Accounting Standards Board

Aldwych House, 71-91 Aldwych, London WC2B 4HN
Telephone: 020 7492 2300 Fax: 020 7492 2301
www.frc.org.uk/asb

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EFRAG
13-14 Avenue des Arts
1210 Brussels
Belgium

Commentletter@efrag.org

Dear Sirs

Revenue Recognition—A European Contribution

1 This letter sets out the comments of the Accounting Standards Board on the above Discussion Paper.

2 We share the view that revenue—in the sense of turnover, or the top line of the income statement—is a very significant feature of financial reporting. Whilst we are not aware of any major problems in practice in applying the relevant existing IFRS—IAS 18 and IAS 11—we agree that their underlying conceptual basis is unclear, and that this creates problems in applying them in new and unusual situations, and, in particular, in determining which standard to apply in borderline cases. We therefore welcome PAAinE's decision to devote resources to this topic.

3 We believe that the Discussion Paper makes a valuable contribution in highlighting areas and issues that require further consideration and discussion, and we would encourage further work on the subject. But we do not believe the analysis provided in the paper points clearly in any particular direction for the development of an appropriate conceptual basis for revenue recognition.

4 We would encourage further work, and would suggest that it would be most fruitful if it addressed what are the appropriate points at which both profit and turnover should be reflected in income and in assets and liabilities, and how these might be measured and reported. Our answer to question 4 sketches the beginning of one possible approach that might be considered. We suggest this because, in our experience, debates over revenue recognition frequently give rise to confusion between the recognition of turnover and that of profit, even where, as in the paper, the issue is clearly stated. On the other hand, an approach that addresses only how profit emerges would incur the risk that questions of revenue would be seen merely as questions of presentation and so not given the attention that their importance deserves.

5 Current UK standards in this area are set out in Application Note G to FRS 5 which was issued in November 2003 ('AN G') and UITF Abstract 40 issued in March 2005. The key principle on which Application Note G is founded is that 'A seller recognises revenue under an exchange transaction with a customer when, and to the extent that, it obtains the right to consideration in exchange for its performance.' We do not recognise this amongst the various approaches discussed in the paper: indeed the paper does not discuss in any detail the idea of 'exchange' or of 'right to consideration'. It is therefore difficult to say whether any of the approaches discussed in the paper are better or worse than that of AN G.

6 In our view, any approach to revenue recognition that merits serious consideration must faithfully reflect both the economic substance of arrangements and their legal nature. To our reading, the various critical event approaches are characterised very narrowly and suggest accounting results that are so far removed from substance and economic reality that they are implausible. For example, under most of the critical event approaches no revenue would be recognised on a daily repetitive cleaning contract until the contract term is over, and under all of them no revenue would be recognised on a construction contract prior to completion It is very doubtful if all those who consider that some form of 'critical event' approach is appropriate would agree that it inevitably leads to these conclusions, In many jurisdictions, for example, a contractor would typically have a legal claim for the work done prior to completion even if his contractual entitlement to be paid only arises on completion. Although the paper briefly discusses modifications to the approaches that might overcome these difficulties, these modifications are

superficial and their rejection is unsurprising. In particular, approach C is rejected because various unresolved issues are noted, although major unresolved issues are not suggested to undermine the continuous approach.

7 In contrast, the 'continuous approach' is sketched so broadly that it appears capable of accommodating a very wide range of treatments. It permits progress under a contract to be assessed in a number of ways and so seems to allow great latitude in recognising revenue in the earlier stages of a contract. Moreover, because the safeguards in IAS 11 (including reliability of estimated outcome) are to be retained, it would appear to allow revenue to be recognised as late as desired—including on completion of a contract. Whilst these shortcoming might be overcome by further development of the approach, any support for the continuous approach must be conditional on their resolution.

8 One of the key distinguishing features of the continuous approach is that it permits revenue to be recognised even though nothing that is of value to the customer has been achieved. The IT company example in paragraph 4.30 makes it clear that revenue is to be recognised on delivery of the computer under the continuous approach even if the computer is useless to the customer until the supplier completes his contract. This seems a very significant point, and one on which a specific question in the invitation to comment might have been expected.

9 The paper states that a major advantage of the continuous approach is that it provides 'a good measure of economic activity undertaken pursuant to a customer contract' (in the third prefatory paragraph to Chapter 4). In other words, if a company works hard for several accounting periods revenue should be recognised in each period and not, as under a completed contract approach, recognised in full in the last period. Whilst we would expect that this would generally be the case, we do not think it right for the model to be designed to achieve this. If the correct principle for the recognition of revenue is identified, then it should be adhered to, even if it leads to volatility in reported results. In any event, it might be the case that the revenue line is not the only means of depicting economic activity in the financial statements: even in the absence of revenue, a company's economic activity would be evident from the accumulation of work in progress—a result that the paper suggests is acceptable in its discussion of the boat builder who happens to have a year when he builds for stock.

10 We agree that the approach to revenue recognition must be compatible with an asset and liability framework. That is, any revenue that is recognised must be represented by changes in assets and liabilities, and the resulting assets and liabilities and their measurement basis must have a clear significance. Unfortunately, although claiming to be based on an asset and liability framework, the paper does not adequately discuss the assets and liabilities and their measurement that result from the various approaches. In particular, it does not demonstrate that the continuous approach is consistent with an asset and liability approach (see our answer to question 6).

11 We note that the paper does not provide a discussion of exchange as a possible element in a principle-based approach to revenue recognition. The idea of exchange seems to offer a number of attractions:

- If revenue recognition is all about doing business with customers, it necessarily involves contracts. The idea of exchange therefore seems to fit naturally as contracts are all about exchange—A promises to do something for B, and B promises do something for A in exchange.

- Secondly an exchange is usually of assets and liabilities. When an asset is exchanged for another, it seems natural that it would be derecognised and the newly received asset recognised. It is to be expected that the value of the new asset will often be greater than that of the asset given up. Thus the idea of exchange seems to link directly to an increase in assets and liabilities.

12 The paper gives two reasons for rejecting the idea of exchange (in paragraph 2.29). The first is that the authors cannot distinguish an exchange of promises from the exchange that is the fulfilment of the promises, but this seems to be an obvious distinction that can be made without difficulty. The second reason is that the idea of 'exchange' does not in itself answer all questions that might be asked: but this seems to be a poor reason for replacing it, by the notion of a 'critical event', which seems to be less rather than more specific.

13 The Appendix to this letter answers the questions raised in the Invitation to Comment and provides further details of our thinking on this subject at this stage.

Yours sincerely

Ian Mackintosh
Chairman

Appendix

ASB responses to questions raised in the Invitation to Comment

Q1 It is stated in the discussion paper (paragraphs 1.4 - 1.10 and Appendix II) that there are weaknesses in the IASB's existing revenue recognition standards, IAS 11 and IAS 18. In particular, the standards do not address certain types of transaction (for example they say little about multiple-element arrangements), they are based on different principles (which leads to inconsistencies and uncertainties and makes it difficult to know how to use the standards to fill the gaps) and there are internal inconsistencies within IAS 18. The paper goes on to say that these gaps, inconsistencies and uncertainties are causing real practical problems. Do you think these comments about the existing standards are fair? (If you do not, could you please explain which comments you think are not fair and why.) Do you have any additional concerns about existing standards? (If you do, please could you explain them.)

A1.1 As stated in our covering letter, we are not aware of any major problems in practice in applying the relevant existing IFRS—IAS 18 and IAS 1. However, we agree that their underlying conceptual basis is unclear, and that this creates problems in applying them in new and unusual situations, and, in particular, in determining which standard to apply in borderline cases.

A1.2 We are less concerned than the authors of the paper that the standards fail to give clear guidance for multiple-element arrangements since that is a problem that can, in our view, only be settled arbitrarily because it involves a one-to-many allocation.

Q2 Paragraph 1.20 states that the objective of the paper is to develop a framework within which to address revenue recognition issues in a consistent way. Paragraph 1.26 explains further that the ultimate objective of the revenue recognition debate should be to develop a set of principles that can be applied to all kinds of industries and business. In other words, rather than have different, competing principles like we do now, we would have a single principle or a single set of principles that apply generally and can be used to address any future gaps in standards.

(a) Do you believe this is an appropriate and realistic objective? (If you do not, please could you explain your reasoning and what you believe is an appropriate and realistic objective.)

(b) Although the objective is to develop principles that can be applied to all kinds of industries and businesses, the paper does not explore sector-specific issues in any detail; the analysis and discussion is generic and not based on any particular sector. (For example, the paper's only reference to financial institutions is to note, in paragraph 1.26, that banks and insurers do not present a revenue number and to observe that it is outside the scope of the paper to consider whether such entities should present a revenue number and what such a number should represent were it to be provided.) Do you believe this approach is appropriate? If you do not, please could

you explain which sector-specific issues the paper should explore and why you think that would improve the quality of the analysis.

A2.1 We believe that the objective as explained above is appropriate and realistic, with the exception that we would suggest that there may be industries and businesses where financial reporting should be dominated by marking to current value of some kind. Banks and insurance companies may be examples. Revenue recognition principles may not be fully applicable in such cases.

A2.2 As mentioned in our covering letter, we believe it may be more fruitful to make progress by considering the recognition of revenue and profit jointly rather than in separate projects.

Q3 Chapter 2 of the paper discusses what revenue is. It does so by examining what the Framework says about revenue (paragraphs 2.5 - 2.13) and what other attributes revenue should have (paragraphs 2.14 - 2.33). It concludes that:

(a) Revenue is a particular type of increase in assets or decrease in liabilities.

(b) Revenue is a gross notion. In other words, if an entity sells an item for €10, making a profit of €2, it will be the €10 rather than the €2 that will be recognised as revenue.

(c) Revenue does not necessarily arise only from enforceable rights and obligations.

(d) Revenue is some sort of measure of activity undertaken pursuant to a contract with a customer. Therefore, without a contract there can be no revenue. Furthermore, revenue will not arise simply from entering into the contract, because at that point there will have been no activity undertaken by the supplier pursuant to the contract.

(e) Revenue does not necessarily involve an exchange.

(f) Revenue is something that arises in the course of ordinary activities.

(g) On the basis of the conclusions summarised above, a working definition of revenue is that revenue is the gross inflow of economic benefits that arises as an entity carries out activities pursuant to a contract with a customer.

Do you agree with these conclusions? (If you do not, please could you state which conclusion you do not agree with and explain your reasoning.) Do you believe that revenue has some additional attributes that should have been referred to? (If you do, please could you describe those additional attributes and explain your reasoning.)

A3.1 We accept the characterisation in conclusion (g) of revenue as a gross inflow of economic benefits. This implies that, because revenue is an inflow, it represents what the entity *obtains* from its performance, which is not necessarily the same as what the entity *puts in* to its performance, nor the *value* of what it produces.

A3.2 The words 'arises as an entity carries out activities pursuant to a contract with a customer' seem to be most appropriate for a continuous approach. We assume that the intent in Chapter 2 was to leave all approaches open, and so would have preferred the more neutral words 'arises as a result of an entity's activities pursuant to a contract with a customer'.

A3.3 We do not find the discussion in the paper sufficient to judge whether revenue might be recognised in the absence of enforceable rights and obligations, as suggested in (c) above. This may depend on precisely what is meant by 'enforceable'.

A3.4 Whilst we do not disagree with (d), we believe that the issue requires a fuller discussion than it is accorded in the Discussion Paper. It would be helpful to analyse exactly how an entity's position differs: (a) when it has manufactured goods under a contract; and (b) when it has manufactured goods for stock, and then go on to consider how those differences should be reflected in financial statements.

A3.5 We do not consider that the arguments in the paper establish that revenue does not necessarily involve an exchange. In our view, an analysis of the notion of exchange and its possible role in revenue recognition is one of the main omissions from the paper.

A3.6 We believe it is helpful if revenue in the sense of turnover is restricted to the ordinary activities of the company. Although we accept that it is challenging to develop a robust definition of 'ordinary activities' we do not think that this difficulty is a fatal objection, and might be content for management to make their own judgement as to what they consider to be ordinary activities, provided it is clear what is and what is not included. (The principle could be that activities that are undertaken in order to earn a margin are ordinary activities.)

Q4 As mentioned in Q3(d), revenue is some sort of measure of activity undertaken pursuant to a contract with a customer. However, the paper's analysis is not conclusive as to exactly what "sort of measure of activity" revenue measures; it could for example be a measure of completion activity (in other words, a measure of the things the supplier has completed) or a measure of activity towards completion (in other words, a measure of the things the supplier has done under

the contract). This issue arises again and again in the paper and is the main issue that separates the critical event approaches discussed in Chapter 3 from the continuous approaches discussed in Chapter 4. The authors believe that a very important test of any proposed accounting solution is whether it is the most useful approach from a user perspective. Which activities do you believe the revenue number should measure: completion, or activity towards completion? Or are there other alternatives that need to be considered? (Please give your reasons for the answer you have given.)

A4.1 We doubt if the dilemma is as sharp as that presented in the question. Obviously financial statements should attempt to give a full and informative picture of both the economic activity of the period and the inflows achieved as a result of economic activity. However, if revenue is simply to represent economic activity under contracts, there is a risk that information on conversion into cash or debtors will be obscured or lost. One way of providing both kinds of information would be for economic activity to be recorded as the acquisition of work-in-progress, to the extent it is recoverable, and for revenue to reflect the conversion of work in progress into cash or debtors (ie an inflow has been achieved).

A4.2 This is clearly similar to current practice, but it does not necessarily determine the recognition of profit. For example, it would, conceptually, be possible where work in progress relates to a specific contract to record an additional asset, an option representing the right to put the work in progress (presumably after further work) to the customer for the agreed price. The result of this would be that profit, but not revenue, were recognised as activity towards completion is carried out.

Q5 Chapter 3 discusses when revenue arises and, in doing so, introduces various critical event approaches to revenue recognition and explores three of them (Approaches A, B and C) in detail.

(a) Do you believe the discussion of Approaches A to C is fair and complete? For example, do you believe that one of the approaches has some additional benefits or weaknesses that have not been mentioned? Or that some of the weaknesses mentioned are not weaknesses? (If you do, please could you explain what you think is unfair and incomplete about the discussion, together with your reasoning.)

(b) Do you believe there are any critical event approaches other than Approaches A to C that have merit and are worth exploring in greater detail? (If you do, please could you describe those approaches and explain why you think they are worth exploring further.)

A5.1 As stated in the covering letter, in our view, the discussion of the so-called 'critical event' approaches presents versions of them that place excessive emphasis on the legal form and insufficient emphasis on the substance. In view of this we find it difficult to comment on the presentation of these approaches.

A5.2 We believe the paper should have considered more carefully notions of 'exchange' and 'customer consideration' to see if such an approach might be workable, and even, perhaps, provide a useful approach to the accounting for construction contracts.

A5.3 We comment on the paper's reasons for not discussing 'exchange' in our covering letter, at paragraphs 11 and 12.

A5.4 The paper admits that it has not analysed the notion of 'right to consideration'. Its reasoning is that: "the same activities undertaken pursuant to the same contract may result in a right to consideration under one country's legal framework but not another. This does not sound like a very promising notion on which to build a principles-based approach to revenue recognition."(paragraph 3.48). However, the legal framework is part of the environment that forms the economic substance of a transaction. So if a right to consideration arises in one country and not another it might well be the case that the economic substance of the two contracts is different and hence require different financial reporting.

Q6 Chapter 4 continues the discussion of when revenue arises by introducing and exploring another type of approach to revenue recognition: the continuous approach (Approach D). Again, do you believe the discussion is fair and complete? (If you do not, please could you explain what you think is unfair and incomplete about the discussion, together with your reasoning.)

A6.1 As stated in the body of our letter, the argument that the continuous approach provides a good measure of economic activity undertaken pursuant to a customer contract, is in our view unconvincing, especially if it essentially relies on the absence of volatility in reported revenue under a long-term contract.

A6.2 We would welcome further discussion of the relationship between "activity that reflects performance towards completion of a contract" and a "gross inflow of economic benefits".

A6.3 Under the continuous approach, it is not necessary to establish that what has been done has any value to the customer: rather it must be 'performance towards completion'. That is why, at least arguably, the swimming pool contractor may recognise revenue when he has only moved his equipment to the site. The paper does not, however, address what are the boundaries of 'performance towards completion'. Suppose, for example, that before the equipment is moved to the site the contractor has had to (i) locate and recruit staff with the appropriate skills and availability; (ii) locate and purchase equipment; (iii) cancel another contract that could not be performed together with the swimming pool contract; (iv) cancel a personal holiday. Which of these acts would justify the recognition of revenue, and why?

A6.4 The arguments in the paper that the continuous approach represents an asset and liability approach (which are set out in paragraph 4.35) seem questionable. The first is that, once some movement has been taken towards completion of the contract, another supplier would take over the contract for less than the amount originally received. But this establishes only that the work done to date has resulted in an asset that might conceivably be transferred: it does not establish that there has been an <u>increase</u> in net assets since that asset might be worth no more than (or indeed less than) the cost of that work. The second argument on this point is that the work done increases the market value of the entity. However, it is well established that there is no clear or precise link between the assets and liabilities that an entity should properly report and the entity's market value.

Q7 The discussion in the paper is about concepts and principles—and not at this stage practicalities—and the paper uses a variety of simple examples to illustrate the various approaches and various conceptual discussion points. The examples are set out in Appendix IV. Do you believe there are other examples that would illustrate or highlight issues of concept or principle that are not so far identified in the paper? If you do, what are those examples and what new aspect of the debate is it that you think they illustrate or highlight?

A7.1 We find the examples appropriate, and think it especially valuable to consider relatively simple examples.

A7.2 It would be interesting to test the approaches by reference to an example where performance will clearly take a long time (longer than one accounting period), and where the supplier's right to payment is clearly contingent (both in substance and in form) on the product being completed and meeting pre-established performance conditions. We would agree that such a contract will rarely arise in practice because it leaves all the risk with the supplier and none with the customer. But this might suggest it is all the more important that revenue is not recognised until it is assured, and permit debate as to whether safeguards such as requiring a reliable estimate of outcome are sufficient.

Q8 What are your views on the relative merits of the approaches discussed in the paper? Do you believe that one approach is preferable to the others and could—perhaps after some further development work—be applied satisfactorily in all circumstances? (Please explain your reasoning.)

A8.1 We do not believe that the analysis in the paper is sufficient to enable a reasonable conclusion to be drawn that any of the approaches discussed should provide a basis for future standards on revenue recognition. In particular, we do not believe that the paper has demonstrated that a so-called critical events approach necessarily precludes revenue arising before a long term construction contract is completed. We also do not consider that the paper articulates strong and compelling conceptual reasons for favouring a continuous approach, nor for presuming that such an approach is consistent with an asset/liability framework.

Q9 At various points in the paper the authors discuss the issue of perspective; from whose perspective or point of view (ie through whose eyes) should performance be assessed? The suppliers or the customers? For example:

(a) the issue is first mentioned in paragraphs 3.36-3.39, where it is explained that one perspective is not necessarily better than the other, although one may be better suited (or even an inherent feature) of one particular approach, whilst another might be better suited or a feature of another approach;

(b) the issue is also discussed in paragraphs 4.4(c), 4.5(b) and 5.7(c), where it is explained that critical event approaches generally (but not necessarily always) apply a customer perspective whilst continuous approaches tend to apply a supplier perspective.

In your opinion is this discussion complete and sufficiently conclusive? If you think it is not, could you please explain what more you think should be said and why.

A9.1 As the paper acknowledges, the perspective to be adopted must to some extent depend on what revenue is supposed to represent. As we are concerned with financial reporting by the supplier, clearly reported revenue must to some extent represent the supplier's perspective. However, if revenue is to represent an inflow (and not merely the expectation of an inflow) it will be necessary for there to be evidence that what has been done has resulted in a claim on the customer. For this reason, the position of the customer is clearly relevant.

Q10 Do you believe there are particular aspects of the revenue debate that have not been covered in this paper but are worthy of consideration. If you do, what are they and why do you believe they are worth exploring further?

10.1 There are, of course, a number of aspects of revenue that are not discussed in the paper, including the measurement of revenue, agency vs principal arrangements, and 'bill and hold' sales. It is possible that 'bill and hold' sales would provide a much more illuminating test of the various approaches than, for example, multiple-element arrangements.

10.2 In our covering letter we highlight the notion of exchange as meriting further exploration. We would add that a substantive approach to 'right to consideration' may be fruitful.

10.3 The paper discusses and discards the notion of customer acceptance, by pointing out that there may be circumstances in which recognition of revenue is justified even where acceptance has not taken place. But this does not, as the paper seems to conclude, mean that customer acceptance is not significant. It may well be the case that customer acceptance is a sufficient condition for the recognition of revenue although it is not a necessary one.

10.4 The discussion of the reversal of revenue does not seem quite on point. That discussion seems to seek to establish that revenue may be recognised even though it cannot be measured with great reliability. We would agree that, whatever reliability threshold is deemed appropriate, 100% certainty should not be required. However the paper assumes that any downward revision to revenue in a subsequent accounting period should be reported by debiting revenue (and this would have the consequence, in the extreme case where there is no other revenue in the second accounting period, of revenue being a negative number). However, there seems little meaning in a negative amount of revenue and reporting revisions to 'year 1 revenue' in the same line as 'year 2 revenue' can only distort the latter. It would, in our view be better for any changes of estimate relating to previously recorded assets and liabilities to be reported separately from current year's revenue—or, as appropriate, as the correction of an error, that is, by restatement.