

# IASB & FASB Convergence Project

## Revenue Recognition

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### **ABSTRACT**

Accounting revenue recognition practices have a pervasive, profound impact on the financial statements of a business entity. As such, soon after committing to a plan for convergence of two major sets of accounting standards with the Norwalk Agreement of 2002, the Financial Accounting Standards Board (FASB) of the United States and the International Accounting Standards Board (IASB) undertook a project to converge their standards of revenue recognition. Through an analysis of historical practices of the two boards and progress to date on the convergence of revenue recognition standards, this paper presents further recommendation for improvement of the convergence effort. Acknowledging the progress to date, we recommend further international and industry collaboration measures to ensure that the resulting standard provides the most useful information possible to financial statement users. Progress to date along with our recommendation assure that the resulting worldwide standard of revenue recognition provides specific principle based guidance that promotes international consistency while providing the flexibility for national and industry specific application.

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### **INTRODUCTION**

In the late 1970s, the Financial Accounting Standards Board (FASB), the accounting standard setter in the United States, began work on the accounting profession's first conceptual framework. Two decades later in 1989, the International Accounting Standards Committee (IASC), an international body similar in purpose to the FASB and the predecessor to the current International Accounting Standards Board (IASB), issued its version of a conceptual framework entitled, "Framework for the Preparation and Presentation of Financial Statements." While there are many similarities between the two conceptual frameworks, differences remain today that result in accounting standards differences. With businesses and capital markets continuing to expand globally, there has been an ongoing effort to resolve these differences with the goal of arriving at a unified and internationally agreed upon set of accounting standards.

In 2002, the Norwalk Agreement between the FASB and IASB sparked the beginning of an ongoing convergence project between the two accounting standard setting bodies (FASB, 2012). The objective of the convergence project is to "create a sound foundation for future accounting standards that are principles-based, internally consistent, and internationally

converged” (IASB, 2012). While the pace of convergence was initially slow, there has been a recent increase in momentum and an ambitious goal of full convergence by 2015 has been set (Defelice and Lamoreaux, 2010). With the targeted date for convergence quickly approaching, it is critical for businesses to have a full understanding of how the proposed new standards may affect their organizations.

This paper focuses on one area critical to all organizations – revenue recognition. We first examine the motivation for converging the criteria that must be met in order for organizations to formally recognize revenue. To explore this area, we provide a timeline of events that led to the current standards for revenue recognition for both the FASB and IASB. Next, we compare and contrast the similarities and differences in current revenue recognition standards while examining the various political environments, constraints, and pressures faced by the different standard setters. We conclude by proposing a set of revenue recognition criteria that incorporates both the FASB and IASB conceptual frameworks, but also considers economic factors, technological advances, various emerging issues, and political pressures.

## **BACKGROUND**

Revenue recognition has been a critical topic of discussion and concern since the FASB began work on its conceptual framework. The first guidance provided to U.S. companies regarding the conditions that must be met in order for revenue to be recognized came from the FASB in 1984 when it released its fifth Statement of Financial Accounting Concepts (SFAC No. 5). This pronouncement defines two broad criteria that must be satisfied before companies can recognize revenue. The first is that revenue must be realizable or realized (i.e., the organization must be able to reasonably estimate the probability that it will be paid). The second is that the revenue must be earned (i.e., the organization has substantially accomplished that which is required in order for the organization to be entitled to the benefits represented by the revenue). Despite the intentions of SFAC No. 5 to offer clear principles regarding the recognition of revenue, the potential ambiguity implicit in these two criteria has led to numerous frauds over the last three decades.

According to a 1999 report issued by the Committee of Sponsoring Organizations (COSO), several frauds during the 1987-1997 time period were a result of overstatements of revenue, typically at the end of an accounting period in an effort to bolster earnings (COSO, 1999). The 1999 COSO report finds that the second criterion of SFAC No. 5 was violated in several of these frauds involving revenue recognition, namely, the recognition of revenue prior to it actually having been earned. Since the issuance of the 1999 COSO report, there have been numerous additional financial reporting frauds that have been attributed to violations of the spirit of SFAC No. 5. Consequently, the Securities and Exchange Commission (SEC), at times in concert with the FASB, have provided additional guidance to companies regarding revenue recognition. Specifically, there have been at least six standards issued subsequent to SFAC No.5 dealing with revenue recognition, with four specific areas being identified as potentially problematic: bill-and-hold arrangements, long-term contract arrangements, barter advertising, and agent-facilitator relation transactions (Briner, 2001).

For example, a bill-and-hold transaction involves a buyer purchasing merchandise from a seller while the seller retains physical custody of the merchandise. To the extent the seller physically separates the merchandise from its active inventory, the seller is permitted to recognize the revenue on the sale. However, this type of transaction has been shown to have a potentially high risk for fraud. Specifically, a seller can set merchandise inventory aside and *claim* it has

been sold to a customer while falsifying purchase orders. Moreover, the SEC has banned the ability of companies to recognize revenue in bill-and-hold transactions when only a verbal agreement to purchase merchandise exists between parties (Briner, 2001).

A recent example involving Groupon illustrates the potential problems inherent in agent-facilitator transactions. In these types of transactions, the agent retains custody of the inventory, but does not have ownership rights to it. Therefore, upon the sale of the inventory, the agent should only recognize the commission on the sale, not the entire value of the sale. Shortly after its initial public offering on November 4, 2011, Groupon's revenue recognition practices came under scrutiny. Specifically, it was found that Groupon was recording the commission on the sale of coupons *and* the coupons being sold as revenue. Consequently, Groupon was forced to restate earnings for its first three months as a publicly listed company, which reduced revenue from 713.4 million to 312.9 million, or a decrease of 56.1-percent (McMillan, 2011).

With ever-increasing competition and pressure for companies to release favorable earnings reports, along with the potential for fraud that exists due to the ambiguity in the current revenue recognition guidance, it has become increasingly critical for the FASB and IASB to establish a unified set of accounting standards. In January 2002, the FASB began discussions on a major project to overhaul the existing revenue recognition standards (FASB, 2012). These discussions began identifying the objectives and scope of the project, which would result in comprehensive guidelines for the recognition of revenue in various industries. While the project would involve amending current SFACs, it would also provide new guidance. In June 2002, the IASB added revenue recognition to its technical agenda. The FASB and IASB entered into a formal agreement in September 2002 to work jointly on the revenue recognition project and to share staff resources. The objectives of the joint project were as follows:

1. Remove inconsistencies and weaknesses in existing revenue requirements.
2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer. (FASB, 2012)

The project began by simultaneously taking two interrelated approaches. Using a "top-down" approach, staff members developed conceptual guidance for the recognition and measurement of revenues. The aim of this approach was to establish the conceptual "back bone" of the new standard. Using a "bottom-up" approach, staff members analyzed the existing authoritative guidance of both the FASB and IASB regarding revenue recognition principles and practices. The objective of this approach was to identify which principles were "working" and, therefore, should be retained in the new standard.

Prior to May 2005, the Boards were developing a revenue recognition model that would measure assets and liabilities at fair values (the so-called "fair value" or "measurement" model). Under this approach, the Boards tentatively agreed that performance obligations should be measured at fair value—that is, the price that the reporting entity would have to pay an unrelated party to assume legal responsibility for performing all of its remaining obligations. However, some Board members expressed concerns regarding the reasonableness of estimating non-observable prices (as is common in practice). Further, there were concerns

regarding the pattern of revenue recognition under such a model. In light of these concerns, the Boards explored an alternative model—the customer consideration model. Under this model, performance obligations would be measured at an allocated customer consideration (i.e., transaction price) amount. After several years of working together, the Boards issued a Discussion Paper, Revenue Recognition in Contracts with Customers, in December 2008 that followed the allocated customer consideration approach.

## **INTERNATIONAL ACCOUNTING STANDARDS BOARD**

To better understand IASB revenue recognition practices prior to convergence efforts, it is important to have an understanding of the Framework for the Preparation and Presentation of Financial Statements. This document is the conceptual framework that was formally adopted by the IASB in 2001. Rather than explicitly defining revenue, this framework defines and discusses the term “income,” which can include revenues and gains. In the context of this paper, it is important to distinguish between revenues and gains as they have different meanings. Revenue, which is the focus of this paper, results from the ordinary operations and activities of an organization and include, but are not limited to: sales, fees, interest, dividends, royalties, and rent (IASB, 2010). Gains on the other hand are defined as “an increase in economic benefits” (IASB, 2010). The current IASB Conceptual Framework still considers gains and benefits to ultimately be similar in nature and will continue to be addressed under the term income.

Under the initial IASB Conceptual Framework, companies were to recognize revenue based on two general assumptions. The first was that it would be probable that any future economic benefit associated with the sale of an item would flow to the organization. This assumption, which has remained unchanged, deals with the degree of uncertainty that the benefits will actually flow to the company. The assumption and the assessment of the uncertainty are to be uniquely based on the evidence available when the financial statements are being prepared. The second assumption is that the cost or value of the item being sold can be measured with reliability. Under these two assumptions, income is to be recognized “...when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably”(IASB 2001).

The second assumption mentioned above explicitly deals with valuation of revenue. Under the IASB’s Conceptual Framework and International Accounting Standard No. 18 (discussed below), revenue is to be measured at the fair value of the received or receivable (IAS 18, 2001). The fair value is defined as the agreed upon price (if the entities are using currency) between the seller and buyer, net of any discounts or rebates allowed by the seller. If the fair value of the goods or services cannot be readily measured by fair market value, companies must measure it by the value or the cost of the services provided. In circumstances where a fair value or cost cannot be determined, the item cannot be included in the balance sheet or income statement. To the extent the item is material in nature, companies are required to disclose the item in the footnotes to the financial statements, along with any supplementary information/data (IASB, 2012).

In 2001, the IASB released IAS No. 18, which is titled “Revenue.” This standard supersedes IAS No. 18 “Revenue Recognition,” which was issued in December 1982. This standard addresses revenues resulting from the sale of goods, the rendering of services, and/or the use by others of entity assets yielding interest, royalties, and dividends (IASB 2001). While the two basic assumptions listed above are still applicable, this standard offers additional guidance

based on the type of revenue being recognized. For example, with respect to the sale of goods, an entity can recognize revenue when all of following criteria are satisfied:

1. The entity has transferred to the buyer the significant risks and rewards of ownership of the merchandise/goods/item.
2. The selling entity will no longer have a controlling ability over the good(s) or continuing managerial involvement.
3. The amount of revenue can be measured reliably.
4. It is probable that benefits will flow to the entity.
5. Cost of the transaction can be measured reliably.

In the majority of cases, the first requirement is satisfied when the title of the goods has been transferred to the buyer and the buyer gains physical custody of the item(s). However, in situations such as overseas sales, the transfer of ownership does not necessarily mean that they buyer has physical custody of the good(s). In these circumstances the first requirement cannot be satisfied unless a) the sales contract states that the good(s) will transfer ownership when the merchandise has passed a certain checkpoint during the shipping/handling process and b) the merchandise passes that predetermined checkpoint.

The second requirement is relatively straightforward. However, it should be noted that post-sale maintenance and/or minor contractual obligations are not considered to constitute a “controlling ability” or “managerial involvement.” To the extent that, based on previous experience and/or other relevant factors, sellers can reasonably estimate expected maintenance/service costs or the possibility of returns, sellers can recognize the revenue (IASB, IAS No. 18, 2001). The third and fourth requirements flow from the initial IASB Conceptual Framework and are applied in a manner similar to that mentioned above.

For the fifth requirement to be satisfied, any expense(s) related to the sales transaction must be recognized when the associated revenue is recognized. In circumstances when a sales transaction is accompanied by a warranty, the associated expense must be recognized at the time of sale, assuming there is a reliable method of measuring the expense (e.g., past experience). If the expense associated with the warranty cannot be reliably measured, the revenue cannot be recognized, but rather must be converted to a liability (IASB, IAS No. 18, 2001).

Revenue recognition for certain servicing industries follows a method referred to as the “percentage of completion” method. While the two basic revenue recognition principles of the IASB Conceptual Framework are still applicable, it is also required that a) the cost up until the point of reporting and b) the cost to complete the service are measurable and that the measurement method is reliable. The industries most affected by these latter two requirements are the construction and repair industries. Given that significant construction contracts often extend beyond a particular reporting time horizon, it would be inappropriate to defer all revenues from the contract until the construction is fully completed. It would also be inappropriate to recognize all revenues from the contract in advance of fully construction completion. Therefore, the “percentage of completion” approach is allowed under these circumstances. According to IAS No. 11 “Construction Contracts,” the contract revenue shall comprise:

1. The initial amount of revenue agreed upon in the contract; and
2. Variations in contract work, claims, and incentives:
  - a. to the extent that it is probable that they will result in revenue; and

- b. They are capable of being reliably measured.

A company can make reliable estimates after both parties have reached an agreement. The agreement must define obligations and rights to the asset for each party and the conditions and terms of the job.

One major difference between construction revenues and other types of revenues is the constant re-measurement of contract revenue inherent in construction contracts. For example, revenue for a five-year construction contract is likely to fluctuate from year-to-year. Major causes of these variations can include unexpected costs, cost escalation due to an agreement in the contract, penalty costs, and unforeseen additional work. Further, construction customers may desire to alter a section of the contract, which could lead to an expansion or reduction of the initial contract. In circumstances in which a customer wishes to expand the extent of work being performed, the company must recalculate revenues and expenses. The additional revenue can be recognized when a) the customer approves the revisions to the contract and b) the amount of additional revenue can be reliably measured.

Other forms of income resulting from construction contracts (e.g., claims or bonuses) have specific requirements that must be met before revenue can be recognized. A claim is defined as an attempt of the contractor to recoup costs that extended beyond the scope of the contract. These costs could result from careless mistakes caused by customers, errors, and contestable costs. Given that these costs are frequently beyond the scope of the contract, the level of uncertainty regarding their amounts is considered relatively high. Therefore, this type of income must meet the requirement that “negotiations have reached an advanced stage such that it is probable that the customer will accept [or pay] for the claim,” and the amount being accepted or paid can be reliably measured (IASB, IAS No. 11, 2001). Bonuses have similar requirements. Specifically, if it is reasonably foreseeable that the contractor’s performance will satisfy bonus requirements, the resulting bonus revenue can be recognized given that it can be reliably measured.

With respect to interest, dividends and royalties, the same two basic criteria listed in the IASB Conceptual Framework must be satisfied prior to revenue being recognized. In addition, the following guidance is offered by the revised standard:

1. Interest shall be recognized using the effective interest method.
2. Dividends shall be recognized when the shareholder’s right to receive payment is established.
3. Royalties shall be recognized on the accrual basis in accordance with the substance of the relevant agreement.

The first requirement states that the effective interest method must be used when recognizing interest revenue. Specifically, an effective interest rate must be used to calculate earnings. The definition of this term refers to the method of calculating amortization cost and the allocation of interest income/expense over a period of time (IASB, IAS No. 39, 2001). An acceptable effective interest rate will discount the financial instruments to their present value. Additionally, all other aspects, expenses, and income of the financial instrument must be considered. In circumstances where the collectability of interest revenue is no longer expected or cannot be guaranteed, the estimated uncollectable amount is to be converted to an expense.

## FINANCIAL ACCOUNTING STANDARDS BOARD

Under United States Generally Accepted Accounting Principles, revenue recognition has generally been determined based on the meeting of two major criteria, prospective revenue is realized or realizable and such prospective revenue is earned. The rationale for the FASB's guidance on revenue recognition is predicated on the income statement focus of financial reporting in the United States. This income statement focus can be seen in the FASB's heavy reliance on the completion of the earning process for recognition of revenue. In addition to meeting these two basic criteria, the U.S. Securities and Exchange Commission in its Staff Accounting Bulletin No. 101 states that revenue recognition criteria are met when the following four events have occurred:

- 1) Persuasive evidence of an arrangement exists.
- 2) Delivery has occurred or services have been rendered.
- 3) The seller's price to the buyer is fixed or determinable.
- 4) Collectibility is reasonably assured. (Briner, 2001)

The often-ambiguous nature of the timing of these four events adds significant complexity to the basic determination of recognizing revenue, that being revenue is recognized when a sale takes place.

As specific industries and obscure transactions add additional complexity to the already complex issue of revenue recognition, the remainder of this section is concerned with pre-codification/pre-convergence U.S. GAAP related to the most common issues in revenue recognition corresponding with the topics discussed from IAS 18 in the previous section. FASB guidance will be cited in relation to sales of goods, sales of services, interest, royalties, and dividends. Providing the historical U.S. GAAP and FASB guidance in relation to these matters provides a foundation for comparison between IFRS and U.S. GAAP as well as a baseline for current and continued convergence between the two sets of standards, which is discussed later in this paper.

The sales of goods and services are generally closely related. Statement of Financial Accounting Concepts (SFAC) No. 5 paragraphs 83 and 84 provide guidance as to the recognition of revenue from these sources. Paragraph 83(b) of SFAC No. 5 states, "an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." Paragraph 84(a) sets forth the two general condition of revenue recognition, revenue being realized or realizable and that revenue be earned by stating that they "are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)." (U.S. Securities and Exchange Commission, 1999)

While the preceding citations of SFAC No. 5 provide guidance on the most common transactions involving the sale of goods and services, special circumstances do exist and are recognized in the concept statement. In circumstances where the sale and/or cash receipt occurs before production and delivery FASB guidance in SFAC No. 5 states that revenue is to be recognized as production and delivery occur, such as in production and delivery of magazine subscriptions. In such a situation, revenue has typically been realized in the form of an upfront subscription payment by the customer meeting the first criteria of revenue recognition. However, revenue is not earned until the periodic delivery of magazine issues; therefore, the

second criteria for revenue recognition necessitates a deferral of revenue recognition. (Financial Accounting Standards Board (FASB)<sup>1</sup>, 2008)

Issues of revenue recognition timing also occur in the case of construction contracts where production occurs over an extended period of time and payment is not received until completion. In such situations guidance in SFAC No. 5 suggests that the percentage of completion method be used where reasonable estimates of results at completion and reliable measures of progress are available. (Financial Accounting Standards Board (FASB)<sup>1</sup>, 2008)

Revenue recognition is further complicated for the sale of goods where the buyer retains the right to return the subject matter of the sale. FASB provides authoritative guidance on the matter in Statement of Financial Accounting Standards No. 48, Revenue Recognition When Right of Return Exists. When the buyer retains the right of return, SFAS No. 48 states that revenue can be recognized at the time of the sale if six criteria are met:

- 1) The seller's price to the buyer is substantially fixed or determinable at the date of sale.
  - 2) The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on resale of the product.
  - 3) The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
  - 4) The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
  - 5) The seller does not have significant obligations for future performance to directly bring about resale of the product by the buyer.
  - 6) The amount of future returns can be reasonably estimated.
- (Financial Accounting Standards Board (FASB)<sup>2</sup>, 2008)

These criteria apply to most retail sales situations as well as most arrangements between manufacturer-wholesaler-retailer. If any of the six criteria are not met, revenue may be recognized either when the return privilege has substantially expired or if those conditions subsequently are met, whichever occurs first. (Financial Accounting Standards Board (FASB)<sup>2</sup>, 2008)

When accounting for interest revenue, SFAC No. 5 in paragraph 84(d) provides general guidance. In providing guidance the FASB states, "If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes." (Financial Accounting Standards Board (FASB)<sup>1</sup>, 2008) Specifically, authoritative guidance is provided for financial institutions in SFAS No.91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Lease, which requires interest revenue recognition treatment for commitment and loan origination fees.

Given the nature of a royalty agreement, in general terms, revenue recognition would be treated substantially in accordance with the guidance provided by SFAC No. 5 in relation to interest or rents, as all grant one party the use of another party's property for a predefined fee. In this regard, revenues for royalties are generally recognized per their contract agreement. SFAS No. 50, Financial Reporting in the Record and Music Industry and SFAS No. 53, Financial Reporting by Producers and Distributors of Motion Picture Films, which was superseded by SFAS No. 139, provide authoritative guidance. SFAS No. 50 specifically addresses revenue recognition when copyrighted material is essentially sold in its entirety where revenue is advised to be recorded when the earning process is complete and collection is reasonably assured. Also

addressed is the licensor receiving a minimum guarantee from the licensee where the licensor is required to record the prospective revenue as a liability consistent with the concept of unearned revenue. (Financial Accounting Standards Board (FASB)3, 2008)

Dividend income is recognized under essentially the same guidance as most other revenue, when it is realized or realizable and earned. However, timing is the key to the guidance provided on recognition of dividend revenue recognition. Current codification under FASB section 946-320-25-4, Financial Services - Investment Companies, Investments - Debt and Equity Securities, Recognition, states that revenue recognition for the recipient of dividend income is to be deferred until the "ex-dividend" date. (FASB Accounting Standards Codification, 2012) As the timing of revenue recognition has major tax implications, the IRS defines the ex-dividend date as, "the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment." The ex-dividend date essentially defines when the earning process begins and ends for the holder of a dividend paying security and, therefore, also defines the date upon which the holder can recognize such revenue.

While the basic tenets of revenue recognition under the FASB's guidance have been followed for decades, problems exist. U.S. GAAP contains no general standard for revenue recognition. Rather, the FASB provides in its conceptual framework general guidance on the matter. Beyond the conceptual framework, U.S. GAAP contains (pre-codification) more than a hundred standards on revenue recognition. The combination of lack a general authoritative standard and over a hundred special application standards can lead to inconsistency in revenue recognition between similar firms. Inconsistent interpretation and application of the earnings process can also lead to misrepresentation, either intentionally or unintentionally, of a company's rights and obligations. (Bohusova, H., & Nerudova, D. 2009)

A step in the direction of simplification of U.S. accounting standards came with the completion of the FASB's codification project. FASB officially adopted the codification of U.S. GAAP on July 1, 2009. The codification project did not change GAAP, but simplified the way in which accounting professionals search the standards for guidance. Instead of navigating the complex series of standards, pronouncements, opinions, and bulletins in search of guidance on accounting issues, the codification has set up a searchable database organized by topic. As a result, the preceding guidance has been superseded by FASB Accounting Standards Codification Topic 105, Generally Accepted Accounting Principles. (FASB, 2012) Simplification of United States accounting standards took on added importance with the decision of the Financial Accounting Standards Board and International Accounting Standards Board to embark on a convergence project to more closely align worldwide accounting standards. Current progress of this effort and recommendations for continued alignment in the area of revenue recognition will be discussed later in this paper.

## **ANALYSIS**

There are many similarities and differences when comparing revenue recognition criteria of IFRS and US GAAP. The similarities and differences are as follows:

Measurement Criteria – both IFRS and US GAAP use the notion of fair value to measure revenue. Both have similar criteria when it comes to an exchange of non-monetary exchanges. FASB states that the revenue for these exchanges would be measured at the fair value of goods or services surrendered. IASB measures the fair value of the item received. If a fair value is not available, the entity receiving the item would use the fair value of the asset relinquished.

When one goes deeper into the definition of fair value, this is where the two accounting bodies diverge. FASB defines fair value as the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at measurement date, an exit price approach. IASB defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (IASB, IAS No. 18, 2001).

The major difference in this definition can be argued for the clause "liability settled". Some FASB board members argue this method of measurement would not be a fair value approach. This approach would be considered "entry value" instead of "exit value".

Recognition criteria – FASB states that revenue can be recognized when it is realized or realizable and must be earned. IASB created criteria that are quite different. Users of IFRS can recognize revenue when it is probable that future economic benefits will flow to the enterprise, and it can be measured reliably.

Revenue definition – extracted from SFAS no.5, FASB standards requires actual or expected cash inflows that have occurred or will result from the entity's ongoing major operation. IFRS standards define revenue as gross inflow of economic benefits during the period arising in the course of ordinary activities of an entity.

Sale of goods – both entities define that revenue from a sales type transaction can be recognized when the goods have been delivered, risks and rewards are transferred, collectability is reasonably assured and measurement is reliable.

Contract revenue recognition – FASB and IASB both use the percentage of completion approach to recognize revenue when there is a reasonable estimate of revenues and costs. The difference in this category lies within the instances where the transaction cannot be reasonably estimated. FASB uses the completed contract method where IASB uses the zero profit method. The zero profit method assumes a break even approach to the contract when a reasonable estimate cannot be obtained. Users of this method can revise the revenues and expenses when the contract is closer to the completion stage.

FASB uses multiple standards to guide revenue recognition for different industry types, whereas IASB only published two standards to address the same subject. This difference can be attributed to the fundamental differences in how FASB and IASB establish standards. FASB approaches accounting standards in a more rules-based approach while IASB uses a broader principles-based one.

It is understandable why IASB tends to use a principles-based approach. IASB standards guide accounting practice for 100+ countries; therefore, detailed rules with multiple exceptions would be necessary to accommodate the various cultures in multiple IFRS adopters. Broader standards rely on professional judgment of the accounting practitioners to comply with the spirit of the standards.

## **RECOMMENDATION FOR CONVERGENCE**

In September of 2002 the Financial Accounting Standards Board and the International Accounting Standards Board signed the Norwalk Agreement, which proclaimed their intentions to eliminate differences between U.S. GAAP and International Financial Reporting Standards and to develop one set of high quality global accounting standards. (James, 2009) Due to its pervasive and dramatic impact on the financial statements of firms worldwide, one of the

specific issues to first be addressed was that of revenue recognition. One month after the adoption of the Norwalk Agreement the IASB and FASB issued a memorandum of understanding, which was reaffirmed and updated in February of 2006 and included an initiative for a joint project on revenue recognition. (Bohusova, H., & Nerudova, D. 2009)

Convergence of revenue recognition standards between the two boards is a massive undertaking. As discussed previously in this paper, IFRS contains two revenue recognition standards, IAS 11 and IAS 18. While this is less cumbersome than the more than one hundred revenue recognition standards in U.S. GAAP, inconsistencies between the principles of the two standards have been noted, which makes them difficult to apply beyond simple transactions. (Bohusova, H., & Nerudova, D. 2009) Our previous discussion of revenue recognition under U.S. GAAP touched on only a handful of basic revenue recognition principles corresponding mostly to those of IAS 18. U.S. GAAP contains upwards of 100 industry-specific standards, the multitude of which can lead to different recognition by different firms given similar transactions.

Significant challenges face the two boards in adopting a joint standard on revenue recognition. Since their inception, IFRSs have been issued as general guidance of basic accounting principles, lacking specific guidance on a transaction level. U.S. GAAP on the other hand consists of specific rules and transaction level guidance on many issues that IFRSs leave to interpretation. A second major issue lies in the difference between the two boards' definition of what gives rise to revenue. As previously discussed, IFRS recognizes revenue based on the rights and obligations or probable future benefits that can be reliably measured. Therefore, the focus of IFRS is the determination of when a transaction creates an effect on the balance sheet. U.S. GAAP on the other hand is concerned with the measurement of revenue in and of itself. Under the FASB's guidance revenue is recognized when cash is realized or realizable and such revenue has been earned, without regard to the balance sheet implications of the transaction.

Because of these two foci, the IASB and FASB joint effort in converging revenue recognition faces two possible models around which to build the standard. First, following the lead of current IFRS revenue recognition standards, the joint standard could take an asset-liability approach. Under the method, revenue is not measured directly, but focuses on the changes in assets and liabilities to determine how much revenue is recognized. A second possibility would be to follow the lead of current FASB guidance in adopting an earning process approach. In following an earning process approach, revenue is measured directly as the earnings process is completed. However, since the method ignores assets and liabilities in determining the recognition of revenue, the balance sheet is susceptible to deferred debits and credits that do not meet the definition of assets and liabilities. (Bohusova, H., & Nerudova, D. 2009)

A first major step toward a unified standard on revenue recognition came in December 2008 when the IASB and FASB issued a discussion paper entitled, "Preliminary views on Revenue Recognition in Contracts with Customers." The boards proposed a standard by which revenue would be recognized entirely based on the firm's contract with the customer. Any remaining rights or obligations in the contract would give rise to net contract assets or net contract liabilities. Under the proposal, revenue would be recognized based on the changes in rights and obligations under a contract entered into with a customer. Rights (assets) arise from a customer's promise of cash or other compensation while obligations (liabilities) arise from the firm's promise to transfer assets to the customer. Revenue is recognized whenever there is an increase in contractual assets or a decrease in contractual liabilities or a combination of both. Remaining rights under the contract are measured, the balance of which will create a net contract asset or a net contract liability. In the proposed standard the boards are adopting an asset-liability approach. The major benefit of this proposal is that agreement exists that there is

more objectivity in measuring and determining changes in assets and liabilities than there is in measuring and determining the completion of the earning process. (Mintz, 2009)

After taking comment letters on the discussion paper of December 2008 and an initial exposure draft in June of 2010, the boards issued a revision of the proposal in "Proposed Accounting Standards Update (Revised), Revenue Recognition (Topic 605) – Revenue from Contracts with Customers: Revision of Exposure Draft Issued June 24, 2010." The new document left the basis of the proposal the same and added implementation guidance and a tentative date for adoption. Recognizing revenue under the standard would be a five-step process:

- 1) Identify the contract with a customer.
- 2) Identify the separate performance obligations in the contract.
- 3) Determine the transaction price.
- 4) Allocate the transaction price.
- 5) Recognize revenue when a performance obligation is satisfied.

Currently the projected timetable for adoption of the new revenue recognition standard is reporting periods beginning on or after January 1, 2015. The proposed standard would apply to all contracts with customers except for leases, insurance, and financial instruments. (Lamoreaux, M. G., 2012)

Since substantial progress has been made to date in the area of convergence on revenue recognition, to the point where final approval is all but assured, further recommendation for convergence will be predicated on the assumption that the proposed standard will be adopted. Recommendations will be made on how to make the new standard more useable to both IASB and FASB constituents and financial statement users. The newly proposed standard appears to improve on often-cited weaknesses of the standards of both bodies. First, IFRS lacks specific guidance at the transaction level, often leading to inconsistencies in application of accounting principle, therefore impairing comparability of financial statements. Second, the standards of U.S. GAAP are a disjointed group of superseded, in whole or part, standards that offer specific and often-restrictive guidance. While the proposed standard goes lengths in addressing IFRS's lack of transaction specificity and GAAP's overwhelming number of overly specific rules, it is lacking in certain areas.

With a goal of providing useful information for decision making, most notably to current and prospective investors and creditors, financial reporting needs to provide as much specific information as possible on the financial condition, performance, and operating environment of each specific firm as possible. The proposed international standard for revenue recognition, as well as the overall concept of a single set of international accounting standards, fails to account for differences among industries and nations as to what constitutes useful financial information. Financial reporting needs of developing economies such as Bangladesh are vastly different from those of the United States. Likewise, while basic concepts of revenue recognition cross industry lines, specific application of those concepts differ for Walmart and Boeing. Due to the special circumstances of various countries and industries we present a recommendation for further improving convergence efforts in the area of revenue recognition.

In order to accommodate the specific needs of financial statement preparers and users of various countries and industries, measures need to be taken to provide a degree of flexibility in the new worldwide standard of revenue recognition. As a component of the new standard for revenue recognition, the IASB should establish international subcommittees to develop industry specific modifications to the overriding standard. While the new standard would remain the

authoritative guidance on the matter, the industry specific subcommittees would provide added detail or special application of the standard to make the resulting financial statements the most useful.

The five-step process for recognizing revenue under the newly proposed standard previously presented still leaves much to interpretation. Step two requires the identification of separate performance obligations in the contract with a customer. Consider the contract for a long-term construction project. Current revenue recognition standards would likely require the use of the percentage of completion method. While not perfect in theory or application it is easily applied, understood, and widely accepted. Step two of the proposed standard could lead different firms, nations, and even individual customer contracts to have different standards for revenue recognition. While consistent with the goal of the asset-liability approach, recognizing revenues as a result of changes in rights and obligations, the new standard could lead to lack of comparability between contracts, firms, and nations. International subcommittees would be able to address the structure of customer contract under the new standard to ensure consistent application of the standard and to address any nation specific issues, such as timing for tax purposes.

Adoption of the new international standard for revenue recognition will face challenges with or without the added recommendation of adding consistency through the use of international subcommittees. As a basic element of financial reporting, revenue recognition relates directly to net income and, therefore, the taxes to be paid in most jurisdictions. Adopting this revenue recognition standard may accelerate the recognition for some jurisdictions or industries and defer such recognition in others. As a result, political pressures will exist both for and against the adoption of the standard and may also lead some jurisdictions to readdress tax policy in response.

Implementation will give rise to issues, as long-held practices will give way to a new and unfamiliar method of revenue recognition, likely leading to initial misstatements. While most admit that the change to the new standard will not drastically change the recognition of most transactions, users of the statements will need a period of adjustment to understand the implications of the new standard, especially net contract assets and liabilities. This may lead to an initial period of stagnation in investment as investors make sense of new statements, or take a wait and see approach to the implications of the new standard. On the firm level, the new standard appears to provide added opportunity for earnings management through the structuring of customer contracts. Revenues appear to be able to be accelerated or deferred by changing the timing or interpretation of exactly when a performance obligation has occurred under the contract. These are in addition to the problem previously discussed that the standard may have the unintended consequence of making the financial statements less comparable and consistent as the five-step process may be applied differently on an industry, national, or even individual contract basis.

## **SUMMARY**

A growing international economy and investor diversification into cross-border capital markets has necessitated the world's two leading accounting standards setters to embark on a convergence project with the goal of creating, "a sound foundation for future accounting standards that are principles-based, internally consistent, and internationally converged." (IASB, 2012) The Financial Accounting Standards Board of the United States and the International Accounting Standards Board began the process with the adoption of the Norwalk Agreement of

2002, with the ambitious goal of implementing a single set of internationally accepted accounting principles by 2015. Due to the pervasive nature of revenue recognition, an effort was undertaken almost immediately after the Norwalk Agreement to address the issue of revenue recognition.

The IASB and the FASB came into the convergence project on revenue recognition from vastly different starting points. Both bodies came into the project with two main criteria for revenue recognition; however, this is where the similarities cease. IASB's standards and framework provided that revenue would be recognized when 1) it is probable that any future economic benefit associated with the item will flow to or from the enterprise and 2) the item's cost or value can be measured with reliability. These two criteria illustrate the IASB's asset-liability approach to revenue recognition. Under this approach, revenue is to be recognized when there is a change in a firm's assets or liabilities related to the transaction. FASB on the other hand entered the convergence project with a completion of the earnings process approach. Under this approach, revenue is recognized when the earnings process is complete with the two major recognition criteria being the prospective revenue is realized or realizable and earned. These criteria are considered independently of any balance sheet affect.

IASB revenue recognition standards entering the convergence project consisted of two standards, IAS 18 and IAS 11. IAS 18 concerns itself with revenues including sale of goods, services, interest, royalties and dividends. IAS 11 focuses on construction contracts. As with all IASB standards, these standard provide principles based guidance without specific guidance at the transaction level. The standards of U.S. GAAP, provided by FASB, on the other hand consist of a set of over one hundred revenue related guidance of specific rules on an industry and transaction level; however, much of the general guidance is provided by Statement of Financial Accounting Concepts No. 5, a non-authoritative source of U.S. GAAP.

As of this writing, the IASB and FASB are poised to adopt a joint standard on revenue recognition. This new world standard would take an asset-liability approach, such as that of pre-convergence IFRS, while containing more specific guidance than IFRS users are accustomed to seeing, taking a cue from the GAAP standards of the United States. Under the new standard, preparers would recognize revenue based on the contracts that they hold with customers. Revenue would result from the changes of contractual rights and obligations. Remaining unrecognized revenue would give rise to net contractual assets or liabilities. While the proposed standard appears to be a marked improvement over either existing standard, problems may arise with consistency and comparability across firms, industries, and nations as the new standard lacks much of the specifics of current U.S. GAAP. To address this, we suggest an additional level of the standard setting bodies, that of international and industry specific subcommittees to advocate for and recommend specific applications of the general standard that will make the financial statements the most useful to their users.

Adoption of the joint standard on revenue recognition will represent a major advancement toward the ultimate goal of creating one set of high quality international accounting standards. With full implementation of the standard slated for 2015, firms will need to start making provisions immediately to begin collecting the required accounting information for presentation of the comparative financial statements for that fiscal year. While this will represent a major step in the process of convergence, the conversation on revenue recognition will not be over. As with all accounting standards, revenue recognition will need to reflect the current needs of current financial statement users. Revenue recognition will continue to be an ongoing discussion as the world economy evolves and the needs of financial statement users evolve with it. As long as the goal of financial reporting is to provide users with the highest quality

comparative and comparable financial statements as possible, the discussion of revenue recognition is not over.

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