



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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Your ref:

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Dear Paul

REVENUE RECOGNITION – A EUROPEAN CONTRIBUTION

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Revenue Recognition – A European Contribution*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW Representation

ICAEW REP 16/08

REVENUE RECOGNITION – A EUROPEAN CONTRIBUTION

Memorandum of comment submitted in February 2008 by The Institute of Chartered Accountants in England and Wales in response to Discussion Paper 3 '*Revenue Recognition - A European Contribution*', published on behalf of Pro-active Accounting Activities in Europe ('PAAinE'), in July 2007

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('the Institute') welcomes the opportunity to comment on Discussion Paper 3 *Revenue Recognition - A European Contribution*, published on behalf of Pro-active Accounting Activities in Europe ('PAAinE') by the European Financial Reporting Advisory Group ('EFRAG') and the Deutsches Rechnungslegungs Standards Committee ('DRSC'), in July 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures that these skills are constantly developed, recognised and valued.

MAJOR ISSUES

Support for the Initiative

4. We commend the authors of this Paper for a timely and cogent analysis of the issues surrounding revenue recognition. We fully expect it to inform the debate in Europe and EFRAG's subsequent response to the FASB/IASB Joint Project on Revenue Recognition (the 'Joint Project').
5. We agree with the judgement of the authors of the Paper in limiting its scope at this stage. The Paper has rightly limited itself to recognition issues. Many difficulties arise in relation to gross vs. net and other presentation issues, measurement and other complex issues that are strictly outside of the recognition debate. We believe that it would have been premature to consider, for example, measurement issues before there is a broad consensus on recognition.

Basis of our response

6. The Financial Reporting Committee of the Institute has considered the views of the working party established to review the Paper, reflected in this submission. However, in view of the early stage of the international debate, the Institute has not subjected the proposals in the Paper to the full process of consultation and public discussion with ICAEW members and other interested parties. We thus reserve the right to modify our tentative views regarding some of the issues raised in the Paper when responding to the detailed proposals expected from the IASB in 2008/2009, which will be subject to that full due process.

General comments on revenue recognition

7. The Paper asserts that revenue is a very important number for users. However, this is not always true - as, for example, in the case of financial institutions which are therefore taken to be outside the scope of the Paper. It might have been more rigorous to consider who looks at revenue - 'the top-line of the income statement' - and what use they make of it, before attempting to establish principles of recognition.
8. We agree with the Paper that revenue recognition based on an asset/liability approach is not necessarily tied to enforceable contract rights. However, assets and liabilities arise as rights under contracts, so performance under the contract must be the key principle underlying the recognition of revenue.
9. As discussed in more detail below in our answers to specific questions, the case for seeing revenue as the change in a contract asset or liability resulting from the supplier carrying out its performance obligations under the contract is perhaps the strongest articulated in the Paper; revenue on this basis would be recognised as contract activity progresses. However, at this stage in the international debate we have yet to reach definitive conclusions on the various alternatives and do not consider that the Paper provides a basis for reaching such conclusions.
10. Judgements about contractual performance are best made by an informed application of principles rather than by applying detailed rules. It is therefore important in setting accounting standards for revenue recognition that the principles are clearly expressed and capable of application to a very broad range of circumstances. While examples may be useful in illustrating the application of principles in specific circumstances, extensive ancillary guidance and examples are inappropriate. At a later stage it will be very important to rigorously test the application of any proposed principles in relation to a variety of business sectors and different types and size of reporting entity.

SPECIFIC QUESTIONS

Q1 It is stated in the discussion paper (paragraphs 1.4 - 1.10 and Appendix II) that there are weaknesses in the IASB's existing revenue recognition standards, IAS 11 and IAS 18. In particular, the standards do not address certain types of transaction (for example they say little about multiple-element arrangements), they are based on different principles (which leads to inconsistencies and uncertainties and makes it difficult to know how to use the standards to fill the gaps) and there are internal inconsistencies within IAS 18. The paper goes on to say that these gaps, inconsistencies and uncertainties are causing real practical problems. Do you think these comments about the existing standards are fair? (If you do not, could you please explain which comments you think are not fair and why.) Do you have any additional concerns about existing standards? (If you do, please could you explain them.)

11. We agree that there are weaknesses in IAS 11 and IAS 18 that can cause problems in practice. However, in our view, problems arise not because the two standards are based on fundamentally different principles, but because the underlying principles are not clearly stated or explained. The overall problem is exacerbated by the fact that revenue recognition is not dealt with

in a single standard but in two, and the requirements of the two standards are not properly reconciled.

12. In fact, the two standards are not inconsistent. IAS 11 is compatible with the services model set out in IAS 18. However, IAS 18 is not clear enough that the two standards are compatible in this regard and that the treatment of goods in IAS 18 is not relevant to IAS 11. The alleged inconsistency relates solely to the explanations given in IAS 18 for the treatment of goods and services under that standard, which we examine below.
13. Under paragraph 4 of IAS 18, recognition of revenue for the supply of goods requires the transfer of significant risks and rewards and of effective control. These criteria generally result in the recognition of revenue for the sale of goods occurring at a single point in time. We agree that this treatment is appropriate for goods, because, for a supply of goods, contractual performance typically occurs at a single point in time. The theoretical and practical problems of applying IAS 18 therefore arise principally from determining where to draw the boundaries between what is a good and what is a service. We see this as a key weakness in IAS 18, that it does not adequately deal with the problems of determining the boundaries between goods and services, which we believe is the real issue.
14. In our view, to achieve a principled approach to revenue recognition, and therefore a consistent approach to goods and services, it is necessary to start with the services approach as the default, and then show how it applies to the supply of goods.

Q2 Paragraph 1.20 states that the objective of the paper is to develop a framework within which to address revenue recognition issues in a consistent way. Paragraph 1.26 explains further that the ultimate objective of the revenue recognition debate should be to develop a set of principles that can be applied to all kinds of industries and business. In other words, rather than have different, competing principles like we do now, we would have a single principle or a single set of principles that apply generally and can be used to address any future gaps in standards.

(a) Do you believe this is an appropriate and realistic objective? (If you do not, please could you explain your reasoning and what you believe is an appropriate and realistic objective.)

(b) Although the objective is to develop principles that can be applied to all kinds of industries and businesses, the paper does not explore sector-specific issues in any detail; the analysis and discussion is generic and not based on any particular sector. (For example, the paper's only reference to financial institutions is to note, in paragraph 1.26, that banks and insurers do not present a revenue number and to observe that it is outside the scope of the paper to consider whether such entities should present a revenue number and what such a number should represent were it to be provided.) Do you believe this approach is appropriate? If you do not, please could you explain which sector-specific issues the paper should explore and why you think that would improve the quality of the analysis.

15. We agree that it is appropriate and realistic to seek to develop a framework within which to address revenue recognition issues in a consistent way and that the approach should be generic and not based on any particular sector.

Q3 Chapter 2 of the paper discusses what revenue is. It does so by examining what the Framework says about revenue (paragraphs 2.5 - 2.13) and what other attributes revenue should have (paragraphs 2.14 - 2.33). It concludes that:

- (a) Revenue is a particular type of increase in assets or decrease in liabilities.**
- (b) Revenue is a gross notion. In other words, if an entity sells an item for €10, making a profit of €2, it will be the €10 rather than the €2 that will be recognised as revenue.**
- (c) Revenue does not necessarily arise only from enforceable rights and obligations.**
- (d) Revenue is some sort of measure of activity undertaken pursuant to a contract with a customer. Therefore, without a contract there can be no revenue. Furthermore, revenue will not arise simply from entering into the contract, because at that point there will have been no activity undertaken by the supplier pursuant to the contract.**
- (e) Revenue does not necessarily involve an exchange.**
- (f) Revenue is something that arises in the course of ordinary activities.**
- (g) On the basis of the conclusions summarised above, a working definition of revenue is that revenue is the gross inflow of economic benefits that arises as an entity carries out activities pursuant to a contract with a customer.**

Do you agree with these conclusions? (If you do not, please could you state which conclusion you do not agree with and explain your reasoning.) Do you believe that revenue has some additional attributes that should have been referred to? (If you do, please could you describe those additional attributes and explain your reasoning.)

16. We agree with the attributes of revenue summarised in 3(a) to 3(g) subject to the following comments.
- 3(b) We agree that revenue is a gross notion. Whether it will always be useful to present gross revenue in the income statement is a presentation consideration, and outside the scope of the Paper.
 - 3(c) We would emphasise that *enforceability* of contract rights is not a factor in recognising revenue.
 - 3(d) We agree that 'revenue will not arise simply from entering into the contract', but think that 'because at that point there will have been no activity undertaken by the supplier pursuant to the contract' needs some clarification. No rights of use are transferred to the customer prior to the contract, but from the supplier's perspective work towards contract completion may well have been carried out already.
 - 3(e) We agree that revenue does not necessarily involve an exchange if this is taken to mean that the finished article has not yet been handed to the buyer.
 - 3(f) We agree that revenue is something that arises in course of 'ordinary activities', in so far as the term is understood in the Framework and

IAS 18, although possibly a phrase such as 'normal operating' would be more appropriate.

Q4 As mentioned in Q3(d), revenue is some sort of measure of activity undertaken pursuant to a contract with a customer. However, the paper's analysis is not conclusive as to exactly what "sort of measure of activity" revenue measures; it could for example be a measure of completion activity (in other words, a measure of the things the supplier has completed) or a measure of activity towards completion (in other words, a measure of the things the supplier has done under the contract). This issue arises again and again in the paper and is the main issue that separates the critical event approaches discussed in Chapter 3 from the continuous approaches discussed in Chapter 4. The authors believe that a very important test of any proposed accounting solution is whether it is the most useful approach from a user perspective. Which activities do you believe the revenue number should measure: completion, or activity towards completion? Or are there other alternatives that need to be considered? (Please give your reasons for the answer you have given.)

17. We agree that this issue is fundamental. We also recognise that the Paper presents perhaps the strongest case for the principle that revenue should measure 'activity towards completion' - that is, contractual activity undertaken by the supplier, and agree that such activity must relate to an agreement with a customer (so that where work is undertaken on a good or service for which there is no explicit or implied contract, no revenue arises). However, at this stage of the international debate we have yet to reach definitive conclusions on the various alternatives, and would emphasise that it will be very important to test the application of any proposed principles in relation to a variety of business sectors and different types and size of reporting entity.

Q5 Chapter 3 discusses when revenue arises and, in doing so, introduces various critical event approaches to revenue recognition and explores three of them (Approaches A, B and C) in detail.

- (a) ***Do you believe the discussion of Approaches A to C is fair and complete? For example, do you believe that one of the approaches has some additional benefits or weaknesses that have not been mentioned? Or that some of the weaknesses mentioned are not weaknesses? (If you do, please could you explain what you think is unfair and incomplete about the discussion, together with your reasoning.)***
- (b) ***Do you believe there are any critical event approaches other than Approaches A to C that have merit and are worth exploring in greater detail? (If you do, please could you describe those approaches and explain why you think they are worth exploring further.)***

18. We have not sought to comment critically at this time on the various alternative approaches.

Q6 Chapter 4 continues the discussion of when revenue arises by introducing and exploring another type of approach to revenue recognition: the continuous approach (Approach D). Again, do you believe the discussion is fair and complete? (If you do not, please could you explain what you think is unfair and incomplete about the discussion, together with your reasoning.)

19. Although the discussion of Approach D seems generally fair and complete, we do, however, believe that the Paper downplays the difficulties of Approach D. For example, paragraph 5.29(b) suggests that Approach D will avoid

disaggregating multiple-element arrangements. We believe that this will be true only in very limited circumstances and normally disaggregation will be necessary, and as difficult under this approach as under Approaches A to C, although as a benefit the resulting recognition pattern will be less 'lumpy' under Approach D.

20. It is also worth emphasising that in our view 'continuous' would not mean that the revenue pattern will necessarily be smooth. The continuous approach measures economic activity, which may or may not be smooth, particularly where a contract involves the supply of goods.

Q7 The discussion in the paper is about concepts and principles—and not at this stage practicalities—and the paper uses a variety of simple examples to illustrate the various approaches and various conceptual discussion points. The examples are set out in Appendix IV. Do you believe there are other examples that would illustrate or highlight issues of concept or principle that are not so far identified in the paper? If you do, what are those examples and what new aspect of the debate is it that you think they illustrate or highlight?

21. We believe that the Paper is correct to deal with concepts and principles without at this stage delving into practicalities. The given examples are appropriate to the scope of the Paper. However, at a later stage it will be important to test the application of the principles in relation to a variety of business sectors and different types and size of reporting entity.
22. Examples are useful in highlighting important principles, but it is important to emphasise that they are illustrations of specific circumstances, and not rules to be followed when circumstances are different, as they inevitably will be in most cases. There may be scope for augmenting the examples in any future paper. (For example, it might be useful to consider the issues arising from a contract to supply a bespoke table made from stock materials.) If the scope of the Paper is extended to look at issues it does not at present address - for example, contingent contracts - examples would be useful.
23. We note also that examples have now been published as part of the Joint Project. These could usefully be considered and perhaps built upon.

Q8 What are your views on the relative merits of the approaches discussed in the paper? Do you believe that one approach is preferable to the others and could—perhaps after some further development work—be applied satisfactorily in all circumstances? (Please explain your reasoning.)

24. As explained above, we have yet to reach definitive conclusions on the various alternatives. As noted above, the Paper perhaps makes the most persuasive case for Approach D: it is presented as aligned better with the Framework than the alternative approaches and as having the broadest applicability - being capable, in principle at least, of being applied satisfactorily in a range of circumstances. The example in the Paper of the boat builder indicates that it may also give the user a better understanding of the business.

Q9 At various points in the paper the authors discuss the issue of perspective; from whose perspective or point of view (ie through whose eyes) should performance be assessed? The suppliers or the customers? For example:

- (a) *the issue is first mentioned in paragraphs 3.36-3.39, where it is explained that one perspective is not necessarily better than the other, although one may be better suited (or even an inherent feature) of one particular approach, whilst another might be better suited or a feature of another approach;*
- (b) *the issue is also discussed in paragraphs 4.4(c), 4.5(b) and 5.7(c), where it is explained that critical event approaches generally (but not necessarily always) apply a customer perspective whilst continuous approaches tend to apply a supplier perspective. In your opinion is this discussion complete and sufficiently conclusive? If you think it is not, could you please explain what more you think should be said and why.*

25. The Paper contains some useful narrative on the issue of perspective. We broadly agree that one particular perspective is not necessarily better than the other, more that the two perspectives may simply be better suited to different approaches.

26. We also agree that the supplier perspective is the most generally appropriate. However, multiple-element contracts, for example, may require a customer perspective. Our preferred basic approach is supplier driven. Where there is a need to unbundle different elements, the customer's perspective may need to be considered. Once unbundled the individual elements are recognised on a supplier basis. The Paper could perhaps have looked at these issues in more detail.

Q10 Do you believe there are particular aspects of the revenue debate that have not been covered in this paper but are worthy of consideration. If you do, what are they and why do you believe they are worth exploring further?

27. We are not clear whether there are plans for either a revised Paper or a new Paper dealing with a broader range of issues. We suggest that given the availability of material from the Joint Project and the imminent publication of documents for formal comment, further exposure of material under the PAAiNE umbrella may be superfluous. Hopefully, this Paper will serve to inform the debate in Europe and EFRAG's responses to the Joint Project.

28. If PAAiNE were to develop further original material on revenue recognition (ie, excluding measurement), we would expect it to engage some or all of the following issues:

- (a) How the assumption and transfer of risks and rewards under the contract interacts with the continuous approach.
- (b) Analysis of the nature and effect of rights and obligations under the contract - for example, in relation to specific performance.
- (c) A clear exposition of how rights to consideration differ from activity.
- (d) How to allocate activity under a contract - that is, when does contract activity start and how is it distributed under the contract?
- (e) How multiple-element transactions should be dealt with.
- (f) Contingent contracts.
- (g) Where to draw the boundary between goods and services.

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