PRELIMINARY PAPER ON THE NOTION OF CONTROL IN REVENUE RECOGNITION AND CONSOLIDATION

The Accounting Standards Council of Singapore (The ASC)
ASC staff contact: Suat Cheng Goh (email: Goh_Suat_Cheng@acra.gov.sg)
Dexter Tan (email: Dexter_Tan@mof.gov.sg)

Executive Summary

The notion of control is becoming increasingly pervasive in the International Financial Reporting Standards (IFRS) formulated by the International Accounting Standards Board (IASB). Specifically, the IASB has put forth its proposals for a single control-based revenue recognition model in its Revenue Recognition project and has tentatively decided on a single control-based consolidation model in its Consolidation project. We are broadly supportive of the IASB's efforts to develop a single revenue recognition/consolidation model that is based on control. However, in order for the control notion to be more robust and more readily applicable for revenue recognition, it should go beyond what is currently envisaged by the IASB to ensure it is rooted in broad and vigorous principles that can be applied to all types of contracts with customers, including collective control situations which are common business arrangements in the Asia-Oceania region. In the context of consolidation, the IASB should re-consider its tentative decisions on the dominant shareholder concept as the control notion for consolidation cannot simply be premised on historical voting patterns at shareholders meetings. It would not be sound accounting practice if businesses are required to consolidate purely due to the action/inaction of others. Conversely, the IASB should incorporate its tentative decisions on situations whereby power is shared in the final consolidation standard to provide more clarity as to who is the controlling party in a joint control setup where control is shared amongst various parties. In this paper, we will set out to demonstrate how the IASB's proposals and tentative decisions reached on the control notion for revenue recognition and consolidation, respectively, would not result in decision-useful financial information that faithfully represent the economic phenomena that they purport to represent. This paper will be tabled for discussion at the upcoming 2nd AOSSG meeting in Tokyo in September.

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Background

1. This paper seeks to provide a preliminary assessment of the notion of control that is currently envisaged by the IASB in its Revenue Recognition and Consolidation projects, the applicability and/or appropriateness of the envisaged control notion in various situations, and whether their application will result in decision-useful financial statements that faithfully represent the economic substance of the underlying transactions.

The Notion of Control in Revenue Recognition

2. The IASB and the US Financial Accounting Standards Board issued a joint ED on Revenue from Contracts with Customers (the ED) in June 2010 that proposes a new standard on accounting for revenue arising from contracts with customers to provide goods or services that are an output of an entity's ordinary activities. If adopted, the proposals would replace various existing standards[1] by creating a single revenue recognition standard for IFRSs and US GAAP that would be applied consistently to transactions across various industries and capital markets.

3. The ED proposes a significant paradigm shift in revenue recognition principle from the "risks and rewards" notion to the "control" notion which is likely to result in very different reported revenue numbers for some entities. In a nutshell, the ED proposes (amongst others) that:
   - Revenue shall be recognised when an entity satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains ***control*** of that good or service.
   - Control is the ability to direct the use of, and receive the benefit from, the good or service.
   - Control can be transferred at a point in time or on a continuous basis.
   - Indicators that control of a good or service has been transferred to the customer include:
     - The customer has an unconditional obligation to pay;
     - The customer has legal title;
     - The customer has physical possession; and
     - The design or function of the good or service is customer-specific.

[1] IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC 31 *Revenue-Barter Transactions Involving Advertising Services*.

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Preliminary Assessment of the IASB's Proposed Control Notion in Revenue Recognition

4. Revenue is a key indicator of an entity's financial performance and plays a pivotal role in the broader context of financial performance reporting. It is therefore imperative that applying the revenue recognition principles in IFRSs will result in revenue numbers which faithfully represent the economic phenomena that they purport to represent.

5. Advocates of the "control" notion believes that the control notion would result in more consistent conclusions about when goods or services are transferred as compared to the "risks and rewards" notion. This is because under the risks and rewards model, an entity would need to make a judgment as to whether a preponderance of the risks and rewards of ownership of a good or service has been transferred to the customer before it can recognise revenue.

6. Whilst we do not dispute the advantages offered by the control-based model and are broadly supportive of the IASB's efforts to develop a single revenue recognition model that is based on control, we believe the ED's interpretation of the concept of control is too narrow/has certain fundamental flaws as demonstrated below:

   - The control notion is too simplistic as it only caters to situations whereby control is transferred from one single party to another single party. It does not consider the implications or the possibilities of a situation whereby control is transferred from one single party to a collective group of individuals, or when the transfer of control is not obvious.
   - The control notion places too much emphasis on the physical delivery of a good or service and accordingly, fails to give due consideration to the rights and obligations of the entity and its customer prior to the physical delivery of the good or service.
   - The ED does not include "risks and rewards" as an indicator of control. This is somewhat inconsistent with the IASB's tentative decision in the Consolidation project that exposure to risks and rewards is an indicator of control. We believe that risks and rewards cannot and should not be decoupled from control as they are not different approaches/mutually exclusive. Risks and rewards will generally derive from control, and thus provide a strong indicator of where that control lies.
   - The assessment of whether control transfers on a continuous basis or at a point in time is one of the most critical judgments to be made in applying the control notion. However, we believe that entities would face considerable practical difficulties in arriving at a clear conclusion of when control is transferred as the guidance and indicators of control proposed in the ED are not robust enough.

7. The following are some examples of situations whereby we believe the use of the control-based model as currently defined in the ED is not appropriate:

A) Collective control situations

In a collective control situation, a buyer owns a specific fraction of a pool of owners' rights but does ***not*** have "full control" over that fraction by virtue of the fact that he is likely to be bound by a collective agreement. This is best exemplified by multi-unit real estate developments which are prevalent not only in Singapore but also in other countries in the Asia-Oceania region such as Malaysia and Hong Kong. In such a situation, the individual buyer of a specific unit will not have "full control" of the unit even after the transfer of the unit from the seller notwithstanding that the buyer has fully assumed all owner rights. This means that the single buyer does not have the power/ability to make changes to his own unit, for instance, changing the shape of the windows of his unit from rectangle to circle, as it infringes on the collective rights of the other buyers. Control criteria that presumes the conveyance of a good lends itself to confusion as to whether such transactions represent the conveyance of a good or of a collection of rights. This confusion manifests itself in arguments that revenue can be recognised only upon the ability to exercise unfettered rights over the good, when in fact the owner never acquires such unfettered rights. In other words, at no point in time was control passed from one single party to another single party in a collective control situation.

Specifically, we believe that the "transfer of control" concept proposed in the ED, which is premised on the assumption of a single seller/single buyer situation, is too simplistic to address the issues that arise from a single seller/multiple buyers situation. As a consequence, we find that developers of multi-unit real estate, who are dealing with multiple buyers in a collective control situation, would not be able to meet the transfer of control requirement during construction as they would have difficulties satisfying most, if not all, of the indicators of control proposed in the ED. We are therefore not persuaded that the control notion proposed in the ED should be applied to collective control situations to determine whether or when an entity has satisfied its performance obligation for revenue recognition purposes.

B) Service contracts

We believe that it is difficult to apply the proposals in the ED to determine when control of a service is transferred to a customer (e.g. audit, valuation, legal and other expert services). This difficulty is amplified in paragraph 31 of the ED which acknowledges that two out of four proposed indicators of control (i.e. physical possession and legal title) would not be relevant to services. We are therefore concerned that the control notion as currently defined in the ED is not appropriate for service contracts and that it could result in significant diversity in practice.

C) Long-term contracts

The control-based model proposed in the ED would put an end to the "percentage of completion method" of revenue recognition for long-term contracts where the asset is transferred to the customer at the end of the contract, instead of on a continuous basis. We believe that the model as currently defined would not result in decision-useful information for such contracts because of the difficulties in applying the concept of continuous transfer of control (which, for example, in law is determined by the balance of respective rights in the particular context). The assessment of whether control transfers on a continuous basis is one of the most critical judgments to be made in applying the control notion. However, the guidance and indicators of control proposed in the ED are not robust enough to allow an entity to arrive at a clear conclusion of whether control is transferred continuously. We are therefore concerned that the control notion proposed in the ED by itself would not result in consistent revenue recognition that faithfully reflects the economic substance of the underlying transaction.

The Notion of Control in Consolidation

8. The IASB initiated a project on consolidation in 2003 with the aim of publishing a single IFRS on consolidation to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation–Special Purpose Entities*. One of the key objectives of this project is to improve the definition of control so that a single principle-based control model can be applied to all entities.

9. The IASB plans to issue the final standard for consolidation and disclosure requirements in the fourth quarter of 2010. It has tentatively decided (amongst others) that:

- ***Control*** is the basis for consolidation.
- A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.
- Power refers to a reporting entity's current ability to direct the activities of an entity that significantly affect the returns. The reporting entity can have that current ability by different means:
  - By having the contractual ability to direct the activities, which can arise from having:
    - → More than half of the voting rights in an entity controlled by voting rights.
    - → Contractual rights within other contractual arrangements that relate to the substantive activities of the entity.
    - → A combination of contractual rights within other contractual arrangements and holding voting rights in the entity.

- In situations in which a reporting entity does not have the contractual ability to direct the activities (e.g. when it holds less than half of the voting rights in an entity), a reporting entity may need to rely on other indicators of power to provide evidence of having the ability to direct.

Preliminary Assessment of the IASB's Tentative Decisions on the Control Notion in Consolidation

10. Many believe that IAS 27 and SIC-12 are based on different consolidation models, the former a control model and the latter a risks and rewards model. This inconsistency is aggravated by the fact that it is often not clear which entities are within the scope of IAS 27 and which are within the scope of SIC-12. These inconsistencies have resulted in significant diversity in practice and created considerable opportunities for structuring. The global financial crisis has also brought to light the importance of a consistent accounting principle for consolidation that can be applied to all entities.

11. The control notion is not a new concept in consolidation and we are generally supportive of the IASB's efforts to develop a single consolidation principle that is based on a control model that can be applied to all entities. However, we have the following concerns with regard to the control notion that is currently envisaged by the IASB:

A) Joint control situations

Similar to the collective control situation discussed under the Revenue Recognition section above, we believe that the control notion for consolidation should cater to joint control situations whereby control is shared amongst various parties. The joint control situation is perhaps best exemplified in the case of a business trust. In a business trust, the economic reality is that no one single party has full control of the trust as control is shared amongst various parties such as the manager of the trust, the board of directors of the manager, the trustee and the unit-holders. In such a situation where it is difficult to exactly pin-point or define who has control, we believe that it is crucial that the final consolidation standard provides sufficient guidance to preparers of financial statements as to the determination of which party in a joint control setup would be required to consolidate the trust.

In this regard, we are glad to note that the IASB has tentatively decided that when two or more parties have discrete, unilateral decision-making authority over different activities of an entity that significantly affect the returns, the party that has the ability to direct the activities that ***most*** significantly affect the returns meets the power element of the control definition. We are broadly supportive of this tentative decision reached by the IASB as we believe it would help to provide some clarity as to who should be the controlling party in a joint control setup. Accordingly, we would recommend that the IASB incorporate this principle in the final consolidation standard, and that the same should also be done to cater for collective control situations in the IASB's revenue recognition project.

B) Dominant shareholder notion

The IASB has tentatively decided that in situations in which a reporting entity holds less than half of the voting rights in an entity and does not have the contractual ability to direct the activities of the entity, it may still have control over that entity considering the size of its holding of voting rights relative to the size and dispersion of holdings of the other vote holders, together with voting patterns at previous shareholders meetings (i.e. the dominant shareholder notion).

The dominant shareholder notion depends on the relative size, dispersion and level of activism of the remaining vote holders. We are concerned that this notion is premised on a presumption that a collective group of widely dispersed vote holders will not come together and thwart the votes of a dominant shareholder simply because past voting patterns at previous shareholders meetings show otherwise. We believe that having seemingly dominant power does not automatically lead to a ***"real"*** ability to direct the activities of an entity, as the remaining vote holders, acting in concert, may still be able to oppose the will of the dominant shareholder. The fact that the remaining vote holders did not collectively attend or vote at previous meetings does not mean that they will not do so in the future. Hence, we are of the view that this presumption of control based on historical extrapolation should not be equated to actual/real control, and that it would not be sound accounting practice if businesses are required to consolidate simply due to the action/inaction of others.

In addition, the application of the dominant shareholder notion based on historical voting records at previous shareholders meetings may result in consolidation of an entity in one period and deconsolidation in the following period should the voting behavior of shareholders change. Furthermore, a new reporting entity would not have the historical evidence to determine if it is the dominant shareholder nor would a reporting entity have the historical evidence to determine if it is the dominant shareholder of a new entity. We believe that the potential unnecessary volatility created by the dominant shareholder notion would impair the decision-usefulness of financial information.

The dominant shareholder notion also blurs the line between significant influence and control, and may inadvertently result in the consolidation of entities that were previously accounted for as associates. This would result in consolidated financial statements showing large non-controlling interests which we believe is not decision-useful to users of financial statements.

Summary and Proposed Course of Action

12. In summary, to ensure that financial statements faithfully represent the economic substance of the underlying transactions, we are of the view that:

    - The control notion for revenue recognition proposed by the IASB should be expanded so as to ensure that it is rooted in broad and robust principles that can be applied to all types of contracts with customers.

- The IASB should re-consider its tentative decisions on the dominant shareholder notion in the context of consolidation. It is our assertion that the control notion for consolidation should not simply be premised on historical voting patterns at shareholders meetings. Conversely, we support the IASB's tentative decisions on situations whereby power is shared and believe that it should be incorporated in the final consolidation standard.

13. In the light of our concerns above and the pervasiveness of the control notion in IFRSs/the IASB's current projects, the ASC believes that an academic research should be carried out that centers around the definition of control, the applicability and/or appropriateness of the control notion in various situations, and the alternative principles that could be applied in situations where application of the control notion is not appropriate. The fundamental objective of this research is to enhance the input to the IASB from the Asia-Oceania region, taking into account the economic phenomena which are prevalent in this region, in order to make a distinctive contribution to the IASB's formulation of a single set of high quality global accounting standards.

14. The ASC intends to commission the research shortly and would like to invite member countries within the Asian-Oceanian Standard-Setters Group who hold similar views to participate in the research.