# In brief

The latest news in financial reporting

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**At a glance**

*Changes are in store for all entities that recognize revenue – some more than others.*

# Revenue recognition – The future is here

## What happened?

On May 28, the FASB and IASB issued their long-awaited converged standard on revenue recognition. Those closely following the project know there are potentially significant changes coming for certain industries, and some level of change for almost all entities. Summarized below are some of the areas that could create the most significant challenges for entities as they transition to the new standard.

### *Transfer of control*

Revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Transfer of control is not the same as transfer of risks and rewards, nor is it necessarily the same as the culmination of an earnings process as it is considered today. Entities will also need to apply new guidance to determine whether revenue should be recognized over time or at a point in time.

### *Variable consideration*

Entities may agree to provide goods or services for consideration that varies upon certain future events occurring or not occurring. Examples include refund rights, performance bonuses, penalties, etc. These amounts are often not recognized as revenue today until the contingency is resolved. Now, an estimate of variable consideration is included in the transaction price if it is probable (U.S. GAAP) or highly probable (IFRS) that the amount will not result in a significant revenue reversal if estimates change. Even if the entire amount of variable consideration fails to meet this threshold, management will need to consider whether a portion (a minimum amount) does meet the criterion. This amount is recognized as revenue when goods or services are transferred to the customer. This could affect entities in multiple industries where variable consideration is currently not recorded until all contingencies are resolved. Management will need to reassess estimates each reporting period, and adjust revenue accordingly.

There is a narrow exception for licenses of intellectual property (IP) where the variable consideration is a sales- or usage-based royalty.

### *Allocation of transaction price based on relative standalone selling price*

Entities that sell multiple goods or services in a single arrangement must allocate the consideration to each of those goods or services. This allocation is based on the price an entity would charge a customer on a standalone basis for each good or service. Management should first consider observable data to estimate the stand alone selling price. An entity will need to estimate the standalone selling price if such data does not exist. Some entities will need to determine the standalone selling price of goods or services that have not previously required this assessment, such as entities that report under US GAAP and issue customer loyalty points.

*Licenses*

Entities that license their IP to customers will need to determine whether the license transfers to the customer over time or at a point in time. A license that is transferred over time allows a customer access to the entity's IP as it exists during the license period. Licenses that are transferred at a point in time allow the customer the right to use the entity's IP as it exists when the license is granted. The customer must be able to direct the use of and obtain substantially all of the remaining benefits from the licensed IP to recognize revenue when the license is granted. The standard includes several examples to assist entities making this assessment.

*Time value of money*

Some contracts provide the customer or the entity with a significant financing benefit (explicitly or implicitly). This is because performance by an entity and payment by its customer may occur at significantly different times. An entity should adjust the transaction price for the time value of money if the contract includes a significant financing component. The standard provides certain exceptions to applying this guidance, and a practical expedient which allows entities to ignore time value of money if the time between transfer of goods or services and payment is less than one year.

*Contract costs*

Entities sometimes incur costs (such as sales commissions or mobilization activities) to obtain or fulfill a contract. Contract costs that meet certain criteria are capitalized as an asset and amortized as revenue is recognized. More costs are expected to be capitalized in some situations. Management will also need to consider how to account for contract costs incurred for contracts that are not completed upon the adoption of the standard.

*Disclosures*

Extensive disclosures are required to provide greater insight into both revenue that has been recognized, and revenue that is expected to be recognized in the future from existing contracts. Quantitative and qualitative information will be provided about the significant judgments and changes in those judgments that management made to determine revenue that is recorded.

## Why is this important?

The new standard will affect most entities that apply U.S. GAAP or IFRS. Entities that currently follow industry-specific guidance should expect the greatest impact.

## What's next?

The standard will be effective for U.S. GAAP reporters for the first interim period within annual reporting periods beginning after December 15, 2016 for public entities and after December 15, 2017 for non-public entities, with no early adoption permitted. The standard will be effective for IFRS reporters for the first interim period within annual reporting periods beginning on or after January 1, 2017, and will allow early adoption, with no delay in effective date for non-public entities.

### Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Revenue team in the National Professional Services Group (1-973-236-7804).

### Authored by:

Dusty Stallings
Partner
Phone: 1-973-236-4062
Email: dusty.stallings@us.pwc.com

David Morgan
Senior Manager
Phone: 1-973-236-5581
Email: david.t.morgan@us.pwc.com