Accounting for revenues: Potential changes in valuation and timing

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ABSTRACT

This paper discusses potential changes in valuation and timing of revenues that result from the Exposure Draft (ED) of the proposed Accounting Standards Update (ASU), Revenue Recognition (Topic 605): Revenue from Contracts with Customers. Comments made to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the boards) during the public comment period are incorporated into the discussion. The ASU proposes a core principle intended to be applied in all cases of revenue recognition. Application of a core principle is expected to help eliminate some of the complexity associated with current US GAAP. Respondents overwhelmingly agree with much of the ASU but express a desire for additional guidance and clarification in many areas. The amount of additional guidance that will be provided by the boards is yet to be determined and will be important not only for revenue recognition, but for the work that remains on other projects identified in the Memorandum of Understanding "The Norwalk Agreement"(FASB, 2002). This paper provides an overview of the proposed standard along with a summary of public comments and an unbiased discussion of the impact the new ASU will have on financial reporting. After reading this paper professionals will be able to evaluate the potential changes in timing and valuation of revenues and form an opinion about the new standard.

Keywords: Revenue Recognition, Accounting Standards Updated Topic 605, IFRS and FASB Converged Standard, Revenue from Contracts with Customers, Exposure Draft, Performance Obligation

INTRODUCTION

The importance of the revenue recognition standard is evidenced by its inclusion as a Category 1 project in the Memorandum of Understanding "The Norwalk Agreement" (FASB, 2002; SEC, 2011). The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (the boards) issued a discussion paper, Revenue Recognition in Contracts with Customers (IASB, 2008) and an Exposure Draft (ED) Revenue from Contracts with Customers in June 2010. After an active public comment period including almost 1,000 comment letters (FASB, 2012b)the boards issued an ED of a proposed Accounting Standards Update (ASU), Revenue Recognition (Topic 605): Revenue from Contracts with Customers (FASB, 2011; Neal, 2011). The public comment period for the revised ED ended on March 13, 2012. The 357 comment letters received were largely in agreement with the proposed ASU; however, many of them identified areas where terms used were vague and could allow for loose interpretation of the standard(FASB, 2012b). The extent of additional guidance that will be provided in the final standard is unknown. Once the new standard takes effect in the United States, users and preparers of financial statements will need to consider the potential for changes in the timing and amount of revenue to be recognized.

The new standard allows for more judgment and requires considerable disclosures. Careful unbiased professional judgment should result in more decision useful financial statements; however, concerns about earnings management cannot be ignored. One example of possible earnings management relates to the allocation of the transaction price among a number of performance obligations. The financial statement preparer must assign a portion of the transaction price to each performance obligation. Revenue is then recognized as the performance obligations are satisfied. To establish a "cookie jar" type reserve more of the transaction price could be allocated to performance obligations that will be fulfilled at the end of the contract. Alternatively, current revenues could be increased by allocating a larger portion of the transaction price to performance obligations that will be completed in the current accounting period. Either of these attempts at earnings management negatively impacts the quality of earnings. Ethical professional judgment will result in the proper allocation of transaction price among performance obligations and provide decision useful financial statements for users.

The new standard has been agreed upon by both the FASB and the IASB (Golden, 2011).The general consensus is that it is an improvement on the standards currently in use by both bodies. ASC 605 identifies current US GAAP and it contains complex and inconsistent rules for the recognition of revenue. International Accounting Standards (IAS) 18, Revenue, and IAS 11, Construction Contracts provide limited guidance and can be challenging to apply to more complex transactions (Golden, 2011). One of the intentions of the revenue recognition project is to address the limitations of current standards by providing one principle that can be applied consistently with an appropriate amount of guidance and improved disclosure requirements. The new standard is a contract based model that recognizes revenue when or as the transfer of goods occurs and the customer obtains control of the asset. This transfer can be made either at a point in time or over a period of time(FASB, 2011).

Compared to current GAAP that can result in revenue recognition at the point of sale, before delivery or in some cases after delivery, recognizing revenue when control over the good or service is transferred to the customer is intended to be a general principle that can be applied in all circumstances. The core principle of the proposed standard is to "Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."(FASB, 2012a)

As presented in the FASB staff document, application of this new standard is accomplished in five steps. The first step is to determine that a contract is in existence; the contract establishes legally enforceable rights and obligations. It can be written, oral or implied by customary business practices. The recognition of revenue from a contract requires that the contract meet the following criteria: commercial substance, approval of contract and commitment to perform, identifiable rights and payment terms. The second step is to identify performance obligations. Performance obligation is a new concept introduced in the ED. "A performance obligation is promise in a contract with a customer to transfer a good or service to the customer. Performance obligations include promises that are implied by an entity's customary business practices, published policies, or specific statements if those promises create a valid expectation of the customer that the entity will perform."(FASB, 2010) Contracts contain separate performance obligations only if a promised good or service is distinct. The ED identifies a good or service to be distinct if "The entity regularly sells the good or service separately" or "the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer."(FASB, 2011) The third step is to determine the transaction price. The ED considers the following items in determining transaction price: variable consideration, time value of money, noncash consideration and consideration payable to a customer. The fourth step is to allocate the transaction price to each performance obligation. Finally, revenue is recognized when or as each performance obligation is satisfied and control is transferred. (FASB, 2012a). Clearly the judgment exercised by financial statement preparers when determining what constitutes a distinct performance obligation, transaction price and the allocation of the transaction price to multiple performance obligations will impact the amount and timing of revenue. This paper examines potential changes to GAAP with particular attention paid to the timing of revenues and discusses many of the public comments made on the current ASU.

Performance Obligations over Time

Paragraph 35 of the ASU provides two criteria that identify circumstances where it would be appropriate to recognize revenue over time rather than at a point in time. A summary of the criteria is provided in Table 1. Paragraph 36 provides guidance to determine whether an asset has an alternative use.

The provision of criteria to determine when a performance obligation is satisfied over time is widely considered an improvement to the original ED. However, many respondents found this section of the ASU to be complex and sometimes challenging to apply. Further clarification about 'alternative use', and a better explanation of how the criteria in paragraph 35 (b) relate to 'transfer of control' were noted as areas that needed improvement. Since the term 'alternative use' as described in the ASU includes contractual restrictions, some respondents raised concerns about the potential misinterpretation of 'alternative use' resulting in revenue being recognized over time when it is not appropriate to do so. "Thus in circumstances where the customer has made a non-refundable payment in full for the item and the contract specifies that the customer is entitled to a specific item that can be identified, the proposals as drafted may enable an entity to conclude that they could recognize revenue as the item is manufactured."

(FASB, 2012b) Other respondents did not find the linkage between the core principle ‘transfer of control’ and the criteria ‘alternative use’ to be intuitive and would like to have paragraph 35 expanded “in a way that more obviously make the link with paragraph 32.”(FASB, 2012b)

Identifying what constitutes the right to payment as it relates to the criteria in 35(b)(iii) resulted in “many questioning whether a ‘right to payment’ meant that milestone or stage payments would be required to be made. Other respondents also questioned whether the payment terms need to be specified in the contract or whether they should also consider general business practices and/or the legal environment in which the contract was signed.”(FASB, 2012b) A small number of respondents expressed concern that the right to payment criteria will result in recognizing revenue as cash payments are made rather than as control is transferred.

Identifying Separate performance obligations

Although the FASB did not ask for specific feedback related to paragraphs 28 through 30 a multiplicity of comments were made about identifying separate performance obligations. Similar to the comments related to paragraph 35 respondents “supported the principle of identifying separate performance obligations on the basis of distinct goods or services.

Many expressed difficulty in applying the criteria to their contracts.(FASB, 2012b) Paragraph 28 identifies a good or service as being distinct if either “(a) The entity regularly sells the good or service separately. (b) The customer can benefit from the good or service either on its own or together with other recourses that are readily available to the customer.”(FASB, 2011) Paragraph 29 clarifies that a good or service is not distinct if both “(a) The goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined items(s) for which the customer has contracted. (b) The bundle of goods or services is significantly modified or customized to fulfill the contract.”(FASB, 2011)

Some industries indicated that there would be difficulty in “determining how much modification or customization would be considered ‘significant’ particularly in cases where the contract requires basic software plus customization services.”(FASB, 2012b) The software industry identified the sale of post-contract support (PCS) as an example of the problem. PCS products are made up of a bundle of other products that “are often sold separately (paragraph 28(a)) to different customers and thus each part may be considered to be distinct.”(FASB, 2012b) Paragraph 30 provides a possible solution to this problem. “As a practical expedient, an entity may account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer.”(FASB, 2011) The respondents from the software industry indicated that additional guidance would be required about “whether the boards think that these services have the same pattern of transfer and further how they may be able to measure progress for these services”(FASB, 2012b). Other industries raising concerns were those that produce similar specialized items and “contracts that provide repetitive services delivered consecutively.”(FASB, 2012b) These respondents questioned whether such contracts would constitute many separate performance obligations or should be accounted for as a single performance obligation.(FASB, 2012b)

Constraining the cumulative amount of revenue recognized

The ASU asked for comments related to constraining the amount of revenue recognized as presented in paragraph 81. "If the amount of consideration to which an entity expects to be entitled is variable, the cumulative amount of revenue the entity recognizes to date should not exceed the amount to which the entity is reasonably assured to be entitled. " (FASB, 2011) An entity can only be reasonably assured if both "The entity has experience with similar types of performance obligation" and "The entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled".(FASB, 2011) Responses to this question centered on the definition of variable consideration, the use of the term "reasonably assured" and determining what constitutes predictive experience.(FASB, 2012b)

The guidance for the ASU includes contingencies as a type of variable consideration. Accounting Standard Codification 450-10-20 defines a contingency as "An existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur." "Some respondents explained that many interpret the term 'contingencies' to be limited to consideration that is dependent on events outside of the control of the entity." (FASB, 2012b) The respondents "broadly agree with the principle of constraint on the cumulative amount of revenue recognized" (FASB, 2012b); However they are looking to the boards for clarification of variable consideration and contingency in the final draft of the standard. "Reasonably assured" is a term used in other standards including auditing requirements. To minimize confusion some respondents suggest "either re-draft the section to avoid the use of any term or select another term that is not used elsewhere in accounting requirements." Others would like the boards to "provide a more robust definition".(FASB, 2012b)

Considerable professional judgment will be required when determining if an entity's experience is predictive. "Some respondents suggested that the term 'predictive experience' was too vague and could be loosely interpreted. In particular, respondents have highlighted that some may conclude that their historical experience is 'predictive' and thus revenue may be recognized even when factors exist that could cause significant changes in the amount of variable consideration."(FASB, 2012b) Respondents indicated the need for clear guidance about what establishes predicative experience to eliminate this potential problem. (FASB, 2012b)

Credit Risk

The original ED required entities to consider the effect of credit risk when determining the transaction price. The revised ASU eliminated that requirement but proposed that customer credit risk should be shown as a separate line item adjacent to revenue. "Almost all respondents agree with the proposal to exclude the effect of customer credit risk from the transaction price."(FASB, 2012b) Less enthusiasm was shown related to the concept of presenting credit risk adjacent to revenue. "Most often, these respondents disagree because they believe that the proximity of the effect of customer credit risk to the revenue line item would inappropriately imply that the entirety of the impairment expense relates to revenue recognized in the current period."(FASB, 2012a) Pricewaterhouse Coopers noted "The requirement to present the impact of credit risk on the face of the income statement in a line item adjacent to revenue is too prescriptive without providing additional benefits."(PricewaterhouseCoopers, 2012) McGladrey commented "Paragraph 69 indicates that uncollectible amounts should be presented in profit or loss as a separate line item adjacent to the revenue line item. We believe some may interpret this guidance to mean uncollectible amounts should be presented as contra revenue."(McGladrey & Pullen, 2012) Some respondents wanted a collectability threshold. "These respondents think that revenue should be recognized only for amounts where there is a reasonably high likelihood of collection (eg probable)."(FASB, 2012a) It seems likely that the general lack of cohesion in the responses will result in further clarification by the boards when the final standard is released during the first quarter of 2013.

Time Value of Money

Paragraph 58 of the ASU states "In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract."(FASB, 2011) Consistent with comments previously discussed, most respondents agreed with the general concepts presented in the ASU but expressed concern about the lack of specific guidance, in this case to identify a significant financing component. Different interpretations of what makes up a 'significant financing component' could result in revenue from similar contracts being recognized during various accounting periods by distinct entities. (FASB, 2012b) Other respondents were concerned with the complex nature of using the time value of money especially for long term contracts and for contracts with cash flows that do not necessarily coincide with the transfer of goods or services.(FASB, 2012b) Finally, the issue of matching and overall consistency with accrual based accounting was noted by some indicating that the proposal "Might result in asymmetrical reporting of an entity's financial performance because the proposals would adjust the contract revenue for the effects of the time value of money but other standards may preclude the entity from adjusting the contract costs for the time value of money." (FASB, 2012b) The time value of money is an accepted concept that is used in other areas of accounting to determine valuation. The boards will need to decide if the added complexity and potential inconsistencies associated with including a time value of money component is prudent for the new revenue recognition standard.

Onerous performance obligations

The ASU identifies a performance obligation as onerous "if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation."(FASB, 2011) Once a performance obligation is determined to be onerous a liability will be recorded "at the amount by which the lowest cost of settling the remaining performance obligation exceeds the amount of the transaction price allocated to that remaining performance obligation."(FASB, 2011) Respondents criticized the ASU paragraphs 86-90 for a number of reasons including: applying the standard at the performance obligation level, the choice of metrics used to measure the liability, and the scope limitation of one year.

When the standard is applied to specific performance obligations rather than the contract in total it "distorts the overall economic intent of the negotiation and fails to capture how management prices and views the transaction."(FASB, 2012b) When management negotiates a contract with a customer it considers the entire contract in its pricing decision. Forcing a business to record a liability at the performance obligation level might not present the most decision useful information to readers, and it could influence how financial statement preparers allocate the transaction price to performance obligations. Respondents also noted that tracing the cost information required to determine if there is an onerous performance obligation may require “costly system changes”(FASB, 2012b). The lowest cost of settling a performance obligation is identified in Paragraph 87as either “(a) The costs that relate directly to satisfying the performance obligation by transferring the promised goods or services or (b) The amount that the entity would pay to exit the performance obligation if the entity is permitted to do so other than by transferring the promised goods or services.”(FASB, 2011) A compelling argument is made by Siemens in comment letter number 270. “Because of contractual limitations an entity typically cannot exit from a single performance obligation but only from the whole contract. That means the costs to exit a performance obligation equal the costs to exit the whole contract. Comparing these costs to the costs that relate directly to satisfying a performance obligation would be inappropriate. Additionally the respective contract may also include profitable performance obligations from which an entity would also have to exit. If the contract as a whole is profitable it is unlikely that an entity would cancel the contract only to exit from a single onerous performance obligation.” (Siemens, 2012) The boards will have to decide if it makes sense to recognize a liability for a portion of the contract that is not profitable when the overall contract is profitable and if the costs associated with collecting the additional cost data is warranted.

Paragraph 86 of the ASU identifies the scope related to an onerous performance obligation. “For a performance obligation that an entity satisfies over time and that the entity expects at contract inception to satisfy over a period of time greater than one year, an entity shall recognized a liability and a corresponding expense if the performance obligation is onerous.”(FASB, 2011) The comments related to the scope were varied. Some suggested that the test be applied to all performance obligations without regard to whether it is satisfied at a point in time or over a period of time and therefore create greater consistency. Most disagreed with the arbitrary choice of one year. “Respondents acknowledge that the proposed limitation of the test attempts to facilitate the application of test by alleviating some of the cost-benefit concerns. They also acknowledge the Boards were limiting the scope of the onerous test to minimize the risk of unintended consequences.” A few expressed that existing guidance addressed in ASC Topic 450 *Contingencies* would be a more appropriate place to make the suggested changes.

Disclosure

Current disclosure requirements related to revenue recognition are widely seen as lacking. The requirements for interim and year end disclosures in the ASU seek to remedy the situation. Respondents recognize the need for further disclosure but were divided about the requirements provided in paragraphs 109-130. In general regulators and users of financial statements found the disclosure standards to be fitting, but preparers found the requirements to be superfluous. “The objective of the proposed disclosure requirements is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.” (FASB, 2011, 2012b) The information required includes disclosure related to contracts with customers, disaggregation of revenue, reconciliation of contract balances, performance obligations, onerous performance obligations, judgments made in the application of the proposed guidance and how the transaction price is allocated among performance obligations. Preparers expressed concern that the disclosures do not pass the cost benefit test and that some of the disclosures relate to forward looking information which would be more appropriate to include in the Management Discussion and Analysis. Users and regulators “commented that the proposed guidance could be enhanced further by requiring some additional disclosures”. “These respondents explained that the proposed disclosures may appear extensive; however, they think this is more reflective of the inadequacy of current disclosure requirements” (FASB, 2012b). All stakeholders will not be equally satisfied with the final standard; however, it is clear that the new disclosure requirements are an improvement on current US GAAP.

Conclusion

In 1998, premature revenue recognition practices were identified as one of the fundamental problems with current financial reporting by Arthur Levitt, SEC Chairman at the time.(Altamuro, Beatty, & Weber, 2005) The pressure for a company to meet or beat expectations undoubtedly continues to influence management today. The additional guidance that may be provided by the boards is yet to be determined and no amount of guidance will be able to make up for the professional judgment exercised by accountants. A common reason for financial statements to be restated is revenue recognition. Peterson examined how complex revenue rules affected misreporting. The study suggested that both unintentional misreporting and cases where mangers used the complex accounting rules to manipulate reporting of revenue increased as the complexity of revenue rules increased (Peterson, 2012). The new standard includes one core principle and attempts to make the rules for revenue recognition consistent. If Peterson’s findings can be applied to all economic entities the new simplified rules could result in fewer restatements.

In each of the areas described in this paper respondents identified various ways the ASU could be interpreted resulting in revenue being recognized during a different accounting period or with inconsistent valuation. Among the timing issues are the allocation of transaction price to different performance obligations and constraining the cumulative amount of revenue recognized in the case of variable revenue. Alternate valuations are possible when applying the time value of money and as a result of the constraints on the cumulative amount of revenue recognized. Comments generally looked for additional guidance and consistency within the ASU. One of the goals of the revenue recognition project is to simplify GAAP with one principle that can be applied consistently. It seems the profession is moving in the direction of a more principle based standard; however, as demonstrated in many of the comment letters, financial statement preparers continue to seek specific guidance to determine proper accounting. In every case no amount of guidance or rules can take the place of ethical professional judgment in financial statement preparation. The balance between overriding principles and specific guidance will continue to be an important theme, not only for revenue recognition but for other standards identified in the MoU.

Table 1		
From Paragraph 35 of ASU 605 Revenue may be recognized over time rather than at a point in time;		
If either the entity's performance creates or enhances an asset (for example work in process) that the customer controls as the asset is created or enhanced.	Or the entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:	
		(i) The customer simultaneously received and consumes the benefits of the entity's performance as the entity performs.
		(ii)Another entity would not need to substantially reperform the work the entity has completed to date if that other entity were to fulfill the remaining obligation to the customer.
		(iii) The entity has a right to payment for performance completed to date, and it expects to fulfill the contract as promised.(FASB, 2011)

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