Revenue Recognition: an IFRS "Hot Spot"

RevenueRecognition.com Staff

Revenue Recognition processes, long considered "extreme" accounting under US GAAP, will be equally difficult under IFRS. The IFRS standard looks much simpler, but is it? What are the implications for accounting processes and systems if it's not?

The Myth of IFRS – Debunked

The impending adoption of IFRS in the US, viewed with varying degrees of dread by those who have to do the actual adopting, carried one small potential for hope–perhaps IFRS Revenue Recognition will greatly simplify the revenue accounting process. However, a recent survey by RevenueRecognition.com found that in countries where IFRS is required, survey respondents reported by an even wider margin than US GAAP respondents, that Revenue Recognition is more complex, more error-prone and more material than other key finance processes

Rules versus Principles

The hopes of a kinder gentler approach to revenue recognition in IFRS are pinned to the substantial difference in the amount of text that supports each standard. IFRS, which is principles-based, provides orders of magnitude less guidance on revenue recognition than US GAAP – a rules-based standard stuffed with industry-specific examples. Ironically the big difference that we can expect is that under IFRS, interpretation of the principles will be more difficult — and more subject to variation, to personal judgment and even to local culture. The actual revenue processes necessary once the judgments are made will have the same degree of difficulty and require the same information system support.

IFRS and US GAAP Revenue Recognition Compared

Let's peel that onion a little. The revenue recognition for US GAAP consists of a multitude of guidance and rules. IFRS in contrast, does not spell out specific rules and practice aids on how to implement revenue recognition accounting. However in both, the revenue recognition fundamentals are the same: revenue is recognizable when it is (1) realized or realizable and (2) when it is earned, regardless of whether any money has actually changed hands. Both cover revenue for essentially the same business activities, namely the sale of goods, services and for assets and royalties.

Under US GAAP revenue recognition accounting is largely built on the following four "Pillars": (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller's price is fixed or determinable, (4) and collectability is reasonably assured. Until each and every one of them is met, revenue must be deferred and can not be recognized. This means that criteria must be established (pretty much dictated by US GAAP) to determine what evidence constitutes a green light for each of these conditions and that evidence must be tracked to completion for all four conditions before any deferred revenue can be moved to the general ledger as revenue. When one considers that this process must take place for every element of accounting in a transaction, it's easy to understand why it's complicated AND error-prone — especially if it's being done manually.

IFRS doesn't simplify this process. It actually has five conditions that must be met in order for the sale of goods to be recognized and four for services. For goods, (1) the significant risks and rewards of ownership have transferred from seller to buyer;(2) the seller does not retain continuing involvement or control over the goods; (3) the amount of revenue can be measured reliably; (4) it is probable that economic benefits will transfer to the seller; and (5) costs incurred or to be incurred can be measured reliably. IFRS, as with US GAAP, includes a "right of return" for goods that also requires a carve-out.

For the sale of services the revenue recognition conditions include the 3rd, 4th and 5th above with the addition of a fourth condition related to completion: the stage of completion can be measured reliably.

It's important to drill home this point: where IFRS differs significantly from US GAAP is that there is little guidance and much judgment involved in determining the "evidence" of completion of this process, but once a determination is made, the process of tracking each of these many conditions to conclusion is the same. It's hard to find an "easier" anywhere in this scenario.

There are some concepts in US GAAP without precise parallel in IFRS: the international standard does not dictate different principles for different industries – it's "all for one," (with the exception of Construction, detailed in IAS 11) and as a consequence there is no such thing as a multiple-element arrangement or Vendor Specific Objective Evidence (VSOE).

However, the application of "Fair Value" is very much in play within IFRS as is the requirement to break out elements of accounting for separate revenue recognition treatment in certain kinds of transactions. Whether under IFRS or US standards, these similar concepts are among the most difficult processes in accounting to manage and track. FASB and the International Accounting Standards Board (IASB) have been working on a joint project to reconcile or merge the two standards. This project could eliminate VSOE but would not be likely to eliminate other forms of Fair Value requirements.

And just as there are concepts in US GAAP without precise parallel in IFRS, the reverse is also true in that IFRS has significant disclosure requirements around accounting methods and controls and exact amounts of revenue in every category for every reporting period. Systems will require depositories and the ability to capture information automatically to meet these requirements.

A Comparison of US GAAP and IFRS Revenue Recognition Rules

US GAAP Goods/Services	IFRS Services	IFRS Goods
1. Persuasive evidence of an arrangement exists	1. The amount of revenue can be measured reliably	1. The significant risks and rewards of ownership have transferred from seller to buyer
2. Delivery has occurred or services have been rendered	2. It is probable that economic benefits will transfer to the seller	2. The seller does not retain continuing involvement or control over the goods
3. Price is fixed or determinable	3. Costs incurred or to be incurred can be measured reliably.	3. The amount of revenue can be measured reliably
4. Collectability is reasonably assured.	4. Stage of completion can be measured reliably.	4. It is probable that economic benefits will transfer to the seller
		5. Costs incurred or to be incurred can be measured reliably. (IFRS, as with US GAAP, includes a "right of return" for goods that also requires a carve-out.)

The Time is NOW

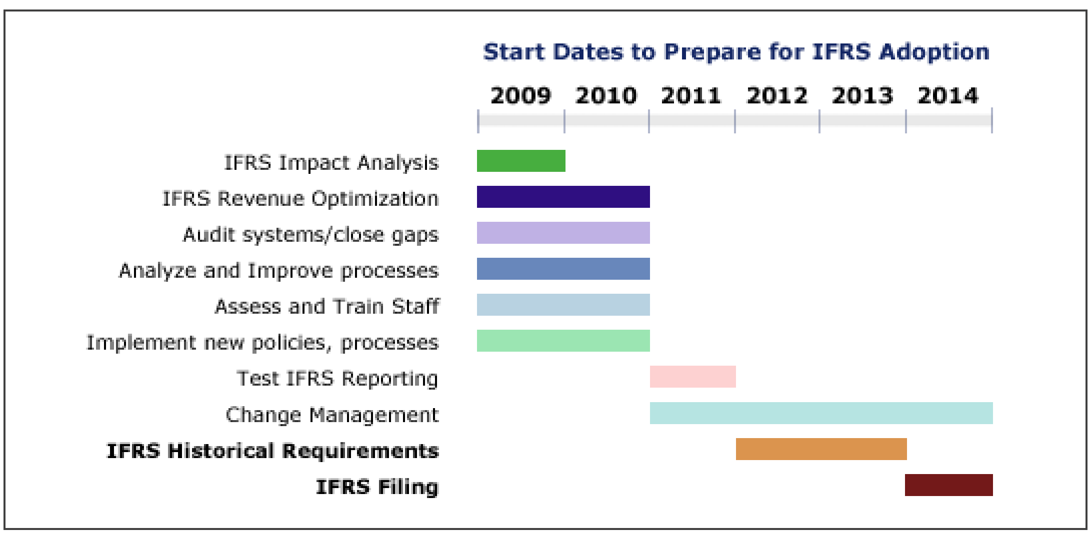
Early preparation will significantly ease the impact on financial reporting, accounting processes, and internal controls. It is also critical in order to give finance and accounting personnel the requisite time to acquire the skills necessary to fully implement IFRS.

Key steps for getting revenue right

- **IFRS Impact Analysis:** Simulate IFRS revenue reporting and determine areas that require special attention
- **IFRS Revenue Optimization:** Review how sales and marketing strategies such as product bundling or pricing are impacting IFRS accounting – all changes must be implemented prior to the first reporting period in 2012.
- **Audit Systems and Close Functional Gaps:** Identify key weaknesses in revenue reporting and close system gaps.
- **Analyze and Improve Revenue Processes:** Determine if current processes provide the internal controls and reporting detail necessary to meet IFRS
- **Assess Staffing:** Roles, responsibilities, and skill sets should be reviewed for compliance with IFRS and training requirements must be determined
- **Implement New Policies and Processes:** New revenue recognition and reporting practices must be ready to run in parallel with US GAAP for two or more years.
- **Test IFRS Reporting:** With new systems and procedures in place, simulate the IFRS reporting process well in advance of 2011 so that any final changes can be made to fully support closing processes and auditor scrutiny.
- **Change Management:** Constant vigilance will be required to make the transition to IFRS, and importantly, to adjust to the inevitable onslaught of changes brought on as auditors and standards setters apply the new concepts.

The most important thing for first time filers to plan for is the fact that three years of audited IFRS statements must be provided. To quote the SEC's Roadmap document: *"To illustrate, if we require IFRS for the years ending on or after December 15, 2014, a calendar year company would report for the year ending December 31, 2014 using IFRS for the years ending December 31, 2012, 2013 and 2014. Many such companies would want to start IFRS internal accounting on January 1, 2012. However, during 2012, 2013 and the first three quarters of 2014, they would continue to be publicly reporting under existing U.S. GAAP."*

Therefore, in order to be ready to file in 2014, project plans for IFRS conversion will have to accommodate a very long lead time as illustrated below:



Business Imperatives: Start Early, Automate

The international standard highlights the fundamental need for centralized systems that manage reporting on an enterprise basis; highly-flexible process and rules management able to handle minute detail, and efficient, error-proof ways to track the varieties of information demanded to meet many IFRS disclosure requirements. Companies that rely on spreadsheets to fill in the functional gaps of their ERP/ Financials infrastructures under US GAAP, should not expect to manage change of this magnitude with the same tools. Experts agree that consolidation and the embedding of appropriate revenue accounting functionality in systems is one of the keys to success with IFRS. This should be done with as little disruption to enterprise processes as possible.

Organizations must do what they can to consolidate and improve their revenue reporting processes prior to this change and they must do it with all haste. Of great consideration is the fact that any operational changes needed to optimize revenue under IFRS must take place prior to the 2012 fiscal year. That means it is imperative for companies to do the impact analysis as soon as possible, because once companies enter the three-year reporting zone for IFRS, they cannot go back and re-write history.

FASB and IASB

Revenue recognition has been highlighted in a recent discussion paper issued by the FASB and IASB. The standards boards are proposing to develop a single set of guidelines to govern contract-based revenue. This is an admirable goal, but companies must be prepared for consequential aftershocks in the years following the initial seismic shift. This highlights yet again the critical need for a sound revenue recognition process with the underlying systems and internal controls. Such systems must be able to apply new and changing revenue recognition rules and processes - no matter if reporting under US GAAP, IFRS or some new version FASB/IFRS.

A flexible approach for controlling the revenue process based on business rules will be essential for managing the inevitable series of changes that will occur as auditors establish industry standards for applying the new concepts as well as the virtually guaranteed prospect of more changes in revenue recognition accounting to come in the future.

About RevenueRecognition.com

RevenueRecognition.com is dedicated to educating finance professionals on revenue management and related issues. The site focuses on revenue accounting; revenue recognition; revenue reporting and forecasting; internal controls; Sarbanes-Oxley compliance; SEC, FASB, and international accounting guidelines; contract management; and industry specific revenue challenges. Contact us at: info@revenuerecognition.com. RevenueRecognition.com is sponsored by Softrax Corporation.

About Softrax

Softrax Corporation is a leading provider of enterprise revenue management and billing software solutions that fundamentally change the way companies manage, analyze, report and forecast their revenue. Softrax solutions automate the entire revenue cycle, from revenue recognition, reporting and forecasting, through complex billing and contract renewals. Hundreds of corporations benefit from using Softrax to optimize their revenue, reduce operating expenses, comply with revenue recognition regulations and Sarbanes-Oxley requirements, and gain unprecedented visibility into their business performance. Softrax Corporation, headquartered in Canton, MA is privately held. More information can be found at www.softrax.com and by calling 1.888.4.SOFTRAX.

RevenueRecognition.com

Revenue Management Resources for Today's Financial Executive