

Revenue recognition and corporate governance



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Revenue recognition is one of the most important accounting concepts to organisations across the globe. Basically, there are two main ways in which an organisation can account for revenue as part of their financial accounts. A company can either use cash based accounting or accruals based accounting. Cash based accounting requires the company to recognise the revenue and to put the figure into their accounts at the point when the cash is received, regardless of how or when the money has been earned. On the other hand, with accruals based accounting the figures will feature in the accounts when the revenues are realised, or when the amount is earned, not necessarily when the cash actually enters the company ^[1].

Countries across the world deal with the issue of revenue recognition very differently and, as such, it is particularly difficult to compare international businesses. The way in which revenue is recognised will have an impact on the perceived financial health of an organisation and different approaches can make it extremely difficult for analysts and investors to make a fair comparison.

In October 2002, the International Accounting Systems Board ("IASB") and the Financial Accounting Standards Board ("FASB") began a joint project to deal with these differences. The original overall aim of the revenue recognition project was to establish a single coherent way of revenue recognition that can be used, globally. Fundamentally, this required the convergence of US GAAP and international standards.

One of the main problems facing FASB and IASB is that the US does not have a general accounting standard relating to revenue recognition. Instead,

different sectors and industries have developed their own ways of dealing with revenue recognition in line with their individual requirements ^[2]. As a result, there is no consistency. Moreover, revenue recognition in the US is seen as particularly complex and is based largely on the discretion of the individual finance teams.

Originally, the project suggested that a fair value asset based approach should be followed. However, it is currently thought that it will not be possible to establish one universal approach. The basic concept of the fair value asset and liability approach is that when a company enters into a contract, it creates rights (assets) and obligations (liabilities). The difference between these assets and liabilities at any point in the contract is the revenue generated by this contract and should be the figures used at the point in which the accounts are drawn up. This started as a fair value approach to the difference in assets and liabilities, but has now shifted more towards the customer consideration approach to valuing the difference between assets and liabilities ^[3].

The FASB and IASB have since recognised that enforcing one standard on a global level will be impossible and have, since 2006, decided to take a more bottom-up approach by conducting an international study of how the above model would work and the way in which it would interact with the cultural differences across the globe ^[4].

It is this cultural difference and historical freedom that presents the greatest challenge to the success of the project. Without a detailed understanding of how the proposed models will work, practically, with reference to the various

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different families of transactions, it will be impossible for the project to reach any definitive conclusion. For this reason, gaining a greater understanding has now become the first and most important priority of the FASB and the IASB when conducting their study relating to revenue recognition.

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Corporate governance is absolutely vital in the administration and control of companies. Essentially, corporate governance refers to the principles, policies, customs, laws and any other factors that deal with the way in which a company is managed. It is key in the way that the relationship with the company directors and the stakeholders in the company interacts. As a general rule, strong corporate governance results in a good level of confidence in the company itself and the wider industry ^[5].

The aims of corporate governance are multiple but are mainly in relation to accountability of the key individuals within the organisation and, in particular, the way in which the company deals with the principal - agent problem ^[6]. It is also about establishing economic efficiency and ensuring the best and most appropriate use of available resources. As the way in which companies are run varies so dramatically from country to country, it is unsurprising that the way corporate governance is managed is equally diverse.

In 2002, the United States took the approach of regulating the way in which corporate governance should work with the Sarbanes-Oxley Act. This Act was drawn up as a rule based approach to corporate governance, following

several accounting scandals which hit the headlines in the US, the most notable being the collapse of ENRON. As part of the legislation, eleven heads of rules were created and the Securities and Exchange Commission was required to make compliance a condition of admission to the exchange. The rules have been criticised as being highly prescriptive and not allowing for flexibility based on organisational differences ^[7] .

Contrast this with the principles based approach taken in the UK and the US. Although both countries follow the Anglo-American approach, which is considered liberal and as giving priority to shareholders, the way they go about achieving this aim is substantially different.

The UK takes a principle based approach with a 'comply or explain' policy ^[8] . This means that a list of principles and best practices has been developed in relation to corporate governance whereby public listed companies must either comply with this best practice or explain why it is not thought necessary in their particular circumstances. In the US, there are statutory rules with which all companies must comply. The UK government felt that it was not possible to create one set of rules that would capture the needs and issues of every type of company; for this reason, it has continued to favour this principle based approach.

Divergences in the way that corporate governance is dealt with across the globe and even across sectors and industries is a natural part of the way business is conducted. All companies have their own issues and structures which require different approaches to control and accountability. The level of prescription that the US government has placed on corporate governance

has resulted in a one size fits all approach which is simply impractical.

Failure to allow a degree of flexibility and adaptability will result in a difficult to manage and ineffective system of corporate governance.

Footnotes

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