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Reinforcing Enforceability

A single word in proposed revenue-accounting standards could significantly alter the income statements of many entities.

As proposed by the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), future revenue-accounting standards will contain a word that may significantly change the amount of revenue and related expenses that entities report. In this column I'll explain the often-overlooked implications of that word: "enforceable."

Exchange Agreements

Entities often enter into agreements with other parties to exchange resources that have economic value. Transactions that result from exchange agreements tend to be similar in economic substance. Typically, one party promises to provide goods and/or services to another party, and the other party promises to pay money for the goods/services.

Despite similarities in their economic substance, exchange agreements can take many forms. They can be *explicit*, that is, formally expressed in written, electronic, or oral communication. Or exchange agreements can be *implicit*, such as when they're based simply on the customary business practices of the parties.

Rights and Obligations

Regardless of the form of an exchange agreement, the parties involved typically understand that they're creating rights and obligations for themselves as a result of what they've explicitly or implicitly promised to do. For example, a vendor that enters into an agreement with a customer understands that it's obligating itself to deliver goods and/or render services. At the same time, the vendor understands that if it performs as promised in the agreement, it will have the right to collect payment from the customer.

Although a typical exchange agreement creates rights and obligations for the parties to the agreement, those rights and obligations may or may not be *enforceable*. In other words, one of the parties may or may not be able to invoke the punitive powers of the government against the other party if the other party fails to keep the promises that it made within the context of the agreement. When available, legal remedies for aggrieved parties help to ensure that each party fulfills its obligations and is able to obtain the benefits of its rights.

The enforceability of the rights and obligations that arise from a particular exchange agreement depends on several factors, which include the subject matter, form, and economic substance of the agreement as well as the characteristics of the legal environment in which the agreement is made. Differences in these factors across agreements and jurisdictions result in differences in enforceability. For example, an agreement that creates enforceable rights and obligations in one jurisdiction may fail to create enforceable rights and obligations in another because of differences in laws. Additionally, because laws and their interpretation by courts can change over time, an agreement that created enforceable rights and obligations in the past may fail to create enforceable rights and obligations in the future, and vice versa.

Enforceability and Proposed Accounting Standards

Over the past decade, the FASB and the IASB have pursued many joint standards-setting projects. The Boards' overall goal for their joint projects has been to improve and converge U.S. Generally Accepted Accounting Principles

(GAAP) and International Financial Reporting Standards (IFRS) at the standard level. Many of the Boards' joint projects have resulted in only minor changes to U.S. GAAP and IFRS, but the nearly complete joint project on revenue will introduce profound changes into both sets of standards.

In November 2011, the FASB and the IASB each issued an exposure draft (ED) of proposed revenue-accounting standards. As proposed in the EDs, a *contract* with a customer must exist in order for a vendor to legitimately recognize revenue for transactions that arise from the contract. Furthermore, the EDs define a contract as an "agreement between two or more parties that creates *enforceable* rights and obligations" [emphasis added]. Thus, for a transaction to be within the scope of the proposed revenue standards, the transaction must arise from an enforceable agreement. Conversely, transactions that arise from nonenforceable agreements would be excluded from the scope of the proposed standard.

Implications of Nonenforceability

The word *enforceable* in the definition of a contract, coupled with the existence of a contract being necessary for revenue to be recognized, means that a vendor would *not* recognize revenue from transactions that arise from nonenforceable agreements. The EDs don't say how such transactions should be accounted for, only that revenue shouldn't be recognized from them.

In drafting the proposed revenue standards, the FASB and the IASB have clearly acknowledged the possibility that some agreements between vendors and customers are unenforceable and therefore would not result in revenue recognition by the vendor. But vendors themselves have paid little attention to this aspect of the proposed standard. As a result, vendors are largely unaware that some revenue that is recognized under existing U.S. GAAP and IFRS would *not* be recognized under forthcoming standards.

For some vendors, the impact of the word *enforceable* on their income statements could be significant if they recognize a significant amount of revenue today from unenforceable agreements with customers. From the research that I've done to date, I've concluded that many vendors *do* recognize a significant amount of revenue today from unenforceable agreements.

Preparing for the Future

There are two key tasks related to "enforceability" that vendors should perform to prepare for forthcoming revenue standards. First, vendors should take a proactive approach to determining the enforceability of their agreements with customers. One useful way of beginning this task is to think in terms of *risk factors* that indicate when an agreement is *less* likely to be enforceable. Here are some risk factors that I've identified:

◆ The parties rely on oral communication or customary business practices (rather than on written or electronic documentation) as the basis for the agreement.

◆ The agreement contains non-arm's-length terms and conditions.

◆ The parties are closely related to each other (e.g., one party is wholly owned by the other or both parties have the same sole owner).

Note that these risk factors aren't *criteria*. That is, none of them is necessary or sufficient for an agreement to be unenforceable. Conversely, the absence of these risk factors doesn't guarantee that an agreement is enforceable. The aim of thinking about these risk factors is to identify those agreements that are *most at risk* of being unenforceable.

In continuing with this first task, it's important to remember that enforceability can vary across agreements, across jurisdictions, and over time. Consequently, vendors should consider:

◆ Obtaining jurisdiction-specific legal opinions from qualified attorneys on agreements for which the risk of unenforceability is the highest.

◆ Modifying the language of their written/electronic/oral agreements and/or modifying their customary business practices (again, with the guidance of qualified attorneys).

◆ Periodically reviewing and refreshing the above over time.

As a second preparation task, vendors should project the financial-statement impact of changing the way transactions arising from nonenforceable agreements are accounted for. Let's say a wholly owned subsidiary of a parent company routinely enters into "sales" agreements with its parent. Under the agreements, the subsidiary promises to provide goods to the parent, and the

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parent promises to pay for the goods upon delivery. Such an agreement might be unenforceable if, for example, the subsidiary couldn't successfully sue its sole owner to collect payment. What would be the impact on the financial statements? At a minimum, reported revenue would be lower. Certain expenses, such as cost-of-sales expense, would also be lower. Instead of reporting revenue and its associated costs, the subsidiary might report a gain or loss on the exchange with the parent. Alternatively, because the customer is the owner of the vendor entity, the exchange might be considered an equity transaction. All of these effects could result in a significant makeover of the subsidiary's stand-alone (i.e., separate-company) income statement.

What's clear when you pay attention to the word *enforceable* is that now is the time to contemplate its impact on your financial accounting and reporting. Doing so will likely require vendors to engage attorneys during the transition to the new revenue standards and on an ongoing basis. It's also likely to affect the work of vendors' external auditors. But anticipating the impact is almost always better than ignoring it and being unpleasantly surprised later. **SF**

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