



AMERICAN ACCOUNTING ASSOCIATION

5717 Bessie Drive • Sarasota, FL 34233-2399 • Phone: (941) 921-7747 • Fax (941) 923-4093
Email: Office@aaahq.org • <http://AAAhq.org>

March 13, 2012

Via Email: www.iasb.org

ED/2011/6 – Revenues from Contracts with Customers

ISBN for complete publication (set of three parts): 978-1-907877-37-7

International Accounting Standards Board
30 Cannon St
London, UK
EC4M 6XH

Response to IASB/FASB ED on Revenues from Contracts with Customers

The American Accounting Association's Financial Accounting Standards Committee (FASC) is pleased to express its comments on the revised exposure draft on Revenues from Contracts with Customers.

Please contact the principal authors, Yuri Biondi (yuri.biondi@free.fr) and Eiko Tsujiyama (tsujiyama@waseda.jp), or the Chairman of the Committee, Yuri Biondi (yuri.biondi@free.fr) for clarifications or discussion.

Sincerely,

Yuri Biondi, PhD, HDR
Chairman, AAA Financial Accounting Standards Committee 2011- 2013

INTRODUCTION

In November 2011, the IASB and FASB jointly issued a call for comment (by 13 March 2012) on a revised exposure draft on revenue recognition. The Financial Accounting Standards Committee (henceforth the Committee) of the American Accounting Association (AAA) is pleased to have an opportunity to express its views on revenue recognition accounting.

This comment was developed by the Financial Accounting Standards Committee (FASC) of the American Accounting Association and does not represent an official position of the American Accounting Association.

The American Accounting Association promotes worldwide excellence in accounting education, research and practice. Founded in 1916 as the American Association of University Instructors in Accounting, its present name was adopted in 1936. The Association is a voluntary organization of persons interested in accounting education and research. Currently the Association has about 6,000 members in the United States and 2,000 international members. The Committee is charged with commenting on regulatory proposals on financial reporting with an aim to provide a research-based perspective on financial reporting. The AAA's membership has a diverse set of views about financial reporting and the Committee does not express views on behalf of all members. The Committee has sought to focus on some key "principles" that can guide standard setting rather than just do a review of research literature. The Committee hopes that this principles-based approach will stimulate discussion among AAA members, regulators, and accounting practitioners regarding important financial reporting regulatory proposals.

This document was prepared by the main authors, having received comments and suggestions from other members of the Committee. We mutually agree to sign a document when we consider it a valuable contribution to the assessment and understanding of the accounting issue (and proposed standard) under consideration.

Acknowledgments: We thank Roshan Ajward for his valuable research assistance. Usual disclaimer applies.

OVERVIEW

The Exposure Draft ED/2011/6 on “Revenues from Contracts with Customers” (henceforth the ED) was jointly issued in November 2011 by the IASB and the FASB (henceforth the Boards). It plans to replace the current accounting standards for revenue recognition, respectively ASC Topic 605 (FASB) and related guidance, IAS 18, *Revenue*, and IAS 11, *Construction Contracts* (IASB). The Boards claim that the ED will improve financial reporting by creating a comprehensive revenue recognition standard that clarifies the principles for recognizing revenue and that can be applied consistently across various transactions, companies, industries and capital markets. If adopted, it is claimed that the standard would improve comparability, simplify the preparation, reduce the need for interpretative guidance on a case-by-case basis, and improve disclosure. The Committee agrees that these goals for the standard are consistent with improved financial reporting of revenue from contracts with customers.

In January 2002, the FASB Board discussed the objective and scope of a potential major project on the recognition of revenues and liabilities in financial statements. That project was planned to result in a new comprehensive accounting standard on revenue recognition, and to amend the related guidance on revenues and liabilities in certain of the FASB Concepts Statements. This project was added to its technical agenda in May 2002.

In October 2004, the Boards added to their agenda a joint project to develop an improved and common conceptual framework that is based on and builds on their existing frameworks. That project addresses certain recognition and measurement issues that were originally included in the scope of the Revenue Recognition project.

Prior to May 2005, the Boards were developing a revenue recognition approach that would measure assets and liabilities at fair value (more precisely, at current exit value). Under that assets and liabilities approach using fair value measures, the Boards tentatively agreed that the fair values of performance obligations should be measured at the legal layoff price, that is, the price that the reporting entity would have to pay an unrelated party to assume legal responsibility for performing all of its remaining obligations. However, some board members had certain practical concerns about reasonably estimating fair values and other Board members had concerns about the pattern of revenue recognition under that approach.

As a result, the Boards agreed to develop another implementation of the asset and liability approach: a customer consideration model (it is also called as performance value model, allocation model). In this model, performance obligations would be measured using an allocation of the customer consideration amount rather than at the fair value of the obligation.

In October 2006, the Boards decided that they should complete the preliminary development of both the fair value and customer consideration models, rather than trying to develop the customer consideration as a 'compromise model' that would command broad support amongst Board members.

Since 2007, the Boards started working on revenue recognition and planned to adopt an assets-liabilities approach based upon fair value model. Practical and theoretical concerns with this measurement model led the Boards to consider the customer consideration model when issuing the joint Discussion Paper in December 2008, as well as the initial Exposure Draft issued in June 2010.

According to the Boards, the revisions to the 2010 Exposure Draft did not necessitate re-exposure for public comments, since the main proposals in the 2011 Exposure Draft would be essentially the same as those in the 2010 Exposure Draft. However, the application guidance and descriptions under each main proposal have been modified significantly to address stakeholder concerns. In particular, the 2011 ED proposes a procedure concerning five steps to achieve revenue recognition: 1. Identify the contract with the customer; 2. Identify the separate performance obligations in the contract; 3. Determine the transaction price; 4. Allocate the transaction price; 5. Recognize revenue when a performance obligation is satisfied. Specifically, significant changes in the 2011 Exposure Draft include: adding criteria to help companies determine when a performance obligation is satisfied over time (**ED paras. 35 and 36**); simplifying the criteria for determining whether a good or service is distinct when identifying separate performance obligations (**ED paras. 26 to 30**); eliminating the proposed requirement to adjust the transaction price for collectability, replacing it with a requirement to present an estimate of uncollectible amounts adjacent to revenue (**ED paras. 68 and 69**); removing the proposed requirement to discount the transaction price when the period between payment and transfer of the promised goods or services will be one year or less (**ED para. 60**); permitting a company to use a most likely amount approach when estimating variable consideration (**ED para. 55**).

In a previous document, our Committee presented an alternative model of revenue recognition (Ohlson and Penman et al. 2011). Later in the letter, we explore some bases for another approach elaborated by the main authors of this letter. The point here is not to advocate a particular model but instead to contrast this approach with the ED, to point out some of the ED's weaknesses. Our approach emphasizes the ongoing performance of business enterprise activity that results in cash and cash equivalents paid by customers and the delivery of products and services performed by the enterprise. This flow of activity is performed over time and throughout multiple contracts with customers.

The present response is meant to raise our concerns with several elements of the ED. The Committee supports the core principle of the **ED (para. 3)** that an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity is entitled and that is likely to be received in

exchange for those goods or services. Nevertheless the Committee has major concerns that the concept of transfer of control and the guidance on the five steps to achieve this core principle are not clear and consistent enough. In particular, we are concerned with the stretched notions of asset, control and transfer, the expected value option allowed to estimate the transaction price, and the identification and satisfaction of performance obligations.

The rest of the letter is organized as follows. The first section presents a constructive critique of the ED. The second section briefly discusses some views from alternative approaches to revenue recognition. The third section provides our summary and conclusion. The appendix provides response to specific questions asked by the ED.

GENERAL COMMENT

Our main concerns are about the accounting model, which includes revenue recognition, revenue measurement, and revenue allocation. The latter element relates to the appropriate timing of revenue and thus income recognition, deserving specific attention (Horton, Macve and Serafeim 2011).

Revenue recognition

The ED introduces the concept of “transfer of control” to identify when the performance obligation is satisfied. The focus on transfer of control is appropriate and consistent when the latter occurs at a single point in time; it is then defined by the ED as the satisfaction of a performance obligation. However, it is not appropriate when that transfer is supposed to occur over time and the product and service is not delivered in the same period as the production activity occurs (**ED paras. 35-36**); it is then defined as the creation of an asset that is meant to satisfy a performance obligation. The ED mixes two different models of recognition. In particular, the ED mixes the critical event approach and the continuous approach, according to the definition of accounting models of revenue recognition provided by EFRAG (2007).¹ Instead of clearly defining and distinguishing the models (as is the case for other standards, such as IAS 38), the two approaches are mixed in a way that stretches the key notions of asset, control, and transfer (**ED paras. 26, 32, 35**) and leads to convolution, confusion, and inconsistency.

Once the Boards moved to the customer consideration model while allowing the percentage-of-completion basis (in substance), the concept of control loses its original function as a clear and consistent guideline. This concept of control may not be appropriate on a conceptual or practical basis in all circumstances. In our opinion, while the concept of control is appropriate in ordinary sales revenue (IAS 18), it is not appropriate in construction

¹ EFRAG (2007) suggested an assets and liabilities approach, but only for revenue allocation. Accordingly, the measured amount only depends on the gross inflow from the customer. On this basis, EFRAG examined three kinds of critical event approaches (denoted as: Approach A, B and C) and a kind of continuous approach (denoted as: Approach D).

and continuous service contracts (IAS 11). This concept is inconsistent with the percentage of completion basis. In case of construction and continuous service contracts, the focus should be on the business enterprise's continuous activity over time.

Having separate standards for distinctive industries (or sectors) has the advantage of clearly defining the model that is to be applied by those industries and only by them. Preparers and users, including investors and financial analysts, may then better understand the applied model and assess its impact. The ED implicitly introduces several models that are not clearly identified as alternatives, but apply by exception and to all industries and contracts. This may lead to modifications not only in construction and continuous service businesses, which were the problematic industries under the control model, but also lead to changes in other businesses. Accounting modeling by exception fails to provide a comprehensive and consistent framework for revenue recognition. The previous articulation between IAS11 and IAS18 did not provide as much discretion to preparers in making the distinction between "over time" and "at a point in time".

Revenue measurement

The Committee is concerned with the measurement option at expected value (**ED para. 55**) that is allowed in a large number of circumstances (**ED paras. 53 and 88**). Preparers may then choose between the expected value (a mark-to-model measurement which is consistent with fair value model) and the most likely amount (a reference to future cash payments by customers which is consistent with customer consideration model). The latter method is expected to keep the recognized revenue substantially in line with the future receipts of cash. This alignment is generally accepted by jurisdictions and practices worldwide. This focus on cash flows is also in line with the needs of investors and users as expressed by the conceptual framework.

The debate about adoption of fair value has not reached a consensus. The Committee does not address that debate in this comment letter. We do not wish to present our comments as a critique of the fair value model but rather to concentrate primarily on issues that apply, regardless of the measurement model.

The second objective the ED gives is to "[p]rovide a more robust framework for addressing revenue issues." Robustness is a well-established concept in statistics. Expected values can be extremely sensitive to outliers-- expected values lack *robustness* from a statistical viewpoint (Huber 1981). In statistics, the median is a robust measure of central tendency, but the mean is not. The mode (that is the most probable amount) is also robust, except in extremely small samples. In economics, robustness (defined in a variety of ways) is increasingly considered an important element in institutional design (Bergemann and Morris 2005; Arya et al. 2009). In the context of revenue recognition, one approach to robustness has a variation of the "earned criteria" and "probable events" playing a greater role than in received (non-robust) economic models (Glover 2004, which builds on Antle and Demski

1989). Although various definitions of robustness have been employed in different papers, they typically require the mechanism to work for a variety of environments rather than allowing the mechanism to be fine-tuned to the particular environment (which is the usual, non-robust approach). This seems the spirit in which the Boards are also using the term. Robustness is an increasing focus of policy research and actual policy making outside of accounting. For example, the topic of the November 2011 Carnegie-Rochester Conference on Public Policy was “Robust Macroeconomic Policy.” Perhaps, robustness deserves a greater place in accounting standard-setting debates (Devine 1963; Barlev 1995). Arguably, robustness is already an important implicit consideration in other accounting standards and in accounting practice in general. Robustness, faithful representation, and reliability are related. A lack of robustness may create room for unintentional errors and/or intentional misstatements through potential manipulation via the probability of outliers and structuring opportunities in conjunction with revenue allocation, especially in cases of long-term contracts and sophisticated arrangements (Larson and Brown 2004).

Revenue allocation

In our opinion, the ED allows several models, including the implicit option to recognize revenue over time. Long-term contracts, as well as construction and continuous service contracts, are likely to be included in this option.

As mentioned above, the key guideline of “transfer of control” does not properly apply to revenue recognition over time. In particular, in case of no “creation of asset with an alternative use” (**ED IN24 (b) (iii)**), the entity does not create an asset, but it can still recognize a revenue when (or as) “has the right to payment for performance completed to date and it expects to fulfill the contract as promised”. Mr. Linsmeier dissented from this exception that can introduce revenue recognition even absent goods and services delivery (**Basis for Conclusions, AV6**). The dissent agrees that this exception factually creates a relevant option on a critical matter (*ibidem*, **AV7**).

One can argue that allowing the expected value measurement option in conjunction with revenue recognition over time creates room for transactions designed to anticipate profits (and delay losses). Ijiri (2005) stressed this problem raised by the development of the FASB accounting model over the decades. This problem is also exemplified by the Enron case where distant future profits were recognized early on the basis of their discounted expected present values (Healy and Palepu 2003; Baker and Hayes 2004; Benston 2006).

We next discuss some ideas and suggestions that may cope with these concerns raised by the ED. The following section is the work of the principal authors, having received comments and suggestions from other members of the Committee.

SOME IDEAS FROM ALTERNATIVE APPROACHES TO REVENUE RECOGNITION

The ED introduces significant judgments on the timing of satisfaction of performance obligations, as well as the estimation of transaction price and its allocation to those performances (**ED para. 124**). It implicitly introduces several models of recognition that are not clearly stated and distinguished.

Organizational and institutional economics connects accounting to the theory of the firm (ICAEW 2010; Coase 1990; Biondi et al. 2007). Accounting systems are then understood as an integral part of the institutional structure of production. These systems contribute to the definition and representation of the performance produced and delivered by those performing entities over time, under conditions of asymmetry and uncertainty that prevent the external markets from being useful for, and robust to, these representations. This perspective of accounting renews and expands upon classic accounting and business economic studies that developed prudent static approaches and dynamic approaches to revenue and income determination in USA, Germany, Italy, and Japan (Biondi and Zambon 2012 eds.). From this perspective, the role for prudence is important because of unresolved uncertainty and asymmetry of information and control, which makes it suitable to treat profits and losses asymmetrically. Accordingly, potential strategic behavior by preparers and limited information and/or rationality by users and preparers are features of the economic environment of the business entity. As long as revenue and income remain uncertain, they should not be recognized by the accounting system that determines their representation and eventual distribution to stakeholders, including shareholders.

Information economics has also studied conditions of asymmetric and incomplete information in a variety of contexts, helping us to gain a more precise understanding of the circumstances in which, for example, treating ambiguous news as bad news is optimal (e.g., Kwon et al. 2001) or subjecting good news to additional scrutiny is optimal (e.g., Christensen and Demski 2003).

These academic perspectives stress that the ongoing business enterprise activity is subject to uncertainty. The ED requires waiting for “resolved uncertainty” only as an exception, when license-based business models are concerned (**ED para. 85**). As confirmed by **IE n. 18**, a payment that is fully contingent on future performance may be recognized as revenue of the current period.

A prudent approach is in line with recent accounting perspectives developed by Wuestemann and Kierzek (2005), Watts (2003), Benston et al. (2003), Ijiri (2005), Basu (2002), and others. Our alternative approach suggests focusing on the ongoing enterprise activity to determine when a good or service is being transferred to the customer, or by convention on a period-by-period basis. In order to deal with cases when the revenue process occurs over time and products and services are not delivered in the same period as the production activity occurs, one solution consists in looking for approaches that combines the balance sheet and income statement in a meaningful way. Despite the emphasis on the

asset-liability approach, the 2011 ED approach is mixed and includes elements of a revenue-expense approach (Marton and Wagenhofer 2010, p. 4, regarding the 2010 ED).

From this perspective, the Committee has already elaborated an alternative approach based upon conservatism, historical cost and flow accounting (Ohlson and Penman et al. 2011).

Furthermore, Biondi (2011) suggested recognition and measurement through the balance sheet, capitalizing the most likely amount of revenue to be received, matched by a deferred income reserve. A similar approach is taken when applying the installment or cost recovery approach to profit recognition. This undiscounted capitalization is subject to the existence of an enforceable contract and probable future cash receipts. This capitalization is expected to be aligned with, and transformed into, receivables and cash over time, as long as the uncertainty about the actual payments is resolved (Ijiri 2005). This capitalization does not depend on complex and subjective measurements of performance obligations, but on the transformation of future cash inflows (that are most likely to occur) into actual claims and eventually cash. The income statement serves then to allocate revenue throughout the contract duration to accounting periods. The capitalized revenue is not allocated to revenue and income unless (until) the productive cycle is accomplished. The latter cycle is identified through the actual delivery of products and services to customers (and the transformation of accrued revenues in cash or receivables), or by convention on a period-by-period basis. This line of reasoning was developed by Schmalenbach (1926) and Walb (1926), while software firms such as Computer Associates (CA) tried to put similar models in practice in the 2000s to respond to concerns with revenue allocation over time raised by their continuous service business models. Instead of introducing complex and discretionary criteria, which make revenue accounting arbitrary and subject to manipulation, this approach introduces simpler and clearer allocation criteria that are understandable and help users assess the managerial discretion in accounting for revenue and income in the case of continuous business models.

In conclusion, these alternative approaches focus on the ongoing enterprise entity activity to determine when a good or service is being transferred to the customer, or by convention on a period-by-period basis. This aspect is clearer under the model already applied in IAS 11. Well-targeted guidance may fix the issues related to specific business models characterized by not only construction contracts, but also sophisticated long-term agreements and continuous service provision.

SUMMARY AND CONCLUSION

The Committee is concerned with a number of options and exceptions introduced by the 2011 ED. These options and exceptions allow alternative accounting models. Their retention on a contract-by-contract basis may create confusion for both preparers and users of financial reporting. It may leave room for intentional misstatements and structuring opportunities to anticipate profits and delay losses.

As a result, the Committee believes that the initial purpose of this project (i.e., creating a comprehensive revenue recognition model that clarifies the principles for recognizing revenue and that can be applied consistently across various transactions, companies, industries, and capital markets) is not achieved and convolution and inconsistency have been introduced.

One of the reasons for preparing this standard was to establish one comprehensive standard for revenue recognition, instead of separate standards concerned with distinctive industries or sectors. However, distinct standards help preparers and users clearly understand and interpret the respective models that are applied, while the ED does not. Methods and problems that are specific to some sectors may then spread to others, involving hazardous changes in accounting practices.

Our Committee has already criticized the revenue recognition project, while arguing for an alternative approach that stresses the need for prudence in revenue and income recognition (Ohlson, Penman et al. 2011). The alternative suggested above focuses on the ongoing flow of enterprise activity to determine when a good or service is being transferred to the customer, or by convention on a period-by-period basis. This aspect is clearer under the model already applied in IAS 11. Well-targeted guidance may fix the issues related to specific business models not only for construction contracts, but also sophisticated long-term agreements and continuous service provision.

The ED involves a number of major and critical options that are included as exceptions and entirely left to preparers' discretion on a contract-by-contract basis. This accounting modeling by exception factually leads to a plurality of accounting methods and approaches that are neither clearly defined for preparers nor clearly presented to users. These options include:

- Contracts which last less than one year or more than one year;
- Variable customer consideration estimated at its expected value or its most likely payment;
- Revenue allocation (step4) and recognition (step5) based on transfer of (control over) an asset that occurs "over time" or "at one point in time";
- Updating and unwinding of time value of money.

The ED does not introduce a single model of revenue recognition. It fails to design an understandable and feasible approach to revenue and income recognition. It even fails in providing clearly defined alternative options.

The ED may then result in confusion and generate an increased variety of under-identified practices. At the same time, it introduces high complexity for and a burden of high costs on preparers.

The Committee recommends the Boards should apply the control model to ordinary sales but not to long-term contracts (construction contracts, continuous service contracts).

If the Boards aim to allow several accounting models, the Committee recommends these models be distinguished under clearly defined alternatives that are to be consistently applied to large categories of contracts with customers, not idiosyncratically, on a contract-by-contract basis. These categories should be presented and disclosed separately in financial statements in a meaningful way.

In conclusion, the ED, in its current form, would not represent an effective improvement over existing IAS 11 and IAS 18 which did not raise major difficulties and shortcomings in the large majority of cases. Instead of issuing a new standard, well-targeted guidance may fix the issues related to business models characterized by sophisticated long-term agreements and continuous service provision.

REFERENCES

- Antle, R., and J. S. Demski. 1989. Revenue recognition. *Contemporary Accounting Research* 5 (2): 423-451.
- Arya, A., J. S. Demski, J. C. Glover, and P. Liang. 2009. Quasi-robust multi-agent contracts. *Management Science* 55 (5): 752-762.
- Baker, C. R., and R. Hayes. 2004. Reflecting form over substance: The case of Enron Corp. *Critical Perspectives on Accounting* 15 (6-7): 767-785.
- Barlev, B. 1995. Determining the stage at which it is appropriate to recognize profit under long-term contracts. *Journal of Business Finance and Accounting* 22 (5): 713-731.
- Basu, S. 1997. The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting and Economics* 24 (1): 3-37.
- Benston, G. J. 2006. Fair-value accounting: A cautionary tale from Enron. *Journal of Accounting and Public Policy* 25 (4): 465-484.
- Benston, G. J., M. Bromwich, R. E. Litan, and A. Wagenhofer. 2003. *Following the Money: The Enron Failure and the State of Corporate Disclosure*. Washington D.C.: AEI-Brookings Joint Centre for Regulatory Studies.
- Bergemann, D., and S. Morris. 2005. Robust mechanism design. *Econometrica* 73 (6): 1771-1813.
- Biondi, Y. 2011. The Pure Logic of Accounting. *Accounting, Economics and Law: A Convivium* 1 (1), n. 7.
- Biondi, Y., and S. Zambon. 2012. *Accounting and Business Economics: Insights from National Traditions*. New York and London: Routledge.
- , R. J. Bloomfield, J. C. Glover, K. Jamal, J. A. Ohlson, S. H. Penman, E. Tsujiyama, and T. J. Wilks. 2011. A perspective on the joint IASB/FASB exposure draft on accounting for leases. *Accounting Horizons* 25 (4): 861-871.
- , Y., A. Canziani, and T. Kirat. 2007. *The Firm as an Entity: Implications for Economics, Accounting, and Law*. New York and London: Routledge.
- Coase, R. H. 1990. Accounting and the theory of the firm. In *The Firm as an Entity: Implications for Economics, Accounting, and Law*, edited by Y. Biondi, A. Canziani, and T. Kirat. New York and London: Routledge.
- Devine, C. T. 1963. The rule of conservatism reexamined. *Journal of Accounting Research* 1 (2): 127-138.
- European Financial Reporting Advisory Group (EFRAG). 2007. *Revenue Recognition – A European Contribution*. Discussion Paper. PAAinE, DRSC, EFRAG and CNC.

- Glover, J. C. 2004. A discussion of 'A model of auditing under bright-line accounting standards'. *Journal of Accounting, Auditing and Finance* 19 (4): 561-564.
- Healy, P. M., and K. G. Palepu. 2003. The fall of Enron. *Journal of Economic Perspectives* 17 (2): 3-26.
- Horton, J., R. Macve, and G. Serafeim. 2011. 'Deprival value' vs. 'fair value' measurement for contract liabilities: How to resolve the 'revenue recognition' conundrum?. *Accounting and Business Research* 41 (5): 491-514.
- Huber, P. J. 1981. *Robust Statistics*. New York: John Wiley and Sons.
- Institute of Chartered Accountants in England and Wales (ICAEW). 2010. *Business Models in Accounting: The Theory of the Firm and Financial Reporting*. London: ICAEW Financial Reporting Faculty.
- Ijiri, Y. 2005. U.S. accounting standards and their environment: A dualistic study of their 75-years of transition. *Journal of Accounting and Public Policy* 24 (4): 255-279.
- Ijiri, Y. and R.K. Jaedicke. 1966. Reliability and Objectivity of Accounting Measurements. *The Accounting Review* 41 (3): 474-483.
- Kwon, Y. K, D. P. Newman, and Y. S. Suh. 2001. The demand for accounting conservatism for management control. In *Accounting Theory: An Information Content Perspective*, edited by J. A. Christensen, and J. S. Demski. New York, NY: McGraw-Hill.
- Larson, R. K., and K. L. Brown. 2004. Where are we with long-term contract accounting?. *Accounting Horizons* 18 (3): 207-219.
- Marton, J., and A. Wagenhofer. 2010. Comment on the IASB discussion paper 'preliminary views on revenue recognition in contracts with customers'. *Accounting in Europe* 7 (1): 3-13.
- Ohlson, J. A., S. H. Penman, Y. Biondi, R. J. Bloomfield, J. C. Glover, K. Jamal, and E. Tsujiyama. 2011. Accounting for revenues: A framework for standard setting. *Accounting Horizons* 25 (3): 577-592.
- , S. H. Penman, R. J. Bloomfield, T. E. Christensen, R. H. Colson, K. Jamal, S. Moehrle, G. Previts, T. Stober, S. Sunder, and R. L. Watts. (2010). A framework for financial reporting standards: Issues and a suggested model. *Accounting Horizons* 24 (3): 471-485.
- Paton, W.A. 1922. *Accounting Theory, with Special Reference to the Corporate Enterprise*. USA: The Ronald Press Company.
- Schmalenbach, E. 1926. *Dynamische Bilanz*. Köln et Opladen: Westdeutscher Verlag. English Translation: *Dynamic Accounting*. 1980. USA: Arno U. Press.
- Tsujiyama, E. 2009. Revenue recognition based on net position: A critical study. *Accounting* 61 (9): 6-15. (English translation available at SSRN: <http://ssrn.com/abstract=1856978>)
- Walb, E. 1926. *Die Erfolgsrechnung privater und öffentlicher Betriebe*. Berlin-Wien: Industrieverlag Spaeth & Linde.
- Watts, R. L. 2003. Conservatism in accounting part I: Explanations and implications. *Accounting Horizons* 17 (3): 207-221.
- . 2003. Conservatism in accounting part II: Evidence and research opportunities. *Accounting Horizons* 17 (4): 287-301.
- Wüstemann, J., and S. Kierzek. 2005. Revenue recognition under IFRS revisited: Conceptual models, current proposals and practical consequences. *Accounting in Europe* 2(1): 69-116.

APPENDIX: RESPONSES TO QUESTIONS

The answers to the following questions have been prepared only by the principal authors (Yuri Biondi and Eiko Tsujiyama).

Question 1: Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

We disagree with the focus on the transfer of control over an asset to represent and recognize revenue to an entity. Since the transfer of control occurs naturally at a point of time and is inconsistent with revenue allocation over time, trying to allocate performance obligations according to the transfer of control for goods and services transferred over time is unduly complex and subjective.

Our alternative approach suggests focusing on the flow of enterprise activity to determine when a good or service is being transferred to the customer, or by convention on a period-by-period basis. This aspect is clearer under the model already applied in IAS 11. Well-targeted guidance may fix the issues related to specific business models characterized by not only construction contracts, but also sophisticated long-term agreements and continuous service provision.

The focus on the transfer of control of an asset makes it difficult to distinguish between revenue from customers and a transaction with related entities which share resources or provide financing (**ED para. 9 (e) and para. 10**). No revenue arises from a transaction with related entities. From this perspective, **ED (para. 11)** is particularly problematic, since it allows contracts to be interpreted as containing revenue, even though they are not sale contracts with customers. Guidance provided by **B38-B48** is merely concerned with straightforward cases of repurchase agreements and does not address these distinctions (and related scope exceptions) comprehensively and consistently. In addition, the focus on the transfer of control makes it difficult to distinguish between revenue recognition and leases (**ED, Basis for Conclusions, AV8 (b)**).

Moreover, this focus is inconsistent with business models which perform under construction and service contracts. These business models are not based upon the transfer of control of assets. The requested identification of performance obligations through “distinct goods and services” (**ED IN19 and para. 23 ff.**) may then result in an arbitrary picture of their performance.

Further concerns are:

- The ED retains a contract-by-contract basis of application that may undermine the analysis and interpretation of information by users. The latter would be unable to identify, and assess the impact of, all the accounting choices made for each contract and the change of these choices over time. This is especially critical when critical options and alternative methods are implicitly allowed but not distinguished and distinguishable by users.
- The ED asks preparers to account for time value of money independently from customer credit risk, even in the case of payments made in advance (**ED IE8 and example 9**). In the latter case, the ED would add hypothetical interest revenue that has been not and will be not paid by customers. In case of payment in arrears, the time value of money should be deducted from the gross revenue: The total between the net revenue and that financing component should remain the most likely amount (in a customer consideration model). However, the ED requires computing and presenting apart from revenue, as an “interest income” (**ED paras. 58-62**). This point has been already criticized by some respondents (**Basis for conclusions, BC149**), but the Boards decided not to amend the ED (**ED BC150**).
- The inclusion of time value of money raises practical and representational problems with the choice of the discount rate, its change over time, as well as the unwinding of the discount (**BC151-BC156**). This inclusion makes the measurement subjective, unreliable, unstable and subject to manipulation (Biondi et al. 2011). In particular: it undermines comparability between companies, since the same contract will be valued differently; it will lead to a situation in which riskier entities will report a lower customer consideration for the same contract because they will discount at a higher rate; it involves double-counting since expected payments are already estimated at their most probable values. In addition, the use of one discount rate chosen once for all at initial recognition undermines comparability over time between different transactions and entities, and make accounting amounts sensitive to the change of interest rates of reference; alternatively, allowing discount rate updates over time introduces all the problems related to unwinding of discounting, including structuring opportunities and manipulation. Therefore, recognition of undiscounted amounts appears to be preferable to avoid these problematic consequences.
- A number of expenditures that cannot be capitalized in other circumstances may be capitalized under this standard as an exception, if adopted. Further categories of assets would be then created in the context of a standard that is not devoted to this creation. However, this capitalization of costs should be addressed in a specific standard.

We acknowledge that revenue recognition can be improved to address the continued relationship with customers, which is involved in some business models (software industries, public private partnerships, and so forth).

Concerning these cases, one alternative is to adopt an accounting approach that combines balance sheet and income statement perspectives in a meaningful way. The recognition and measurement in the balance sheet should respect prudence. The allocation of revenue to periods of reference should be done in accordance with the actual delivery of products and services to customers over time. Alternatively, especially if this delivery cannot be identified clearly, this allocation may follow a simple and clear conventional periodic basis, as it is the case for depreciation patterns.

Question 2: Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

We agree with the need to estimate the most likely amount that will be eventually paid by the customer. However, the application of IFRS9 devoted to financial instruments (**ED para. 69**) introduces undue complexity and difficulty in this estimation. The latter may follow simple methods based on entity's experience and other conditions to be disclosed.

Question 3: Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

We are concerned with undue subjectivity and discretion that is left to preparers in revenue (and income) recognition. The latter should be kept in line with cash and cash-equivalent basis of measurement. The present version of the ED does not stress this link in a consistent and comprehensive way.

For the reasons expressed above, we agree with the need to estimate the most likely amount that will be eventually paid by the customers. However, for these same reasons, the measurement option at expected value (**ED para. 55**) that is allowed in a large number of circumstances (**ED para. 53 and para. 82**) raises concerns about subjectivity, unreliability,

non-robustness, manipulation and structuring opportunities. This option might function in the fair value model, but it is inconsistent with the customer consideration model. The expected value option is especially problematic in conjunction with recognition of revenue and income over time. This combination does not respond to the concerns raised by the design of transactions to anticipate profits (and delay losses) stressed by Ijiri (2005) regarding the development of the FASB accounting model over the last decades. This problem was exemplified by the Enron case where long-distant future profits were recognized on the basis of their discounted present values (Healy and Palepu 2003; Baker and Hayes 2004; Benston 2006). The ED method does not avoid the risk recognizing discounted or undiscounted values of future revenues as profits allocated to the current period and passed through the income statement. Clever managers could structure non-cancellable long-term contracts to front-load revenue recognition, and further argue for inputs-based allocation and negligible uncertainty (based on similar contracts and past experience) in order to front-load the profit recognition. Let us take the example of a build-operate-and-transfer agreement for the delivery of energy through an electric power plant. The contract lasts for several years and assets (goods and services) are transferred both over the contract (produced energy) and at the end of the contract (the plant itself). According to the ED, the entity would be allowed to identify the contract with the customer (which receives the energy and the plant) at inception as a variable-consideration contract. The entity may then assess the contract at the expected value of the customer consideration, and, through an input-based method of allocation, recognize most part of the revenue at the start-up of the plant (when most expenditures are already disbursed). This would front-load income that should be instead recognized according to the progressive delivery of products and services (that is, the flow of produced and delivered energy over time).

Question 4: For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognize a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

Generally speaking, we disagree with excessive disaggregation of contracts (or contract components) and with the contract-by-contract basis. This is especially problematic with the recognition of an expense related to a computed negative amount called “onerous performance obligation” (**ED para. 86**). When the overall contract is profitable, this does not represent (yet) an actual loss to be expensed. However, the ED does not offer any possibility to consider wholes of contracts (or contract components) as basis of accounting, instead of single contracts (or contract components).

Income and revenue recognition should instead be based upon the flow of the whole enterprise activity over time.

Question 5: The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports.² The disclosures that would be required (if material) are:

- The disaggregation of revenue (paragraphs 114 and 115)
- A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- An analysis of the entity's remaining performance obligations (paragraphs 119–121)
- Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)
- A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfill a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

We would rather the Boards follow simpler and clearer accounting models for revenue recognition, which do not require such complex and subjective disclosures. We are unsure the benefits from disclosure are large enough to overcome the costs and hazards of preparing and auditing them (**Basis for Conclusions, AV1-AV4**).

Question 6: For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

As mentioned in the main text of this comment letter, the control model makes sense for the ordinary sales, but should not be expanded to all cases and circumstances (sales of property, plant and equipment: construction contracts; public-private partnerships; etc.). Such extensions raise conceptual and practical problems and may cause unexpected consequences due to the introduction of recognition and measurement that may be subjective, unreliable, unstable, and subject to manipulation.

² In the IASB exposure draft, see paragraph D19 in Appendix D.

Comment by Richard Macve

I support the Committee's conclusion that: "the ED, in its current form, would not represent an effective improvement over existing IAS 11 and IAS 18 which did not raise major difficulties and shortcomings in the large majority of cases. Instead of issuing a new standard, well-targeted guidance may fix the issues related to business models characterized by sophisticated long-term agreements and continuous service provision."

Given the conceptual twists and turns that the comment letter documents as having been taken during the life of this project it is important that alternative conceptual perspectives are offered, as the Committee does in this comment letter. However, I consider that the exclusion from this project (and correspondingly from this comment letter) of insurance—which features contracts ranging from the very short-term (e.g. trip insurance) to the very long-term (e.g. life insurance) and raises the same issues of principle—undermines the Boards' objective of providing a comprehensive basis for recognition of revenue across industries. The two projects should be considered and re-exposed together.

This comment letter advances an argument for a revenue recognition basis that is consistent with this Committee's previous comments that it refers to. However I believe that equal consideration should be given by the Boards to alternative conceptual approaches that may enable reconciliation between the 'asset/liability' approach and the 'matching costs and revenues' approach and may also be extended to contracts such as insurance contracts. Initial exploration of this can be found in Horton *et al.* (2011), as cited in this comment letter.

American Accounting Association
Financial Accounting Standards Committee 2011 – 2012

Yuri Biondi (principal author and chairman), Centre National de la Recherche Scientifique
(Cnrs)

Jonathan Glover, Carnegie Mellon University

Nicole Thorne Jenkins, Vanderbilt University

Bjorn Jorgensen, University of Colorado at Boulder

John Lacey, California State University – Long Beach

Richard Macve, London School of Economics

Eiko Tsujiyama (principal author), Waseda University