The financial statements in assessing a company’s performance and prospects.

Business, Company

Introduction

Revenue is a key element to the users of the financial statements, in assessing a company's performance and prospects. However, revenue-recognition standards in U. S GAAP differ from those in IFRS, and both sets of requirements are considered to be in need of improvement. In June 2002 the FASB and the IASB started a joint project to clarify those principles and to create common revenue-recognition standards that companies can apply across various industries and transactions. It aims to remove inconsistencies and weaknesses in existing revenue-recognition standards and practices and to provide a more robust framework for addressing revenue recognition issues. In this report we are going to analyze the main problems that are involved in the revenue-recognition, the views that have been taken into concern by the two boards and assess the appropriateness of the project and their thinking.

Main Problems involved in revenue recognition:

Problems arise in both US. GAAP and IFRS. As far as it concerns the US. GAAP, many standards exists that define an earnings process inconsistently. At this case the concept of an earning process might not be precisely defined and people often disagree on how it applies to particular situations. Take into consideration a cable television provider. Does its earnings process involve only the provision of a cable signal to the customer over the subscription period or is the service of connecting the customer to the cable network an additional earnings process?

According to the Statement No. 52 of FASB,?? Financial Reporting by Cable Television Companies??, ‘ an entity accounts for connection services as a separate earnings process and recognizes revenue for them when rendered (but only in an amount equal to direct costs).’ The fact that entities apply the earning process differently to economically similar transactions makes the usefulness of the approach questionable.

There are also some gaps in guidance and conflicts with asset and liability definitions. There is not for example a general standard on recognizing revenue for services. More guidance is needed because the earnings approach sometimes leads to misinterpretation of an entity’s contractual rights and responsibilities in financial statements. Such approach accounts for revenue with little consideration of how assets and liabilities arise and change over the life of a contract.

As with the US. GAAP, revenue-recognition standards in IFRS could lead to misinterpretation of the financial statements since the recognized amounts might not represent the economic reality. This due to the fact that revenue-recognition of a sale, depends mostly on when the risks and rewards of ownership of the goods are transferred to a customer. This could lead a firm to recognize a good as inventory even after the customer has obtained control over it. This is inconsistent with the IASB definition of an asset which depends on the control of the good and not on the risk and the rewards of owning the good.

IFRS also lack guidance in transactions that involve the delivery of more than one good or service, that is a multiple element arrangement. IAS 18 does not state clearly how or when a firm entity should segment a single transaction into components. Guidance is also needed on the measurement of the elements of such arrangements. As no particular measurement target exists, entities apply various approaches to comparable transactions, that lessens the comparability of revenues across entities. This comparability is also being reduced by the non-existence of a clear distinction between goods and services.

There is also inconsistency between IAS 11 and IAS 18. Between those two there is not a clear and straightforward principle to apply in changing and complex transactions. The IAS 11 principle states that an economic entity should recognize revenue as the activities required to complete a contract that takes place. The IAS 18 on the contrary, states that revenue should be recognised only when an entity transfers control and the risks and the rewards of ownership of the goods to the customer.

The views taken by the two boards

Both IASB and FASB are pursuing an approach that focuses on changes in assets and liabilities rather than concept of realization and earned. The approach was chosen because the realization earned approach involves recognising late debits and overdue credits that do not meet the definitions of assets and liabilities.

Through this approach revenue-recognition would result from changes in assets and liabilities rather than from satisfaction of the realization and earned criteria.

The basic principle of the new proposed model is that an entity should recognise revenue when it transfers goods or services to a customer in the amount of consideration that the entity expects to receive from the customer.

There have been suggested five key-proposals for this model. The first is concerned with identifying the contracts with the customer. A company could combine two or more contracts together if the prices of those contracts are interdependent. Equally, a company could account a single contract as two or more contracts if some goods or services are priced independently of other goods or services.

The second is how to identify the separate performance obligations. A contract is all about promises to provide goods or services to a customer. Such promises are called “ performance obligations”. An entity would account for a performance obligation separately only if the promised good or service is distinct. A good or service is distinct if it is sold separately or if it could be sold separately because it has a distinct function and profit margin.

The third one is how to determine the transaction price. The transaction price is the amount of deliberation an entity expects to obtain from the customer in exchange for transferring goods or services. This price would reflect the company’s probability weighted estimate of variable

consideration in addition to the effects of the customer's credit risk and the time value ofmoney.

The fourth one is how to allocate this price. A company would allocate the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each performance obligation.

The last one is how to recognize revenue when a performance obligation is satisfied. An entity should recognize revenue when it satisfies a performance obligation by transferring the promised good or service to the customer, which is when the customer obtains control of the promised good or service. The amount of revenue recognized is the amount allocated to that performance obligation in the transaction price allocation step.

Reasoned Critique

Many entities criticized the proposed model, but we will take into account the views of ''Big 4''.

PriceWaterhouseCoopers agree with the board's objective to define certain principles for revenue recognition that would provide clearer and more consistent guidance. There are however some concepts of the proposed model that according to their opinion, are ambiguous. According to them, ''the boards should consider a more practical approach in areas such as:

(1)identification and separation of distinct performance obligations;

(2)measurement and presentation of the impact of credit risk on revenue;

(3)the impact of the time value of money on revenue recognition; and

(4)accounting for warranties.'' The changes in those areas should benefit the adopting entities at a greater level in comparison with the incremental processes, systems and other costs that may occur.

KPMG believes that it's a critical that the new standard provide a framework capable of addressing the broad range of current and emerging revenue recognition issues. Despite the substantial changes in all areas, there are still some that lack revision or need further development. According to KPMG those areas are ''the concept and indicators of transfer of control, identification of distinct performance obligations, determination of the transaction price for transactions with variable consideration, consideration of collectability in the determination of the transaction price, recognition of onerous performance obligations, and identification of constructive performance obligations.'' The boards should test the proposed model effectiveness to assess where it's capable of being applied to various types of transactions.

Ernst & Young strongly believe that the five-step model will help entities to apply those principles. They are concerned however, about the application of the proposed model and the consequences of it. The organization notes: ''A new standard on revenue will impact all entities and the consequences of some aspects of the model are only the beginning to become apparent. It needs to be given further consideration to the potential effects of the proposed model, including the subsequent accounting for transactions and that constituents need more time to consider the proposals and comment further on them.''

Finally Deloitte follows a more negative attitude towards the whole project. The organization disagrees with certain aspects of the Exposure Drafts proposals and they are more skeptical with the proposed model. The organization notes: ‘’ Our main concern with the ED is that the material in relation to ‘ control’ is neither well developed nor clearly explained-we believe that the ED’s proposals on how the transaction price should be allocated between performance obligations and on how to account for contract modifications that are judged interdependent, should be modified.’’

The proposed model seems to be rather controversial. The clarity and the effectiveness of certain concepts seem to be questioned. A reasonable reaction, in my opinion, since many entities and accounting firms would be hesitant in the beginning. The same applies and for both IASB and FASB. A concept project of such scale as the revenue recognition joint-project, will have major difficulties in its conceptual framework. As long as, it stays in theory and is not tested under real circumstances, it will always have those who opposed to it. It needs to be field tested to ensure that is capable of being applied normally. There are many aspects that need to be revised and change. The Boards should take into account the results of the application of the proposed model and seek ways in which the adaption and transition would be smoother and better.

Conclusion

There are some serious implications in the revenue recognition process. For that reason, the two Boards proposed some views to help in eliminating those problems. Those views have been criticized by the world as for their

strengths and weaknesses and the effectiveness of the proposed model has been questioned.

Nonetheless, FASB-IASB joint revenue recognition project is a significant effort, which is crucial for the future accounting standards. As Sir David Tweedie, chairman of the IASB, said: ‘ The proposal by the two boards is the result of our intensified joint efforts. It is an important step towards a single global principle-based standard that would make it absolutely clear when revenue is recognized and why,’’.