IFRS news

Emerging issues and practical guidance*

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Revenue recognition to 'fundamentally change'

Revenue recognition, the one accounting policy that every CFO still understands, is about to change. Accounting Consulting Services partners Tony De Bell in the central team and Dusty Stallings in the US explain the changes that are expected from the exposure draft (ED) 'Revenue from contracts with customers', issued by the IASB and FASB last month.

What is the issue?

The IASB and FASB have proposed a new revenue recognition model that could fundamentally alter the way entities across a variety of industries recognise revenue. The proposed model requires a contract-based approach that focuses on the assets and liabilities that are created when an entity enters into and performs under a contract.

The proposed model requires revenue to be recognised when an entity satisfies its obligations to its customer (performance obligations). A performance application can be as simple as an online retailer promising to deliver an MP3 player. Alternatively, a promise to build and deliver an aircraft carrier would also be a performance obligation or perhaps a number of performance obligations. The proposal defines a performance obligation as an enforceable promise in the contract that includes explicit and implicit promises to transfer goods and services to a customer. Performance obligations are satisfied when control of a good or service transfers to the customer, which is when the customer is able to use, and receive benefits from, the good or service.

Identifying the performance obligations in a contract will be critical in applying the proposed model and will require significant judgement. This may be particularly challenging for service arrangements and long-term contracts, such as a contract to build a ship. It will also be challenging to determine when performance obligations should be combined and when they should be separated; this will be a key driver in determining the amount and timing of revenue recognition.

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

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The transaction price will include variable or contingent consideration when such amounts can be reasonably estimated. This is a fundamental change from most current practice. In those cases, the transaction price is measured using a probability-weighted estimate of the consideration expected to be received. For example, movies are licensed for a base fee plus a percentage of box office receipts. Revenue would be recognised when the box office receipts can be estimated. The transaction price should also reflect the customer's credit risk by recognising only a probability-weighted estimate of the expected receipts and the impact of the time value of money, when material. The proposal will generally require greater use of estimates than under existing guidance.

The proposed model requires the transaction price to be allocated to performance obligations based on relative stand-alone selling prices – for example, a contract for a telecom entity to supply a handset and airtime. Other allocation methods used under existing guidance will not be permitted. The best evidence of the stand-alone selling price is the price of a good or service when the entity sells it separately. The selling price is estimated if a stand-alone selling price is not available.

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

The proposal includes application guidance for some of the common issues that arise in accounting for revenue, including product warranties, rights of return and licences. Product warranties will be accounted for differently from under current practice, which may impact the timing and measurement of revenue. The proposal also includes a model for customer return rights, which is generally consistent with current practice. The timing of revenue recognition for licences of intangible assets will depend on whether the licence is exclusive, and whether or not the licence is for the entire economic life of the asset.

The new model will require more extensive disclosures than currently required under IFRS. These disclosures focus on qualitative and quantitative information, and the significant judgements and assumptions made in measuring and recognising revenue.

The proposal requires full retrospective application upon adoption, meaning that management applies the model to all contracts in existence in any of the periods presented (even for contracts completed before the year of adoption). The ED does not propose a specific effective date. We anticipate the final standard to have an effective date no earlier than 2014, given the proposed retrospective application of the new model.

Am I affected?

The proposal will affect most entities. Entities that have followed industry-specific guidance in the past may be more significantly affected. For example, the new model could cause pervasive change in the construction, pharmaceutical, aerospace, and defence and technology sectors. PwC is producing industry-specific guidance on the proposals – see below.

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

What do I need to do?

These proposals are an output of the boards' joints efforts to develop a revenue recognition standard based on the same principles. The comment letter period ends on 22 October 2010, and a final standard is expected in mid-2011. More comprehensive analysis of the proposal, including industry-specific analysis, is available in PwC's 'Practical guide to IFRS – Revenue recognition'.

Given the potential impact of the proposed changes, management should begin to assess the implications of the new model on their existing contracts and current business practices. Management should also consider commenting on the ED to ensure their views on the proposed changes are considered.

'Executive guide to IFRS' now out

The 'Executive guide to IFRS' is a compendium of PwC's' topic summaries. It is intended as a reference tool for executives, accountants, legal practitioners, company administrators, financial advisers, auditors and academics.

The summaries include key information on each of the major accounting topics. They also contain a list of resources available on each topic, including the text of standards, interpretations, EDs, etc; and PwC's' guidance and interpretations, tools, practice aids and publications that relate to the topic.

To order hard copies, contact your local PricewaterhouseCoopers office or place your order online here. This publication can be used in conjunction with the online version, which is continually being updated as the topics develop. Click here to access the latest up-to-date topic summaries for free.

IASB modifies work programme and timetable

The IASB has a full agenda as a result of various factors, including pressure from the G20 following the financial crisis and the timetable for convergence with the FASB. This timetable was increasingly seen as problematic, so the IASB and FASB issued a joint statement in June, acknowledging that some projects would be prioritised and some deferred. Leader of PwC's Accounting Consulting Services in the UK, Peter Holgate provides a summary from the IASB's perspective.

Top priorities

The IASB's modified strategy retained the target completion date of June 2011 for the projects that it believes are most urgently in need of improvement. These are:

- Financial instruments (see below).
- Presentation of other comprehensive income – ED published in June (see *IFRS news*, June 2010, p3); final standard due in the second half of this year.
- Fair value measurement (see this edition of *IFRS news*, 'Cannon Street Press, p4).
- Revenue recognition – ED published in July; see this edition of *IFRS news*, p1.
- Leases – ED due imminently; timing of standard unclear.

Other June 2011 targets

Other priorities that the IASB aimed to complete by June 2011 and their actual status are as follows:

- A new project to address differences between the IFRS and US standards on balance sheet netting of certain financial instruments (ED due in Q4 2010; standard in Q2 2011).
- The project on accounting treatment of derecognition of assets has been changed into one on disclosures about derecognised assets and other off balance sheet risks (standard due in Q3 2010).
- Replacement of IAS 27 and disclosures about unconsolidated SPEs and structured entities (standard due in Q4 2010); and consolidation in the context of investment companies (ED due Q4 2010; standard Q2 2011).
- Insurance contracts (ED due imminently; timing of standard not clear).

Lower priority projects

Projects that the boards believe are lower priority are now targeted for completion after the original June 2011 target date. The following projects are therefore being delayed:

- Financial statement presentation – a more fundamental review of presentation.
- Financial instruments with characteristics of equity (the 'debt/equity project').
- Other aspects of consolidations.
- De-recognition – accounting treatment.
- Financial instruments.

Financial instruments

The boards' statement acknowledges the difficulties attached to improving and converging the two sets of financial instruments standards. They have issued proposals that differ in the following ways:

- The IASB has divided financial instruments guidance into sub-topics;
- The FASB has issued more comprehensive guidance and advocates more fair value accounting and a different approach to impairment.

The boards will begin joint deliberations in the second half of 2010. They expect to complete their joint consideration of feedback and issue new standards by Q2 2011.

Other projects

The boards' statement primarily addresses their joint projects. A number of other projects are on the IASB's agenda, with varying degrees of co-operation with the FASB. For example:

- Post-employment benefits: the IASB issued an ED in April 2010 and plans to issue a revised standard in Q1 2011.
- Emissions trading schemes: the boards are aiming for a standard in 2012.

Various projects are not referred to in the boards' statement – in particular: deferred tax, provisions/liabilities, rate-regulated activities and extractive industries. It is reasonable to assume that these are still on the IASB's agenda but with lower priority.

Am I affected?

The IASB's work programme involves new or revised standards in many areas of accounting. All entities reporting under IFRS (or that plan to do so) will be affected by the IASB work plan.

What do I need to do?

The work programme is extensive, even with the deferral of some projects; the flow of proposals and final standards will be heavy. A practical concern is implementation – both the effective date and the transition arrangements. We encourage companies and other constituents to keep an eye on the IASB's output and to comment on the proposals.

Cannon Street Press

Fair value measurement

What is the issue?

The IASB has re-exposed its proposals for fair value measurement disclosures; it has put forward an additional requirement for the entity to consider the expected effect of correlation between inputs when performing the uncertainty analysis. In other words, it would no longer be possible to ignore the interdependencies between input variables.

For example, if changing an assumption about credit spreads implies a corresponding change in an assumption about pre-payment rates, the uncertainty analysis should take this into account. In contrast, under the proposals in the May 2009 exposure draft, the uncertainty analysis could have been performed by holding the pre-payment rate constant while changing the assumption about credit spreads.

The 2009 ED included a requirement to disclose a measurement uncertainty (sensitivity) analysis for all fair value measurements categorised within Level 3 of the fair value hierarchy. A similar requirement already exists in IFRS 7 for Level 3 fair value measurements of financial instruments. This uncertainty analysis requires that, if different unobservable inputs could have reasonably been used, and those alternative inputs would have increased or decreased the fair value significantly, management states that fact and discloses what the effect would be, and how it was calculated. The sensitivity calculation could be performed by changing one input while holding all other variables constant.

The re-exposure draft was developed as part of discussions with the FASB on the fundamental principles of fair value measurement. At the same time, the FASB has published an exposure draft of its own on amendments to Topic 820 (Fair Value Measurements and Disclosures), which includes a similar proposal.

Am I affected?

This proposed amendment might alter the disclosures that management will be required to make if it has or will have assets or liabilities measured at fair value and categorised in Level 3 of the fair value hierarchy. Consideration of the effects of correlation between possible inputs could require significant additional effort, depending on the number and nature of inputs and the complexity of the model used.

What do I need to do?

Comments on the proposed amendment are due on 7 September 2010. The Board expects to finalise the fair value measurement standard in quarter 4 of 2010. Management should begin to think about the effects of correlation between possible inputs.

Leases proposals due

The IASB is expected to publish its exposure draft on accounting for leases imminently. PwC's 'Straight away' guidance will be available soon after the ED is published. This can be viewed at pwc.com/ifrs (under Publications, 'Straight aways') or by clicking here.

What's in a name?

A few name changes have been made at the global standard setter as part of its Constitutional Review. These changes, implemented in an effort to reflect more clearly what the bodies do, are: The IASC Foundation becomes the IFRS Foundation; the International Financial Reporting Interpretations Committee (IFRIC) becomes the IFRS Interpretations Committee; and the Standards Advisory Council (SAC) becomes the IFRS Advisory Council.

The name of the International Accounting Standards Board (IASB) will remain unchanged. The IASB's new website address will be www.ifrs.org, although all webpages are being re-routed so they are still accessible under the previous address. accessible under the previous address.

EU endorses IAS 24 and IFRIC 14

The EU has endorsed the amendments to IAS 24, 'Related party disclosures'. The amendments remove the requirement for government-related entities to disclose details of all transactions with the government and other government-related entities; they also clarify and simplify the definition of a related party.

The EU has also endorsed the amendments to IFRIC 14, 'Prepayments of a minimum funding requirement'. This amendment only applies to entities that are required to make minimum funding contributions to a defined benefit pension plan. It removes an unintended consequence of IFRIC 14 related to voluntary pension prepayments when there is a minimum funding requirement.

Both of these amendments are effective for annual periods on or after 1 January 2011.

IASB/FASB publish 'staff draft' of financial statement presentation proposals

The IASB and FASB published in July a staff draft of an exposure draft ('staff draft') that will propose changes to the presentation of financial statements under IFRS and US GAAP. The boards believe that the revised format will allow users of the financial statements to better understand a company's performance by requiring entities to subdivide their financial position, comprehensive income and cash flows into core operations and other activities. Global ACS partners Tony De Bell in the central team and Adrian Dadd in Russia explain.

The staff draft reflects the tentative decisions of the two boards. Their modified convergence strategy delays the publication of the official exposure draft until the first quarter of 2011. The boards plan to use the extra time to consult further with stakeholders and evaluate concerns about: (1) the cost benefit; and (2) the implications for financial reporting of financial institutions. The staff draft was released to provide information to constituents to facilitate the boards' further consultation.

New format for the financial statements

The staff draft explains the boards' tentative conclusions on a new format for the primary financial statements, with a focus on cohesiveness and disaggregation of information. The proposed new categories for the statements of financial position and their comprehensive income are shown below.

Information will be further disaggregated by function in the primary financial statements and by nature in the footnotes. 'Function' refers to an entity's primary activities in (for example, selling goods or selling services). 'Nature' refers to the economic characteristics or attributes that distinguish assets, liabilities, income and expenses (for example, the nature of expenses includes labour and materials, etc). The disaggregation and cohesiveness principles do not apply to the statement of changes in equity.

Statement of cash flows

The boards have tentatively concluded that cash flows should be presented using the direct method and that a reconciliation from operating income to net cash from operating activities (that is, an indirect reconciliation) should also be presented. The boards believe that the direct-method cash flow statement, together with the indirect reconciliation, provides more transparent and useful cash flow data. The staff draft suggests that direct-method cash flow information could be prepared either using information directly from the accounting records or by deriving it from changes in assets and liabilities. This is an important clarification from the boards' 2008 discussion paper.

New categories for the 'Statement of financial position'

Business
- Operating
- Financing arising from operating activities
- Investing

Discontinuing operations
Income taxes
Financing
- Debt
- Equity

Total assets
Total liabilities

New categories for the 'Statement of comprehensive income'

Business
- Operating
- Financing arising from operating activities

Total operating income
- Investing

Total business income
Financing
Income taxes
Net income from continuing operations
Discontinued operations
Net income
Other comprehensive income
Total other comprehensive income

Roll-forward analyses

The staff draft includes a proposal that all companies (except non-public entities) provide a 'roll-forward' presentation of changes in significant assets and liabilities. This presentation would include an analysis and explanation of the nature of transactions and re-measurements that caused the changes in the account balances.

Net debt reconciliation

The IASB has tentatively concluded that all companies present, in a single note, the changes in each item of debt, cash, short-term investments and finance leases. The staff draft does not define net debt explicitly but requires presentation of the information needed to determine net debt in a single note. This conclusion reflects comments on the 2008 discussion paper.

Convergence with US GAAP

The boards' tentative conclusions are expected to result in similar presentation of financial statements under IFRS and US GAAP, but there are three key differences between the proposals:

(1) the FASB but not IASB will require the disaggregated information to be provided by segment;
(2) the IASB's proposal includes a separate note that reconciles changes in debt and related financial balances (a net debt reconciliation); and
(3) the IASB's proposal requires certain additional disaggregated line items in the balance sheet.

Am I affected?

The proposals would change the presentation and disclosure of three of the primary financial statements and would therefore affect all preparers and users of IFRS and US GAAP. The proposals would not apply to not-for-profit entities, entities applying 'IFRS for Small and Medium Entities' and employee benefit plans.

What do I need to do?

The boards have not formally invited comment on the staff draft but would welcome input. They expect to issue the official exposure drafts during the first quarter of 2011 and final standards at the end of 2011.

The tentative conclusions in the staff draft would significantly alter presentation and disclosure in the financial statements. Management should consider the potential impact on the financial statements and the information needed to comply with the additional disclosure requirements. Management should also consider whether to provide input for the boards as they work towards finalising their exposure drafts.

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