Revenue Recognition
Convergence between IFRS and US GAAP

By Richard Howard, ACA

Can we blame the marketeers for confusion about revenue recognition? Richard Howard thinks we can. He takes a look at the background to the IASB's discussion paper and considers the likely impact of the proposed changes.

Non-accountants must find it difficult to understand how you can recognise revenue differently depending on which side of the Atlantic you live on. In a simple world, the customer buys a product, pays the cash and the sale is recognised.

As an accountant, I blame the marketing and sales department for making our lives difficult. In years gone by, the sale was made and the invoice hit the top line. Then we started to get products being sold with added services (or vice-a-versa); TVs being sold with long term warranties, mobile phone contracts sold with a free phone, tickets sold for concerts which will not occur for a number of months and software sold with free upgrades.

In determining how to account for these sales, on this side of the Atlantic, we have managed to get by with one basic IFRS standard - IAS 18. On occasion, IFRICs have been issued such as one to provide guidance on accounting for customer loyalty programmes, but for the most part we have managed to apply the same general principles. Unfortunately for our US colleagues, their marketing and sales departments must be slightly more imaginative, as on last count; over 100 standards on revenue recognition have been required under US GAAP. Some say this is because US GAAP is rules-based. As an accountant again I blame the marketing people.

Why else would our US colleagues have had to issue such a large number of very specific standards, ranging from EITF 00-22 *Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future* to FASB Technical Bulletin 90-1- *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* to Technical Bulletin 79 *The Meaning of the Term 'Customer' as It Applies to Health Care Facilities under FASB Statement No. 14*!

It is against this backdrop that the IASB and FASB issued their discussion paper just before Christmas, entitled not 'Accounting for Sales', or 'Revenue Recognition' but '*Preliminary Views on Revenue Recognition in Contracts with Customers*'. You might think that if the marketeers got their hands on it, we would have a shorter title, but since it is because of them we find ourselves in this situation, it may be wise to keep them at bay. It is very apparent from both the time it has taken to issue this discussion paper and the 118 pages it covers that much thought has gone into this framework. To attempt to issue one standard covering all industries requires a principles-based approach and much thought behind the scenes. With comments requested by June 19 this year, it will be after that before we see whether the principles advocated will satisfy all industries. Ultimately, the final success of this standard will depend on the number of exceptions necessary where it is deemed the standard's principles are at odds with reality - and there are exceptions to every standard, so this should not be an issue.

How quickly the standard can be agreed will however have a more wide ranging effect as this will give an indication as to how quickly US GAAP and IFRS can converge. With the transition to IFRS in the US not currently enjoying the same level of support from within the SEC that it previously may have had, convergence projects such as this one may ultimately be the route that ensures direct comparability between IFRS and US GAAP.

Basic Principles

So what basic principle are the IASB and FASB betting on to bring everyone together?

The boards propose that revenue should be recognised on the basis of an increase in an entity's net position in a contract with a customer. Breaking this down, the discussion paper goes on to state that revenue is recognised when a contract asset increases or a contract liability decreases, which occurs as an entity performs the obligations inherent in the contract.

Furthermore, the discussion paper sets out a number of principles that should be kept in mind in the framework:

- A performance obligation is a promise in a contract; however such a contract can be explicit or implicit.
- When an entity promises to provide a good, it is a promise to transfer an asset to the customer.
- Likewise, when an entity provides a service, it is promising to transfer an asset, even though the customer may not consume the asset straight away.
- An entity is determined to have transferred an asset or service when the customer obtains control of the asset or it receives the promised service.

The one basic principle above which is bound to result in debate is the concept of recognising revenue only when the customer obtains control. I will come back to this point.

The other area of debate will be the concept of measurement. The IASB and the FASB have not yet expressed a view as to how an entity will measure the movement in the obligations inherent in a contract, however the discussion paper does point out that performance obligation should be measured at the transaction price. In making this straight forward comment, the boards add to it by stating that if a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative stand alone underlying selling price of goods and services involved. A very simple comment to make but one that differs from practice in many industries under US GAAP as we shall discuss later.

So what might change?

For most entities, the proposed standard would not result in a material change in how they recognise revenue. If, however, you work in construction or with a technology company, you might wish to read on.

- By using a contract based revenue recognition principle, relying on when the customer takes control of the asset, entities that at present recognise revenue for construction type contracts would recognise revenue during construction only if the customer controls the item constructed.
- In some industries, contractual promises are accounted for differently. For example, warranties or after sales servicing are accounted for as a cost accrual. This model would suggest that after sales services and warranties form part of the contract and hence should be recognised as revenue when they are satisfied.
- Some standards, specifically a number in the US, limit the use of estimates in revenue recognition. The most notable of these is in the technology industry where SOP 97-2 *Software Revenue Recognition* requires objective and reliable evidence of a selling price in order to account for that element of a contract separately. In other words you cannot estimate the separate price for an element of the contract which is not sold separately in an open market. In the proposed standard, companies would be allowed to estimate the stand alone selling prices of undelivered elements of a sale and recognise revenue on these separately.
- Finally, capitalisation of costs incurred in gaining a contract would only be allowed to be capitalised if and where they are eligible for capitalisation under other standards. In some industries, sales commissions are recognised over the period of a sale; however the draft standard would require such costs to be recognised up front.

How will things shape up?

As noted above, for most entities, the proposed standard will have minimal impact on current practice. While the standard setters have not excluded any particular contracts from the proposed model, they do question its relevance to provide 'decision useful information' for financial instruments, insurance or leasing as well as for biological assets. Further exemptions are however still to be played for as the boards admit that they will consider whether any further contracts should be excluded after reviewing comments on the discussion paper.

As for its effect on others:

- In applying US GAAP, the standard will hopefully provide consistency against the numerous standards which up until now have resulted in an inconsistent revenue recognition approach under US GAAP.[1]
- For US technology companies, the proposed approach to estimating the selling price of various parts of contracts will result in earlier recognition of revenue where there are multiple deliverable elements to each contract.
- For construction companies, on both sides of the Atlantic, unless the standard is amended to reflect the specifics of their industry or if it is excluded altogether, we may see unbundling of construction contracts. Although, whether there will be an appetite among customers to buy a building brick by brick in order to placate accounting standard setters is open to debate.
- Finally for those industries that utilise bill and hold arrangement such as in the car industry, well unfortunately, this still needs to be looked at!

[1] Under US GAAP, the connection fee paid to cable television provider is accounted for separately than the on-going subscription while for a telephone company; the connection fee has to be recognised over the contract period. This anomaly arises as they are covered by separate standards.

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