The International Accounting Standards Board First Floor 30 Cannon Street London, EC4M 6XH

Dear Sirs

Revenue recognition in contracts with customers

The Association of Taxation Technicians ('ATT') welcomes the opportunity to comment on the Board's preliminary views in relation to developing a new Standard on revenue recognition. Founded in 1989, the ATT is a charity formed to advance public education in, and promote the study of, the administration and practice of taxation and to help raise the standards of tax compliance in the UK, thereby protecting the public from inadequate advice. With a membership of over 6,000, the ATT has become the leading professional body for those providing tax compliance services and related activities in the UK.

It may perhaps be wondered why a body concerned with taxation, rather than accountancy, is concerning itself with International Accounting Standards. The answer is quite simple; UK tax law requires trading profits of all forms and sizes of business to be computed in accordance with generally accepted accounting practice.¹

As International Accounting Standards are part of that practice, the adoption of the proposed Standard will have implications for all businesses regardless of their size or the structure they choose to adopt. Our particular concerns are in the context of service providers, which include our members in practice, their clients and those small or 'micro' businesses, who do not have professional advisers.

Executive summary

- We strongly agree with the basic thrust of the proposed standard i.e. that revenue should be recognised at the point at which the asset is transferred to the customer.
- Contracts for the provision of services require special consideration and again we agree that the point at which the service is transferred to the customer is when that service is received by him. Put another way, it is when the service has been supplied to the customer and he has therefore received the benefit of that service and not before.
- It is imperative that the Standard should provide tightly-worded definition of the point in time at which revenue should be recognised in the case of services to avoid the possibility of conflicting interpretations as has occurred in the UK over UITF 40.
- The Standard should also address the issue of the apparent conflict between the principle of not recognising revenue until the service has been provided and the UK Standard on stocks and work in progress²

¹ Income Tax (Trading and Other Income) Act 2005, s. 25 and Corporation Tax Act 2009, s. 46(1).

² Statement of Standard Accounting Practice 9.

• It is also essential to bear in mind that the Standard will impact on all entities of whatever size and in whatever vehicle is adopted. Therefore the Standard must be presented in terms that are understandable and capable of being applied by business proprietors.

The basic thrust of the Board's proposal

We strongly support the decision to focus the proposed Standard on the contract between the service provider and the client, particularly the statement that a service provider satisfies a performance obligation when the customer has received the promised service. This approach provides for certainty and has the added advantage of commonsense; until the customer has received the benefit of service there can be no performance of the entity's contractual obligations. This approach also clearly equates to the position under English contract law where, under what is termed an 'entire' contract, the provider has no right to any consideration until he has performed his obligation in its entirety. Most contracts entered into by the majority of small and micro businesses will fall into this category. Because such an approach has the advantage of common sense, it will be easily understood, and because it is fair, it will be readily adopted by those businesses.

The Board's proposal is a welcome move away from the uncertainty which is inherent in the current IAS 18 in its application to contracts for the provision of services. The current Standard requires revenue to be recognised when it is *probable* that economic benefits will flow to the entity and that the revenue, stage of completion and remaining costs can be measured reliably. A requirement of this type can lead to differing interpretations such as those which created the confusion and controversy in the UK surrounding UITF 40.

The provision of services

As the Board's Discussion Paper acknowledges, to apply the same principles to the supply of goods and the provision of services requires a slightly modified definition of the term 'asset'. Nevertheless, we agree that the customer does receive an asset in the form of the service when it is provided. It is at that point that the customer has the benefit of that service. To take as an example a tax adviser undertaking to complete and submit a client's tax return, that service is clearly completed when the completed return is submitted to the tax authorities. It is only at that time that the client can be said to have received the benefit of that service. In other cases such as, say, the provision of tax planning advice in connection with potential liabilities to death duties, he has had the benefit of it when supplied, even though he may choose not to follow that advice. He thus 'consumes' the advice whether he acts upon it (and therefore realises the benefit of that advice) or rejects it (and therefore 'writes off' any benefit from that advice.

The Standard needs to be clear on the position to be adopted for contracts for the provision of ongoing services on an 'as and when required' basis. It seems to the Association that each request for advice will be a separate 'performance obligation' and an appropriate amount of revenue should be recognised when the service provider supplies that advice. The position is a little more complex in a case where the service

³ Discussion Paper, Para. S22.

⁴ Ibid, Para. 3.13.

provider accepts a retainer on a regular, say quarterly, basis. If in a particular quarter there has been no call for the entity to provide any services, then has there been any performance of contractual obligations? It would clearly be absurd for an entity to receive a quarterly fee in such a situation and not recognise it as revenue. In such a case we feel that the entity performs its obligations by being *available* to provide services even if none are actually required to be provided in that quarter.

Finally, as a 'long-stop' measure, we believe that, where the duration of a contract extends over a period of more than 12 months without a performance obligation having been satisfied, revenue should be recognised on every anniversary of the commencement of the contract until such an obligation is satisfied.

The UITF 40 controversy

We believe the Board's approach to this issue can put an end once and for all to the controversy which reigned in the UK over the interpretation of Application Note G to FRS 5 and, subsequently, UITF 40.

In February 2003 the Accounting Standards Board published an exposure draft of Application Note G which was intended to be a temporary expedient to address 'questionable practices' of some who were accruing amounts in respect of future business income in order to strengthen their balance sheets. It was temporary in the sense that it was to have effect until such time as the IASB had adopted a new standard to replace IAS 18. It was stressed at the time that the application note would not give rise to any significant changes to the policies to be adopted by the majority of UK entities; it was merely a codification of existing good practice to 'enable auditors to remind companies that turnover can be recognised only when a business has done that which it has agreed with its customer it would do'. 5"

The Application Note in its final form was published in November 2003⁶. An article by a project director at the ASB confirmed that 'New guidance from the ASB codifies existing good practice for the recognition and measurement of turnover'.⁷

Both Application Note G and, latterly UITF 40, prescribed that the point in time when revenue should be recognised is when a 'right to consideration' is obtained by the entity as a result of the performance of its obligation under the contract. Whilst this could be interpreted as being compatible with the Board's proposed approach, some within the accountancy profession, including the CCAB, took the view that a 'right to consideration' could accrue during the currency of the contract and therefore, where the contract was not completed at the year end, an appropriate proportion of the expected revenue from that contract should be recognised. This was contrary to the expressed intention of the ASB and, as a result, led to a great deal of uncertainty about the true effect of Application Note G and UITF 40.

This uncertainty began when an article in *Taxation* magazine in January 2004 suggested that unincorporated service providers would have to begin to recognise, as work in progress, unbilled proprietor/partner time at the year end. Another article in

⁵ ASB Press release PN213 of 27 February 2003 - http://www.frc.org.uk/asb/press/pub0299.html

⁶ Application Note G to FRS 5 issued 13 November 2003 -

http://www.frc.org.uk/images/uploaded/documents/ACF562.pdf

⁷ Accountancy, December 2003

the same magazine the following month contradicted this interpretation. As the Application Note was to have effect for accounts ending on or after 23 December 2003, there was some urgency to provide our members with guidance as to how the Application Note affected them and their clients. Following a discussion with the then Technical Director of the ASB, (who had in fact drafted the Application Note), the Association issued guidance to members in March 2004. This stated that there had in fact been no change in generally accepted accounting practice and that revenue should continue to be recognised when the service had been provided. However the continuing uncertainty over the effect of the Application Note led to it being referred to the Urgent Issues Task Force who, in November 2004, issued Information Sheet 70, an exposure draft of a proposed Abstract⁸.

As indicated earlier, the current view of the CCAB⁹ is that where a contract for the provision of services has not been completed at the financial year-end, some part of the expected revenue from that contract must be recognised, regardless of the fact that the client may not have received any benefit from the work performed by the service provider by that time and regardless of the actual duration of the contract. This is totally contrary to the Board's proposed Standard. The CCAB base this view upon the definition of a 'long-term contract' in SSAP 9 Stocks and long-term contracts, which they claim would include a contract for the provision of a service (i.e not related to the sale or construction of goods) which has not been completed at the year-end, despite the fact that the duration of that contract may not exceed one year. The CCAB therefore say that it follows that revenue should be recognised to reflect the partial performance by the entity of its contractual obligations.

The CCAB view is perhaps best illustrated by an example given in the guidance¹¹;

"John is half way through completing Sam's tax return at the end of June. Does he accrue the right to 50% of the consideration that Sam has agreed to pay for the tax return? Commonsense would suggest not. Sam has no use for half a tax return. Indeed, one could argue that it is worth less to him than no tax return as the penalties for submitting incorrect returns are greater than those for submitting no return at all.

It is true that a half-completed tax return is of little practical use. But the working assumption is that contracts will progress to completion. In general, John will complete the tax returns that he is working on. (If that is not the case for a significant number of John's assignments, the accounting treatment might well be different.)

From a technical perspective, UITF 40.11¹² pushes John into SSAP 9 for accounting for this contract, the completion of a tax return being a single

⁸ UITF Information Sheet 70 of 30 November 2004 -

http://www.frc.org.uk/images/uploaded/documents/UITF%20Info%20Sheet%2070.pdf

⁹ CCAB Guidance on the Application of UITF 40,

⁽www.ccab.org.uk/PDFs/CCAB%20Guidance%20on%20the%20application%20of%20UITF%2040.pdf)

SSAP 9, para. 22

CCAB Guidance on the Application of UITF 40, Part 3, Question 3

Actually we feel this should refer to UITF 40.13 which reads 'The definition is clear that a contract for services that constitute a single project with duration of more than a year should be accounted for as

project. SSAP 9.29¹³ requires that, where the outcome of the contract can be determined revenue is ascertained in a manner appropriate to the stage of completion.

This is entirely consistent with FRS 5 AN G, which requires that revenue is recognised by reference to performance and the right to consideration. The only circumstance under which it would not be appropriate for John to recognise any revenue would be if his right to consideration was contingent on a specific trigger event, the outcome of which he cannot control (as outlined in UITF 40.19¹⁴). The stage of completion is not necessarily determined on a straight-line, time incurred, basis but is influenced by the value to the client of the work done to date."

The CCAB have therefore interpreted SSAP 9 in such a way as to say that some part of the expected revenue for the uncompleted contract must be recognised *before* the entity has transferred the asset to the customer by performing its obligation to supply the service.

The conflict with SSAP 9

The extension of SSAP 9 to contracts for services adopted by the CCAB is, we feel, misguided. It is true that the definition of a long-term contract also includes a contract entered into for the provision of a service, but the whole focus of the Standard is on the design, manufacture or construction of a single substantial asset. In other words a contract for services is only within that definition if it relates to a single project (which by inference must also be 'substantial') and the duration of that contract will normally exceed 12 months. Indeed this was recognised by the UITF in the exposure draft of the proposed abstract;

"The definition is clear that, in the case of contracts for assets, only those for 'a single substantial asset' are required to be accounted for as long-term contracts. Similarly, in the case of a contract for a combination of assets and services only those that 'constitute a single project' are required to be accounted for as long-term contracts. There is, however, no express analogous restriction in the case of contracts for services. However, it seems clear that this is the intent: it would be anomalous for there to be a difference between contracts for assets and contracts for services in this respect. (Emphasis added)

a long-term contract. It is also clear that contracts with a shorter duration should be accounted for as long-term if contract activity falls into different accounting periods and a failure to reflect turnover and attributable profit would result in distortion of turnover and results, such that the financial statements would fail to give a true and fair view.'

[&]quot;Where it is considered that the outcome of a long-term contract can be assessed with reasonable certainty before its conclusion, the prudently calculated attributable profit should be recognised in the profit and loss account as the difference between the reported turnover and related costs for that contract."

¹⁴ "Where the substance of a contract is that a right to consideration does not arise until the occurrence of a critical event, revenue is not recognised until that event occurs. This only applies where the right to consideration is conditional or contingent on a specified future event or outcome, the occurrence of which is outside the control of the seller".

Thus contracts that require services to be provided on an ongoing basis rather than the provision of a single service (or a number of services that constitute a single project) do not fall to be accounted for as long-term contracts under SSAP 9. For example, a contract to provide general professional advice on an ongoing basis should not be accounted for as a long-term contract. Similarly, a contract to provide repetitive services (such as maintenance or cleaning) should not be accounted for as a long-term contract."¹⁵

For reasons which have never been explained, the words emphasised did not appear in the final draft of UITF 40¹⁶. Nevertheless those comments in Information Note 70 are still valid. To apply the same principles to both a contract for the construction of a nuclear power station and one for the completion of an individual's tax return is absurd. This absurdity also extends to the fact that a contract of extremely short duration can be classed as a long-term contract simply because it happens to straddle a financial year-end.

In the event, UITF 40 has failed to dispel the controversy over the true meaning of Application Note G. On the one hand, it requires any contract for a single service, however short a duration and however insignificant in itself, to be accounted for as a long-term contract under SSAP 9 with a consequent recognition of some part of the expected revenue¹⁷, and yet it also says that where a right to consideration does not arise until the occurrence of a critical event, revenue is not to be recognised until that event occurs.¹⁸

As mentioned earlier, the position under contract law is that the entity has no right to demand payment for the service until he has fulfilled its part of the bargain (or as the Discussion Paper says, when the customer has received the promised service).

It is clear that if the CCAB maintains its stance, it will run contrary to the Board's preliminary view that revenue should not be recognised until the service has been provided. We accept that there could be situations where a contract for the provision of services extends over a considerable period, but as indicated earlier, this issue could be addressed by requiring revenue to be recognised at least once a year.

We therefore strongly urge the Board to take this opportunity to address the issue of the incompatibility of UITF 40 and SSAP 9 with the proposed new International Accounting Standard. It should make a clear and unambiguous pronouncement to the effect that, in connection with service contracts which are not 'substantial', revenue should not be recognised until there is a legal entitlement to it under the terms of the contract. In other words, that SSAP 9 is not applicable in such cases.

The need for clarity

The Association feels strongly that the proposed Standard should be worded in such a way as to not permit differing interpretations. In particular, it must make clear that it

¹⁵ UITF Information Sheet 70, paras. 10 & 11

http://www.frc.org.uk/images/uploaded/documents/UITF%2040.pdf

¹⁷ UITF 40, paras. 24 & 25

¹⁸ Ibid para.27

is not possible for revenue to be deemed to accrue over the life of the contract.¹⁹ In other words, at any point in time, revenue either should be recognised or it should not. This is an absolute concept; either a performance obligation has been satisfied or it has not. There can be no concept of partial satisfaction of that obligation.

An absolute concept will be easily understood by small business proprietors and can therefore be complied with without any misunderstanding. It will also be seen as fair and sensible. The proprietor will recognise income from a contract when he has earned it, i.e. when he has done what he has undertaken to do and when he is entitled to invoice for his fees and seek to recover them.

Such a commonsense and commercially realistic approach is also more likely to be applied by business proprietors than the highly artificial approach recommended by the CCAB of recognising a proportion of the expected income (and paying tax on it) before the business has any legal right to demand any payment.

It is therefore imperative that the final version of the Standard be expressed in unequivocal terms, reflect the realities of business life and thus be acceptable to, and be capable of being applied by, the proprietors of small and micro businesses.

Should the Board wish to discuss these issues further, we would be happy for members of our Technical Committee to attend a meeting.

Yours faithfully

Anie J. Bailey

Annie Bailey President

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¹⁹ Other than in the exceptional case of a contract where no performance obligation has been satisfied within 12 months of the contracts inception.