## Revenue Recognition Project – the Revised Model issued in November 2011

## Comment by R K Graham, Chairman of the Audit Committee of Wolfson Microelectronics plc and Psion plc

Having now had a chance to review the Revised Exposure Draft on the above subject, I thought it appropriate to add my comments to what I suspect are a number of others. The International Accounting Standards Board (IASB) has clearly taken on board a number of observations made regarding the initial ED and to that extent it should be given credit, but the revised ED still appears to me to be far too complex and, as with a number of standards, takes too much of an academic rather than a commercial view to the subject.

Also, as part of this preamble, it concerns me that although considerable effort has been expended on revenue recognition, inadequate thought has been given to the concept of gross margin, which for many companies is almost as important an indicator as revenue itself; until the IASB bites the bullet and reassesses the importance of the old accounting concept of accruals (or matching) the final results under IFRS are likely to be the subject of material distortions which will add credit neither to the standards themselves nor to accounts generally.

## Specific issues

Much of the revised ED (like its predecessor) revolves around the identification of the separate "performance obligations". This is then overlaid with the idea that revenue should be recognised when or as the customer obtains control of the good or service. These two concepts may, and often are, not be consistent inter se and in my view this academic distinction does not have appropriate regard to the way in which contracts are negotiated. This departure from commercial reality is evidenced also in the way the revised ED might allow "variable consideration" to be estimated and allocated to performance obligations. The fact is contract terms are negotiated in the round and acceptability of a contract by either customer or supplier will reflect the combined assessment of attributes, costs and risks and these may be perceived quite differently from the customer's viewpoint to those of the supplier. Thus, the idea of allocating strictly part of the consideration to specific elements based on some external judgement of what the fair market price might be is at odds with the rationale used to negotiate the whole contract.

The revised ED says that a performance obligation is a satisfied over time if ... the entity's performance creates an asset with no "alternative use" to the entity. This concept of no alternative use is a curious one indeed because for very many contracts, even those, for example, involving the provision of legal services,  $^9/_{10}$  of the goods or services being provided may have an alternative use (i.e. be of value to a different customer), but it is the  $^1/_{10}$  which is a thing of real distinguishable value to the customer, something that he is actually prepared to pay a significant amount of money for. In short, I do not like the concept of no alternative use and feel that it is likely to be open to misinterpretation.

For construction or other long term contracts, the most important thing is the profit taken over the contract's duration: without a matching concept, revenue is an almost

irrelevant statistic. However, the revised ED has muddied the waters further by distinguishing onerous performance obligations and then artificially sub-dividing these further to those which are satisfied over a period of more than one year as against those taking less than one year. In my view, the one year test is a curious one (why is 11 months so much different from 13 months?) and if a performance obligation is onerous, then it should be reported on at the end of any accounting period for which the contract period extends. Once again, this really misses the main point, namely that in negotiating a contract all obligations will be considered, some will be more onerous than others, but in order to provide a proper report on revenues and gross profit achieved at any time, a company should make an assessment as to the cost to complete, allowing for a contingency which will be on the cost line rather than the revenue line, that will make allowance for the degree of difficulty or the risk attaching to the contract (as an aside, that is why the old concept of prudence was so important in times gone by).

The section on presentation of bad debt expense concentrates on a customer's credit risk (i.e. collectability) whereas for the main part, any revenue shortfall is likely to be as a result of a customer arguing that parts of the contract were not delivered and up to the required standard and he should qualify for a discount; the likelihood of this occurring might well have been built into the contract price by the supplier and should therefore properly (consistent with the basis of negotiation) be a deduction from the revenues line rather than being shown separately.

Another area of the revised ED which goes against the grain is the concept of capitalising contract acquisition costs and incremental costs of obtaining a contract of longer than one year. The idea of capitalising such costs is anathema to previous good accountancy practice because the cost of obtaining contracts is a necessary cost of doing business and it will be expected that some you win and some you lose – that is one of the skills which a successful contractor will be good at, namely deciding which contracts to go for and at what stage to bale out because the likelihood of success has fallen to an unacceptable level (the art of qualification). Accordingly, in my view, neither contract acquisition costs nor set up costs should be capitalised as such; the former should be written off as incurred and the latter will be considered as part of the costs of fulfilling the contract and therefore profit taken should allow for such costs as part of the overall calculation.

The revised ED refers to a number of additional disclosures that may be considered appropriate but to my mind this reference to disclosures is not necessarily appropriate to the standard. That is not to say that good practice would not agree with the proposals to provide disaggregated information on revenues by type of goods or services, geography, contract duration or any other measure; and on the cost side, it might well be good practice to show the costs of contract acquisitions identifying overall costs against success rates. However, there are other standards on dealing with business segmentation and providing information to readers of accounts on the business and final model of companies, so to try and impose further information requirements in a separated way as part of this standard seems to me to be inappropriate.

Finally, in the general comments section, I would highlight the importance of obtaining agreement with HMR&C (and other taxation authorities) that the revenue

and profit reported consequent to any final standard should be the basis on which tax is charged. My concern here, however, is that if the incidence of tax varies materially from pre-existing practice (and possibly with the way in which monies are received) then there could be a serious amount of extra work required by companies in providing appropriate information for the right tax charge to be calculated.

## Conclusion

My concern is that this revised Exposure Draft, as with its predecessor, introduces a number of new concepts which will be complicated to implement and I am not sure that any reader of accounts will be much the wiser — indeed my suspicion is that because so many of the concepts differ from the way contracts are negotiated, the accounts will not reflect a true and fair view, at least if one considers that concept to relate to the commercial reality of life. I also worry that all the attention is being paid to measure the single line, namely revenue, rather than looking at every related, and just as material, matters such as gross profit/gross margin and reported profit.

Finally I cannot restrain myself from saying that the value and worthiness of any standard which may emerge from this process will be tainted by the fact that it is not part of any Conceptual Framework. Until the IASB bites the bullet and completes the Conceptual Framework there is bound to be a number of inconsistencies and an overall lack of coherence of the standards and this therefore devalues the whole purpose of having a set of standards which should have international respect and acceptance.

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