<u>Submission to recent Exposure Drafts dealing primarily with revenue recognition but also leasing.</u>

Background

The International Accounting Standards Board (IASB) have been very active over the past year and in the second half of 2010 have issued some 7 exposure drafts, 6 new standards and an estimated 8 recently completed projects. For 2011 a further 5 exposure drafts are expected and 14 new standards. This sort of level of activity is causing a huge burden on industry, which is charged with compliance and, it seems to me, for little overall benefit. Of course the vision of "convergence" (in particular with the US) is worthy, but this should not be done in a way and at a pace that seriously compromises the quality of the standards and their relevance to business and, in particular, users of accounts.

In this context, one cannot help but observe that at present the IASB has not even completed the conceptual framework project. Thus, we are seeing a glut of new proposed standards without any real coherence as to what they are trying to achieve other than an apparent crusade towards "convergence". Many of the new standards seem to flow directly from academic thinking with little or no relationship to the commercial rationale lying behind the underlying transactions. Furthermore, the consequences as reflected in company results, its assets and liabilities contained in accounting statements are in many cases most unlikely to benefit the users of those accounts. Ironically it was Sir David Tweedie himself who recently commented that one of the most useful elements of a company's report and accounts is the business/operational review – this is becoming increasingly true because the profit and loss account, the source and application of funds statement and the balance sheet are all becoming a total hotch potch with different and inconsistent concepts being applied such that not one of them, in its entirety, does the job for which it is designed.

It is within the foregoing context that I make my observations on current proposals regarding revenue recognition and leasing.

The revenue recognition project

In July 2010, the IASB and the FASB (in the US) issued their joint exposure draft "Revenue from contracts with customers". The comment period ended on 22nd October 2010 but I understand that subsequent submissions are also being considered, which is why I have decided to set out my views. These of course do have the benefit of the feedback from the main firms of accountants and the summary of the submissions already made. It appears that most respondents have been generally in favour of "convergence" as a concept. This is fine so long as the resultant standard(s) involves minimal change from what in practice seems to be working pretty satisfactorily, albeit with one or two inconsistencies between IFRS and FRS. However, the new exposure draft seems to change in a fairly significant way how revenue is recognised throughout the world and this without any good argument for making the changes proposed. Here I would repeat the point that without a

conceptual framework in place, it is far from clear what the IASB is trying to achieve by such a significant (in certain areas) array of changes.

Some issues in practice

In this section I do not aim to provide a detailed analysis of each and every issue that might emerge. What I seek to do is to highlight some inconsistencies or other solecisms where:

- the concept of substance over form has not been applied;
- the new proposals will be inconsistent with the underlying commercial rationale.
- as a consequence of the abandonment of the former concept of accruals and matching as was used to good effect in UK GAAP the results shown in the profit and loss account provides information which is very likely to mislead users.
- 1. The ideas of measurement of revenue where deferred and/or contingent consideration has to be recognised (if possible to estimate) will almost certainly fall foul of all the concepts I have referred to above. It will provide:
 - inappropriate volatility of earnings
 - no linkage of revenues with cash
 - a likelihood of significant tax being payable in advance if revenues have to be booked before cash is received and
 - little correlation with the underlying commercial rationale.

By way of example, if a contract provides for additional revenues/consideration to be received depending on sales volumes of a distributor there will need to be a major exercise in assessing the probable future outcome for such agreements. Normally such contracts are entered into because it is very difficult to identify how successful the arrangement is likely to be and "payment by results" is the sensible deal struck: as a result the estimate will almost certainly be wrong, cost a great deal of time and effort to identify and fail to reflect the nature of the bargain.

- 2. The allocation of the transaction price to separate performance obligations presupposes that the mere fact that separate performance applications can be identified means that they are truly separate from the whole. By way of illustration we have the complexity of making a judgement when the transaction price of a good differs depending on the bundle of goods supplied or the customer to which it is sold. It is understood that under US GAAP as previously applied there was a concept of applying a residual method to allocate the transaction price when a stand alone selling price could not easily be determined. This seems a very practical way of proceeding but appears to be outlawed under the current arrangements.
- 3. Product warranties are now to be distinguished between two types, one that deals with coverage for latent defects in the product and the other which provides a customer with cover for faults that arise after the product is transferred. This seems a very nebulous distinction and therefore the principle of deferring revenues in a different way dependent on which type of warranty applies seems to be a case of "theory trumping practice". Furthermore, the concept of deferring

- revenues to cover future warranties (with which I agree) is totally inconsistent with the idea of taking revenues early based on current estimate of future royalties. Accounting theory is nothing without consistency.
- 4. The application of the transfer of control as being a pre-requisite to recognise revenues creates a nonsense when applied to long-term contracts. Essentially this means that a company working flat out on one or two large contracts will not be allowed to recognise any revenues until the customer ultimately obtains control of the goods or construction being developed. Such a company will inevitably make a loss throughout the period of the contract and then after 3, 4, 5 or however many years will then record a very large profit. Firstly this is entirely inconsistent with the idea mentioned above of royalty or deferred revenues being recognised early, but secondly means that the results recorded have no relationship to the commercial reality. For long term contracts the idea of a continuous transfer of control should be applied such that, as now, profit can be taken on such contracts where the outcome can be reasonably estimated, albeit making an appropriate provision for costs to complete. It goes without saying that whilst tax revenues will have been advanced if deferred revenue is taken in advance they will be seriously retarded by the IASB's approach to long term contracts - neither have any good commercial justification.
- 5. Collectability (of revenues) is now considered to be a determinant in computing the level of revenues to be recognised. In previous standards the IASB has been at pains to disallow any idea of a general provision against collectability of debtors or accounts receivable and yet this seems now to be allowed under a different guise. As a long standing accountant, I believe there is a very real place for general provisions subject to their being properly justified by circumstances (normally there is a good history available). For the IASB now to continue with its stance (i.e. a prohibition of the concept of general provisions) and yet introduce the concept of collectability (which does pretty much the same job) seems to show muddled thinking, particularly so when any over collections against the provisions initially put in place are recorded as a negative overhead rather than being a subsequent adjustment to the revenue line.

Leases

In the heading to this submission I refer to leases and a number of comments which have been made in this submission apply equally to the exposure draft on leasing contracts. The idea of both operating and financial leases being treated as though they were the same does actually have some merit and complies with the old principle used under UK GAAP of "substance over form". However, this very simple and benign change has been savaged by the complexity that is now proposed in a number of areas and in particular:

- The idea of a renewal option being "more likely than not to occur", rather than reasonably certain will create a massive amount of work to produce an illusory degree of likelihood.
- The idea of contingent or variable lease costs being the subject of a judgement up front so that lease payments which may, for example, be dependent on retail sales are accounted for on a straight line method, cuts across the commercial rationale designed so that the lessee would pay rentals in accordance with the

level of activity. The proposed concept is inconsistent with the commercial reality and with the lessee's ability to pay. It is simply bizarre to force both sides of a lease arrangement to make commercial judgements at a time when it is virtually impossible to make such judgements with any accuracy. The subsequent accounts are therefore bound to be wrong, which will mean inappropriate costs or revenues being accounted for and a concomitant mis-matching of charges for taxation.

Conclusion

My conclusion is a simple one, namely that the IASB appears to be being carried away with a mission to "converge" without proper concerns for other users or preparers of accounts. This seems to be an appropriate time for the conceptual framework to be put in place (Lord knows we have seen enough standards so far for such a framework to be possible) and if in preparing the conceptual framework inconsistencies are identified, then already existing standards should be cleared up and made compliant before anything else is attempted; there will then be a great deal more support for any new standards. This may not suit Sir David Tweedie on his declared/overt wish to fly on a plane which is actually shown as an asset on the books of the airline, but I would also suggest that he and the IASB are in danger of creating a number of ducks which do not fulfil the quacking test.

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