Financial Accounting Standards Board Announces Common Revenue Standard

On May 28, 2014, the Financial Accounting Standards Board ("FASB") issued jointly written revenue recognition standards with the International Accounting Standards Board ("IASB").[1] The announcement of this update to revenue recognition marks over ten years of negotiation between the FASB and IASB to (1) develop a high-quality global accounting standard for revenue recognition, and (2) reduce instances where companies in different jurisdictions have different accounting for similar types of transactions and revenue.

I. Background

Prior to the announcement of this unified standard, the FASB's generally accepted accounting principles ("GAAP"), used in the U.S., and the IASB's International Financial Reporting Standards ("IFRS"), used in Europe and other jurisdictions, differed significantly. Consequently, economically similar transactions frequently have dissimilar revenue reporting.[2] According to the FASB and IASB, the GAAP guidelines are overly prescriptive, whereas the IFRS guidelines are not sufficiently detailed.[3] Entities reporting revenue under GAAP often have to look to industry-specific guidance, while entities reporting revenue under IFRS often have little or no guidance for complex transactions.

The FASB observed that "revenue is an important number to users of financial statements in assessing an entity's financial performance and position." Because of the importance of revenue recognition, the FASB and IASB devised an updated and uniform standard in order to remove perceived shortcomings and inconsistencies in GAAP and IFRS revenue reporting standards. This updated standard aims "to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and IFRS that [will]:

1. Remove inconsistencies and weaknesses in 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."[4]

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[1] *See* "Revenue from Contracts with Customers," FASB Accounting Standards Update No. 2014-09 (Topic 606), *available at,* http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175828814244&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=1265035&blobheadervalue1=filename%3DASU_2014-09_Section_A.pdf&blobcol=urldata&blobtable=MungoBlobs; IASB International Financial Reporting Standard 15. This updated standard replaces the FASB's generally accepted accounting principles and the IASB's two main revenue recognition standards, IAS 18, *Revenue*, and IAS 11, *Construction Contracts*. *See* Topic 606 at 1.

[2] Topic 606 at 7.

[3] *See* Topic 606 at 7; *see also* Evan Weinberger, "New Accounting Rule Takes Aim at Service Contracts," LAW 360 (May 28, 2014), *available at,* http://www.law360.com/articles/542192/new-accounting-rule-takes-aim-at-service-contracts ("The IFRS guidelines were not sufficiently detailed about when revenue should be recorded, either at the point of sale or when a payment is made.").

[4] Topic 606 at 1.

II. Core Principles of the Update: Five-Step Model

The FASB and IASB's update to revenue recognition standards will affect any entity that either (1) enters into contracts with customers to transfer goods or services, or (2) enters into contracts for the transfer of nonfinancial assets. This update will apply to revenue from contracts across all industries. In short, any company that has revenue will be affected by these updated standards.[5]

The core principle of this updated guidance regarding revenue recognition is that "an entity should recognize revenue to depict the transfer of promised 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 service. To achieve that core principle, an entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation."[6]

This five-step process is principles-focused, and provides a single, comprehensive model for reporting revenue, thus superseding GAAP's industry-specific guidance.[7] In addition to consolidating revenue recognition guidelines into one standard, this five-step model places significant reliance on contract terms, and will require professional judgment to interpret and determine when revenue is recognized.[8]

Additionally, the updated standard mandates qualitative and quantitative disclosures that sufficiently enable "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."[9]

III. Timeline

The new standard will go into effect for public companies on January 1, 2017. The new standard will go into effect for non-profit and private companies on January 1, 2018. While the FASB precludes entities from applying this unified standard before these designated dates, the IASB will allow for premature application of the updated standard.

The FASB and IASB have announced the formation of the Joint Transition Group for Revenue Recognition ("TRG"). The TRG will discuss potential implementation issues that could arise for companies and

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[5] *See* Topic 606 at 8. Although these updated accounting standards will have a broad, global impact, particular sectors are expected to experience a deeper impact, including: telecommunications, computer software, construction, real estate sales, and asset management. *See* Steve Burkholder, "FASB, IASB Issue Sweeping, Long-Awaited, Generally Aligned Revenue Reporting Rules," BNA FIN ACCT. RESOURCE CENTER (Jun. 4, 2014), *available at*, http://www.bna.com/fasb-iasb-issue-n17179890986.

[6] Topic 606 at 2.

[7] Topic 606 at 8 (explaining that "because the guidance in this Update is principles-based, it can be applied to all contracts with customers regardless of industry-specific or transaction-specific fact patterns.").

[8] *See* Topic 606 at 2-6. Application of the new principles-based standard will require professional judgment and disclosure of the judgments made will be required. *See* Topic 606 at 2, 43, 47-48.

[9] Topic 606 at 6-7.

organizations as they implement this new revenue recognition standard. Although the TRG will not issue guidance, stakeholders can submit potential implementation issues for discussion at TRG meetings.[10] The TRG will hold its first meeting on July 18, 2014, and will hold five subsequent meetings before 2016.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

[10] "FASB and IASB Announce the Formation of the Joint Transition Resource Group For Revenue Recognition," FASB (Jun. 3, 2014), *available at*, http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176164099926. Instructions for submitting a potential implementation issue are available at, http://www.ifrs.org/The-organisation/Advisory-bodies/Joint-Revenue-Transition-Resource-Group/Pages/Home.aspx.