers and performance.

How PwC can help

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