

# **Issues arising from the Joint IASB/FASB Discussion Paper ‘Preliminary Views on Revenue Recognition in Contracts with Customers’: Comments from the British Accounting Association Special Interest Group in Financial Accounting and Reporting**

The Financial Accounting and Reporting Special Interest Group (FARSIG) is a special interest group of the British Accounting Association. Its technical committee is charged with commenting on Discussion Papers and Exposure Drafts issued by standard setters on issues relating to financial accounting and reporting. Its views represent those of its members and not those of the BAA.

The British Accounting Association (BAA) is the representative body for UK accounting academics and others interested in the study of accounting and finance in the UK. The BAA Special Interest Group in Financial Accounting and Reporting is the BAA’s designated group specialising in issues relating to financial reporting. This response has been formulated by Pauline Weetman (Edinburgh University) with comments from David Oldroyd and has been approved by the Technical Committee of the Special Interest Group.

## ***Principal Issues Raised by the Exposure Draft***

As preparation for our response we have read again the much-cited paper by Professor John Myers entitled ‘The critical event and recognition of net profit’.<sup>1</sup> Myers’ first concern, relating specifically to US GAAP, was: ‘We [i.e. the US] have relied on a variety of rules for specific situations, not on an over-all principle’. He was also concerned to identify a principle ‘which is compatible with economic theory and at the same time coordinates most current accounting practices’. Although his paper is headlined ‘Criteria for revenue “recognition”’ in the compendium by edited by Zeff and Keller (1973)<sup>2</sup>, Myers’ discussion focuses mainly on ‘income recognition’ (using the American terminology equated to what others might call ‘profit recognition’). Myers assumes that profit in accounting is the same as profit for the economist, seen as a reward for having taken the risks of the enterprise. From this assumption he

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<sup>1</sup> Myers, J. (1959). The critical event and recognition of net profit. *The Accounting Review* 34(4): 528-532). Reprinted in Zeff and Keller (1973).

<sup>2</sup> Zeff, S.A. and Keller, T.F. (1973). *Financial Accounting Theory I: Issues and Controversies*. Second edition. McGraw Hill Book Company.

asserts that profit is earned by the operating cycle which he then equates with ‘the round trip from one balance sheet position back to that position’. Myers then seeks to define one moment in time at which profit should be recognised in that cycle. However he is clear in saying that the consideration of one moment in time is a device to set some limits on the article he is writing. The choice of a point estimate is not derived from economic theory. Having set the scene, the remainder of Myers’ paper is devoted to examining what he calls the ‘critical function theory’ against existing accounting practices. He concludes: ‘It [the theory of the critical event] is a theory based on a fundamental economic process rather than upon such frequently used rationalizations as convenience, conservatism, certainty, tax timing, and legal passage of title.’ He recognises that the critical event theory that he proposed might be rejected in favour of another. His final plea is for ‘the development of a single theory for the timing of profit recognition’.

The message we take from Myers is that a single principle is an overriding aim and that economic theory should have a place in determining or justifying that principle. We note Myers’ support for analysis based on the reward for taking risk.

In the context of this preparatory thought we strongly support the aim of the discussion paper to create a unifying principle for the recognition of revenue. We do not think it is necessary to defend the concept of a ‘critical event’ based on a single point in time, as Myers indicates this was a practical device to facilitate debate. We do however believe that the economic rationale of the proposed solution should be clear. We do not find that rationale in the discussion paper. We see instead the focus on what Myers called a ‘rationalization’, based on a potentially misplaced faith in the absolute integrity of a legal contract. The theme running through our responses is that the evidence from the legal contract can be a starting point but should be tested against a ‘risk and reward’ analysis where there is any risk of the resulting revenue not representing the activity of the enterprise during the business cycle.

Moving forward in time we note with interest the repeated use of a ‘risk and reward’ form of analysis in the SEC Staff Accounting Bulletin (2003)<sup>3</sup> in giving opinions on various problems of revenue recognition.

From our reading of various publications on revenue recognition and from observing individual companies we note that in many cases of fraudulent or poor accounting practice the fault has lain more with failures of internal control than with accounting standards themselves. The failures of internal control have allowed inappropriate recording of transactions through shifting the underlying accounting records or transactions (inventory, invoices) from one accounting period to another.

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<sup>3</sup> SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins [Topic 13: Revenue Recognition](#) Revised as of December 2003. M:\research\revenue recognition\sab revenue recognition.mht

Academic researchers have sought to identify the impact of announced earnings restatements. We quote from Palmrose et al. (2004: 87):<sup>4</sup>

‘Overall, our results indicate that characteristics of the restatement, in addition to the fact of the restatement, are critical in determining the market response. This distinction generally has not been made in comments by the SEC or in coverage of restatements by the business press. The severe market reactions commonly remarked upon are due primarily to a subset of restatements that involved fraudulent activity and have large, negative income effects. In particular, one of the issues targeted by the SEC—income-increasing, non-core IPR&D (in-process research and development) restatements—appear to induce little market response. Our results suggest a greater investor concern over restatements that carry negative implications for management integrity than those due to more technical accounting issues.’

A strong theme of our responses to the specific questions is that the focus on a ‘contract’, without also considering the nature of the contract terms, carries the risk of giving legal practice precedence over the economic substance of the transaction or event causing the change in an asset or liability.

We feel that the complexity of the contract-based approach proposed in the discussion paper, and the focus on disaggregating and dissecting contract terms, may not address the deeper problems of a lack of integrity in matters of revenue recognition.

## ***Answers to specific questions***

### ***Chapter 2: A contract-based revenue recognition principle***

***Q1. Do you agree with the boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?***

We agree with the proposal to have a single principle of revenue recognition. We also agree that the principle should have regard to changes in an entity’s assets or liabilities. However the focus on a ‘contract’ carries the risk of giving legal practice precedence over the economic substance of the transaction or event causing the change in an asset or liability. The term ‘revenue’ relates to a flow and in our opinion a single principle of revenue recognition should have regard to the economic nature of that flow. If the terms of a contract reflect that economic nature then the contract will in all likelihood provide a fair indication of the process of revenue generation. If the terms of the contract are artificially created then the revenue recognised will be similarly artificial. We propose that the terms of the contract should be scrutinised having regard to the benefits and risks relating to the context in which the contract is operated, such that entities would be challenged to describe and confirm the economic integrity of the revenue recognised in the period.

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<sup>4</sup> Palmrose, Z-V., Richardson, V.J. and Scholz, S. (2004). Determinants of market reactions to restatement announcements. *Journal of Accounting and Economics* 37, 59–89.

Paragraph 2.37 states that revenue should be recognised on the basis of increases in an entity's net position with a customer. We comment later on aspects of the contract with the customer where the net position is more meaningfully separated into an activity that may be described as 'revenue' and a cost that is incurred in gaining the agreement with the customer to purchase the goods or services.

**Q2. Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?**

Application of the principle would not provide decision-useful information if a contract were contrived to produce a pattern of revenue recognition that did not reflect the transfer of benefit to the customer and the elimination of risk for the seller/provider/supplier. We suggest that a 'risk and reward' test should be applied to a contract to test that the performance criteria set in the contract represent the economic activity of the selling entity.

As an example we recall a typical case discussed in the UK in the 1980s during the development of the exposure drafts leading eventually to the UK standard FRS 5 *Reporting the substance of transactions* (first issued 1994). A building owned by company A was sold to bank X under a legally binding contract of sale and all legal processes related to sale were observed correctly. Separately a rental agreement was created under which company A leased the building from bank X at a variable rental reflecting current interest rates and with put and call options that ensured the building would return to ownership by company A in five years' time, with any risks or benefits of changes in the fair value of the building falling to A. This arrangement created the economic substance of a loan but had the legal form of a sale. Arrangements of this type were common at the time, created by lawyers and greatly frustrating to auditors who, prior to FRS 5, had no basis on which to argue against the client's question: 'Where does it say we can't record this as a sale?'

During the early 1980s in the UK there were organisations advertising services to create off-balance sheet arrangements by suitably worded contracts for sale. We predict such an industry for contract creation would re-emerge and a 'principle' based on contracts would soon grow into a major exemplar of anti-avoidance regulation.

We note that when the UK Accounting Standards Board issued a Discussion Paper in 2001 it used the language of contracts but referred first of all to the transfer of benefit. It also used the language of economic activity in referring to, and defining, a 'business cycle'. In this form of wording the contract constitutes an example of the principle and not the principle itself.

'In the context of a business operating cycle, revenue is the class of gains, before deduction of associated costs, arising as a result of benefit being transferred to a customer in an exchange transaction (ie under a contract). An operating cycle is a sequence of business activities, carried out with a view to profit, which involves the transfer of benefit to customers in exchange for consideration (ie payment).' ASB (2001)<sup>5</sup>

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<sup>5</sup> Accounting Standards Board July 2001 Discussion Paper: Revenue Recognition. UK Accounting Standards Board: London.

**Q3. Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.**

The definition appears precise but does not allow for the possibility of parallel agreements, customs or practices that may nullify all or part of the formal contract.

The definition gives the appearance of comparability but it relies on the concept of 'enforceability' which varies across different regimes and cultures. It would not be possible to retain the US reference to 'enforceable at law' because there are countries where enforceability relies on custom and personal relations. The wording of IAS 32, cited in paragraph 2.12, 'little, if any, discretion to avoid' provides a principle which sets the broad tone of 'enforceable'. We believe that guidance should be retained.

### **Chapter 3: Performance obligations**

**Q4. Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.**

Firstly we are concerned that the discussion document (para 3.2) equates 'performance obligation' with 'to transfer an asset (such as a good or a service)'. This gives a very narrow meaning to 'performance obligation' and creates an element of circularity as subsequent discussion in the paper then equates revenue recognition with performance obligation. In our view there are some performance obligations that extinguish a liability. The discussion paper appears to be aiming to narrow down the ordinary meaning of the phrase. In the process it distorts the ordinary meaning.

Secondly the nature of this question, and much of the tone of the discussion paper, implies that a contract is created independently of the wishes and preferences of the parties involved. In reality a contract is merely a representation of the desires of the parties. Contracts will reflect the business culture of a country or a selection of countries and therefore the appeal to 'consistency' will be more apparent than real. There is, as yet, no international standardisation of contract law.

The question asks for examples. If this discussion paper becomes a standard then the examples will be created. The document places total trust in the terms of a contract. Contracts are written as a 'meeting of minds'. However in some cases one party to the contract may have considerable power over the mind of the other party. We can think in particular of the power of food supermarkets in the UK over relatively small scale suppliers. The revenue recognised by those suppliers, in amount and timing, is strongly dictated by the purchasing preferences of the customer. Enforceability lies with the customer. The supplier accepts the terms or loses the customer. The definition of a contract in the discussion paper does not recognise such unequal bargaining power.

***Q5. Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?***

We already know that revenues have been manipulated by using mechanisms for asset transfer. There are schemes involving warehousing, where the supplier transfers assets to a holding warehouse and the customer takes possession at a later date when payment is made. It would not be difficult to envisage a contract that transferred the asset at the earlier date, allowing revenue to be recognised, with a separate contract for possession at the later date as a security against payment.

We suggest it would be useful for the IASB to demonstrate the robustness of the proposals in the discussion paper by a ‘test to destruction’ against known examples of revenue distortion.

***Q6. Do you think that an entity’s obligation to accept a returned good and refund the customer’s consideration is a performance obligation? Why or why not?***

Yes, it is a performance obligation in the sense that the entity will honour the obligation if the customer makes the request. However it is not a performance that creates revenue and it does not need to be separated out as a revenue-generating activity. In some cases it is a marketing cost that attracts the customer to buy here rather than elsewhere. In other cases it is a form of off-balance sheet finance (e.g. with motor traders). The discussion paper (para 3.35) seeks to argue that offering the right to return is a service to the customer. In some businesses only a proportion of customers will exercise the right. The accounting will record a ‘failed sale’ but the goodwill created may lead to a further sale. We do not accept the ‘consequence’ in paragraph 3.42 that a right of return means that the inventory must continue to be recognised. We think the UK standard FRS 5 takes the right approach when it considers the commercial substance of the right to return, in its section on Consignment Stock [Inventory]. The standard includes indicators of when the inventory is that of the supplying entity and when it is the inventory of the receiving entity. Analysis of that type reflects the commercial (or economic) substance of the transaction rather than relying on contract terms. It was the experience in the 1980s that such ‘right of return’ contracts could be written in one way and applied in another. We would predict that such creative contract writing would re-emerge under the proposals in the discussion paper.

***Q7. Do you think that sales incentives (eg. discounts on future sales, customer loyalty points and ‘free’ goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?***

No, they are a cost of earning revenue. They could be regarded as the price payable to the customer to persuade the customer to accept the contract.

## **Chapter 4: Satisfaction of performance obligations**

**Q8. Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.**

Yes, in most circumstances. However if the asset is transferred into a holding arrangement there may be a gap in time between the supplier providing the goods and the customer taking control of them. A risk/reward test is needed to supplement a control test.

**Q9. The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.**

The answer would depend on the meaning of the word 'satisfied'. Paragraph 4.4 equates satisfaction with transfer of an asset to the customer. Paragraph 4.5 equates transfer of the asset with control. Paragraph 4.8 states that satisfaction is determined by when the customer receives the promised goods and services and not by the activities of the entity in producing those goods and services. Chapter 4 imposes a very specific meaning on 'performance' and it is all related to transfer of assets. This focus on asset transfer leads to recognised difficulties when one asset satisfies more than one aspect of 'performance' in its everyday meaning of 'activity'. The resulting discussion of painting (paras 4.49 to 4.58) is an illustration of the complexities of relying on asset transfer as evidence of satisfaction. We would say very simply: 'If the contract is to paint the wall, we want to see it painted. The performance of this contract rests on completing the application of paint to the walls. We have no thoughts about controlling paint cans.' Paragraph 4.58 suggests there would be some doubt about the performance obligation in this case. If it takes 11 paragraphs to analyse painting a wall, we envisage considerable implementation guidance being needed. A risk/reward analysis arrives at the answer by looking at the totality of the contract, rather than its separate components.

We would also point here to those types of long-term contract where the asset cannot pass into the control of the customer until it has been fully commissioned at the end of the contract period (examples could include a nuclear power station or a warship). Stage payments, or extent of work certified by an expert, would continue to provide a 'fair' means of allocating revenue for purposes of periodic accounting.

## **Chapter 5: Measurement of performance obligations**

**Q10. In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.**

**(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?**

Yes. We agree because it makes sense. Taking the alternative of a current exit price approach brings in a valuation concept that should be debated in principle rather than slipped in through a back door. If the exit price approach became discredited it would jeopardise the good features of this aim for a common principle of revenue recognition.

**(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?**

Yes. There is an expectation on the part of decision makers that they are adequately informed on what risks the entity faces. An onerous increase in a performance obligation, if material, could affect the decisions made by users and they should know about it. Such remeasurement would also be consistent with a general expectation of prudence in financial reporting.

**(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.**

No.

**(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.**

No. The transaction price at inception is understandable and verifiable.

**Q11. The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.**

We agree that the costs of obtaining the contract should be recognised as an expense at the contract inception.

**(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?**

Yes. The costs are incurred to obtain the agreement to the contract. There is no continuing asset. We think also that recognising the costs as an expense makes management accountable for their decisions over which contracts to enter.

**(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.**

We do not have any examples to suggest.

**Q12. Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?**

Yes providing these are market prices and not artificial devices.

**Q13. Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?**

Estimates should only be used if they convey meaningful information. If the exercise of estimation becomes more important than the underlying meaning then it should not happen. Representing the economic or commercial substance of the transaction should be a guiding principle.

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