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April 18, 2011

Ms Soh Siew Luie
Head (Corporate Regulation and Governance)
Ministry of Finance
Singapore

Dear Ms Soh,

Re: Report on Control in Revenue Recognition

I have had the pleasure of reading the report on control in revenue recognition (the report) that you sent for review.

Revenue recognition has historically been a difficult subject for accounting standards boards to deal with because there is a wide diversity of revenue models used in the economy with significant variation by industry. This has led to the proliferation of guidance, and a lot of industry specific practices. In the most recent exposure draft, unfortunately the accounting standards boards failed to develop a clear conceptual principle to guide revenue recognition. Thus the difficulties in applying these rules will continue even if this exposure draft is adopted.

The report notes, perhaps too politely, that the exposure draft fails to develop a clear principle for revenue recognition. In addition, the exposure draft proposes a mode of reasoning based on satisfying performance obligations which is inconsistent with the boards conceptual framework (based on changes in assets and liabilities). This is noted in your report, though again the authors are very polite in pointing out this contradiction.

The report correctly partitions the economy into three classes: tangible goods that are ready for sale, provision of services, and construction contracts. For tangible goods, the criteria for control work reasonable well (especially obtaining legal title and/or physical possession of the asset). For services and construction contracts the concept of control does not work well. The report makes a good use of the accounting principle of transfer of risk and reward to essentially propose that services and construction projects could use the percentage of completion method , and thus control is transferred continuously to the customer.

The report tries too hard to be seen as just an extension of the current model (which is unworkable in my opinion) and so puts a lot of stress on having the customer specifying the scope of services as a criteria for revenue recognition. While in some cases this criteria properly results in some service contracts and construction projects being eligible for the percentage of completion method, it leaves other contracts that also deserve the same accounting treatment outside the set of permissable activities. It would have been better to have a more general criteria wherby all services and construction projects would be eligible for the percentage of completion method.

The use of customer specification of scope leads to a false logic which actually leads to the opposite conclusion from the one in Appendix I of the report. Since the client cannot specify the scope of an external audit (by law and professional standards), the external audit example in the appendix should lead to a recommendation of no revenue recognition until the audit is complete. Yet if the company had contracted an auditor to perform internal audit work, then the client would be setting the scope of the work and the revenue could be recognized when a performance obligation (interim audit) has been completed. I would argue that it does not make sense to recognize revenue at end of the interim audit for an internal audit outsourcing project, but then not recognize any revenue for an external audit. Revenue should be recognized for both audits at completion of the interim audit. The report thus gets to the right answer for recognition of revenue for an external audit, but applies an incorrect test (client setting the scope). It would be better to let all service contracts and construction projects qualify for the percentage of completion method. The same analysis applies to the ship building example in illustration 2.

Overall, the report does a good job of identifying the conceptual weaknesses (and contradictions) in the revenue recognition exposure draft. The report also identifies the key areas that should guide thinking about revenue recognition (split between tangible goods ready for sale, services and construction contracts). The report reasons very well from first principles (transfer of risks and obligations) and comes to the right conclusions on revenue recognition in the illustrations provided. The only concern i have is with reliance on a test regarding customer specification of scope, which I view as being too restrictive, and likely to cause interpretation problems in practice. Given the time and resource constraints, the committee has done a very good job of summarizing the issues involved and providing a framework for thinking about revenue recognition.

Best Wishes

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