

FASB/IASB – The Move Toward Conversion Continues

-Revenue Recognition

-Financial Statement Presentation

-Leases

Three ED's are coming!

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Revenue Recognition

After years of debate, FASB and IASB will soon issue their exposure drafts on how to recognize revenue

Eventually, this project could replace much of SAB 104 and those FASB Statements, AcSEC SOP's & Guides, and EITF's on revenue recognition

Why do we need a new revenue recognition model?

Improve, Remove Inconsistencies, and Simplify!



Revenue Recognition – The new model

Contract Based – right to receive payment/performance obligation results in a net contract position

The performance obligation to provide goods and services is a liability *not* deferred revenue.

Recognize revenue when there is a decrease in the performance obligation (i.e., an increase in the net contract position)

What if contract has multiple elements? Use the new EITF's model - it seems to be pretty good – allocate based on estimated selling prices of each element

How are performance obligations satisfied?

When entity transfers the promised goods or service to the customer

That is, when the customer obtains control and it is the customer's (e.g., customer can direct its use and receive benefits – title, possession and must pay for it)

Then company reduces performance obligation (*dr*) and recognizes revenue (*cr*) in income!

Is this better than trying to determine when the “earnings process is complete”?

Warranties and Sales Returns

Are they performance obligations?

Warranty

If it's for defects on date of sale – no, it's not a performance obligation -instead estimate liability, and don't recognize revenue

If it's for defects arising later, yes, it's a performance obligation and allocate revenue

Is this practical to do?

Sales Returns

It is not a performance obligation

Do not recognize revenue for goods expected to be returned, instead record a *probability weighted estimate* of the refund liability and revise it as estimate changes

Record an asset (reduce cost of sales) for right to recover inventory at its cost

Logical?

Measurement after Inception

The Onerous Test



1/2/10 – Enter contract with customer	\$ 5 M
6/30/10 – Performance obligation	3 M
- Direct costs (expected) to complete	3.6 M

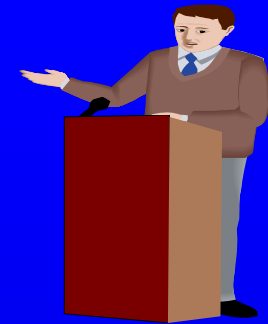
This is an onerous contract and a loss must be recorded

Dr.	Contract loss expense	\$600m
Cr.	Contract loss liability	\$600m

Loss is based on *cost* not current value (i.e., no future profit)

Update quarterly

Other Possible Changes?



- Percentage of completion – does customer “control” the item as it is constructed (e.g., 1st 6 of 10 floors)?
- What about costs – could a sales commission be capitalized to “better match costs and revenues”?
Expense selling, advertising & marketing!
- More disclosures – for ex., reconcile the beginning and ending contract position, disclose the principal judgments used in accounting for contracts and the timing of performance obligations

Timing and Transition

FASB's preference – adopt on a fully retrospective basis.

Would this be practical for preparers?

Is this what users want?

Timing – Give companies plenty of time to prepare
– no early adoption

Will we have convergence?

Will this new model sell?

Preparers? Auditors? Users? Regulators?

Financial Statement Presentation

(Throw out all your old text books)



Will Financial Statements Ever Look The Same?

FASB & IASB's goal – improve usefulness of financial statements and make them easier to understand

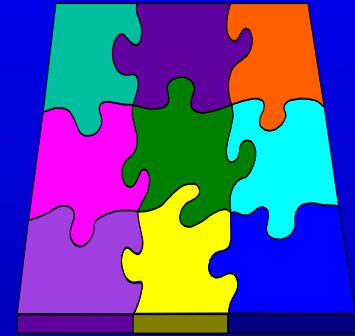
The FASB and IASB are about to issue an exposure draft to require detailed information to clearly communicate an integrated (cohesive) financial picture

The model will require a format *substantially* different than what we see today – this proposal will be controversial!

The “Cohesiveness” Principle

Categories for each of the Statements of Fin. Pos.,
Comp. Inc., and Cash Flows:

- Business – operating, investing & financing
arising from operations*
- Financing- nonowner/owner*
- Income taxes (continuing operations)*
- Discontinued operations (net of tax)*
- Other comprehensive income (net of tax)*
- Equity (for the balance sheet)*



Goal – financial statements should be clear and articulate!
Management judgment - but apply cohesiveness principle at
category level and, if feasible, at the line item as well

STATEMENT OF COMPREHENSIVE INCOME

(a separate proposal)

Sales	\$1,000
Costs	<u>800</u>
Net income (business & investing shown separately)	200
<i>Other Comprehensive income (after tax)</i>	
Available for sale (today, tomorrow the new model)	30
Cash flow hedges	(20)
Unfunded accumulated benefit obligation	(15)
Foreign translation adjustment	<u>(10)</u>
Total OCI	<u>(15)</u>
Total Comprehensive income	<u>\$185</u>
EPS – based just on net income	<u>\$2.00</u>

Would this be an improvement ?

More Changes



- . Cash flow statement – mandate direct method, and require reconciliation in footnote – Expensive? Practical? Users needs?
- . Disaggregation by function, nature, and measurement bases (e.g., fair value, historical cost)
- . Require meaningful subtotals and related headings for each section, category and subcategories
- . More segment disclosures (e.g., operating cash flow)
- . No more extraordinary items

The Analysis of Changes (public entities only)

All significant asset and liability line items

Opening balance, changes, ending balance

Include *changes* due to:

Cash inflows/outflows

Accounting allocations (deprec.)

Routine accruals

Provisions/reserves (bad debts)

Business acquisition/disposition

Remeasurements (fair value)

Will users benefit from this analysis?

Will it be costly to prepare?



WHEN & HOW?



- Decide on effective date next year
- Provide adequate lead time to get ready (10 years?)
- Preference – Retrospective!
- Reactions- Preparers? Auditors? Users?
Regulators?

Is this all a good idea? Will the balance sheet still balance (Assets – Liabilities = Equity)?

- Any convergence issues with IASB?

Leases - they are going on the balance sheet? YES!

The lease accounting model under FAS 13 (and its many, many amendments and interpretations) has long been considered broken and unfixable

The FASB (& IASB) will soon propose a new model

Lessee:

Asset - Right to use an asset during the lease term

Liability - Obligation to pay rentals (present value)

Lessor:

Asset- Right to receive rent – a receivable (present value)

Liability- Performance obligation to let lessee use asset



Applicability

- Property, plant, and equipment
- Exclude leases where title transfers or there is a bargain purchase (these are purchases/sales)
- Simplified treatment for leases where *maximum* term is under one year (but no specific materiality exception) – put asset & liability on balance sheet gross
- Accounting begins when lease is signed but present the asset & liability net until delivery



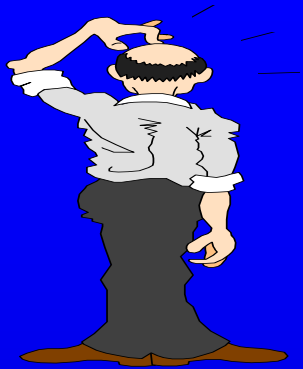
Lessee Accounting

- The right to use asset is the present value of rent plus initial direct costs – amortize and test for impairment if necessary
- Obligation to pay rent – use incremental borrowing rate or implicit rate if readily determinable – use interest method going forward - the fair value option for the liability is prohibited.

Lessor Accounting

- A performance obligation approach – permitting the lessee to use the asset – revenue is recognized over the lease term (i.e., lessor is performing)
- In addition to the right to receive rent (a receivable – use the interest method), the lessor continues to keep the leased asset on the balance sheet – thus it has two assets! Logical? Is there an alternative (*e.g., just reduce the leased asset by the rent receivable*)?
- Should lessor show lease assets and obligations net?
- Use implicit interest rate in lease to discount and initial direct costs are capitalized

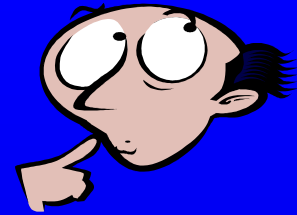
Does lessor accounting really need fixing?



The Lease Term – options to renew How many years should you use to calculate rent?

- Use the *longest* possible lease term that is “more likely than not to occur” – but how do you know?
- Reassess the estimate each period if there is a change in facts and circumstances
- Lessee would adjust asset & liability. Lessor would adjust its performance obligation
- Don’t change the original discount rate

Contingent Rent



- Example – lessee has to pay lessor extra rent based on a percentage of sales – what do you do?
- Include these amounts on balance sheet using an “expected outcome “ approach (lessors must be able to reliably measure the amount)
- Reassess quarterly if there is a material change in estimate
- Lessees adjust P&L, lessors adjust original amount and allocate to performance obligation
- Continue to use original discount rate



Issues to Consider!

- Will users really be better off with all leases on the Balance Sheet?
- What will the impact be of recording lease liabilities – the obligation to pay rent- on the perceived health of the company?
- Will many companies be in default on covenants?
- Are we achieving convergence with the IASB?
- What will happen next? – timing, transition?

Conversion vs. Just Adopting IFRS?

- Someday maybe we will all follow IFRS?
- How is the movement towards possibly adopting international standards and these concurrent convergence efforts working out?
- What should an accountant be doing to get ready for all these changes?



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