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DISCUSSION PAPER
Preliminary Views on Revenue Recognition in Contracts with Customers

The Swedish Enterprise Accounting Group (SEAG) is a forum for Chief Accountants from the largest Swedish listed companies. The Group is administered by the Confederation of Swedish Enterprise, to which most participating companies of SEAG are joined.

Representing preparers´ point of view, SEAG welcomes the opportunity to comment on the above-mentioned Discussion paper.

Introduction and general comments

Even though we have a number of comments below, where we do not agree with the DP proposals, we want to underline that we in many aspects are positive to the DP. The recognition principles give valuable guidance for the more complex customer contracts that many industrial companies today agrees with their customers. However, even if we principally agree that one recognition principle would be preferable our experience and view is that there is not one principle that in practice is applicable to all types of non-financial businesses.

Since a change of IAS 41 at present is not within the scope of the revenue recognition project, adding exclusion for another industrial sector of Sweden would still mean that the DP is valid for the majority of Swedish companies. Rather, since many companies support the DP a delay of the adoption due to problems for certain industries would be negative for those companies that welcome the new guidance in the DP. We therefore propose that long term contracts without separate performance obligations should continue to apply the POC method.

One practical preparer perspective of the DP is that the DP gives valuable guidance in relation to certain key paragraphs of IAS 18, especially those paragraphs that prescribe the accounting in relation to measurement of revenue and identification of the transaction (p. 9 – 13).

Question 1
Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We are in principle positive to the proposal to have one principle but do not agree to what extent this is achievable. The DP in general supports most industrial and service companies, especially IT-companies with a US GAAP background. However, we note from the DP, e. g. S11, that the Board itself recognizes that it does not adhere to a single revenue recognition principle. For Swedish industrial companies especially the present exclusion for forest companies (IAS 41) makes this obvious but also in relation to other scope exclusions for contracts within IAS 39, insurance contracts of IFRS 4 and leasing contracts of IAS 17. As we develop further below we also believe that the scope exclusions would have to comprise construction contracts now accounted for under IAS 11.

To companies with long term contracts without separate performance obligations the proposed model of the DP would mean a reintroduction of the completed contract model - that same model which the IAS 11 was developed to counter - in order to avoid the then obvious draw-back or failure of the completed contract model to represent a fair income generating business model of the company. Such a reintroduction would not be acceptable. A separate model for companies with this type of contracts needs to be maintained. Such a model is also relevant for other companies with contracts of a special character, compared to one-piece or multi-component deliveries of most industrial companies. We propose a solution to this in our answer to question 2.

Question 2
Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Typically this relates to contracts where there is no continuous legal transfer of performance obligations.

The DP focuses on measurement based on separation of customer contracts in performance obligations. Performance obligations will, in short, be treated as "separate contracts" and allocation between them is crucial.

In situations where the legal transfers do not occur in sequence/ parallel with the vendor's fulfilment of a contract the timing of revenue recognition will not reflect the earnings cycle of the company. In contracts where there is no "continuous legal transfer" the vendor in most cases has the unconditional right to receive payments for work performed, plus a margin, if the customer cancels the contract. Focusing on continuous legal transfers in contracts where this does not occur is therefore not, in our view, reflecting the economic substance of the fulfilment of a customer contract, neither from the perspective of the vendor, nor the customer.

Construction contracts conditions are typically so diversely structured that identifiable milestones/separate performance obligations (customer acceptance clearance) are not at hand. A possibility of a continuous transfer approach is suggested by the DP. However, it lacks the clarity to make a comparison to the well-established POC method of IAS 11 possible. We also note that essential components for a comparison to IAS 11 are not part of the DP but indicated (appendix C) to be potentially developed at a later stage of the project. For these reasons any consistent conclusion of the viability of the DP as regards typical construction contracts cannot be made.

Our proposal is therefore that in situations where a customer contract lacks continuous legal transfer of assets the POC-method should still apply until revenue recognition principles are defined that reflect the earnings cycle of such a contract. Since the DP well supports most companies it should be non-mandatory to apply POC in circumstances permitting application of IAS 11 as of today. A shift from the present IAS 11 will add increased complexity for both internal and external reporting and requires careful field tests for to ensure a proper balance between costs and increased value for users. Swedish companies with long term contracts would be happy to be engaged in such tests.

We also note that guidance is not given regarding software accounting and license fees/ royalties.

Question 3
Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We agree with the definition.

Question 4
Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

We agree with the definition of performance obligation but believe that the Board should consider a more specific guidance. In A5 it is only stated that "(evidenced by the fact that other entities sell such services separately)". Paragraph 3.25 on the other hand has a too broad principle-based definition.

Question 5
Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Revenue recognition becomes inconsistent if the revenue recognition for a simultaneous delivery of two identical products into two different jurisdictions is made at two different occasions only because the local rules for transfer of ownership in these two jurisdictions differ. How can the application of an IFRS be made dependent on inconsistent local legal rules? For example, shall revenue be recognized when a truck has been formally registered, which in many countries may be the point of time when legal transfer occurs instead of, as today, at the delivery to the customer? Also, how do internationally accepted delivery terms

(Incoterms) interact with laws and rules in different countries? Often the combination of local rules can be very complex, for example the impact on these from income tax and VAT legislations. Basically we prefer a principle based on the risk and reward view.

Question 6
Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

In our view the probability of a return should be considered. Over certain probability levels revenue should be deferred until the right of return expires or is calculated to be below the probability threshold, otherwise the right of return should not impact the accounting. From a practical perspective we recommend that recognition of provisions should still be a possibility. In fact, we think that a refund policy is an unconditional obligation to accept returns. This view is supported by Example 9 in ED IAS 37. A provision should be recognised reflecting the likelihood of an entity being required to refund any purchases made by customers before the balance sheet date.

Question 7
Do you think that sales incentives (e. g. discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

We agree. However, if the right to for example free goods requires the customer to sign a new contract then the impact should be applied on the new contract (when that is signed).

Question 8
Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Our main concern is that a vendor and a customer might structure a contract to "optimize" the impact on the financial statements of one or both parties. If a contract does not reflect "the economic content, including timing" that would require the parties to adjust the accounting, ensuring a reflection of "agreement reality". See also our answer to question 5.

Question 9
The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Yes, that type of contracts we comment in our answer to question 2.

Question 10
In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.
(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

We agree and very much welcome that "current exit price" and similar approaches are not proposed.

It should be noted that the DP presents a very simplified situation. The model implies, and the appendix C of the DP acknowledges, the need to take into consideration the time value of money in measuring the rights and obligations of a contract. In this respect a high degree of complexity will be added irrespectively of if the requirements for the balance sheet presentation will be net or gross value.

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

A performance obligation should be deemed onerous provided that the whole contract is onerous. Many customer-specific construction contracts have highly variable outcomes. There are, for example, contracts that have been affected by the high volatility in steel prices in recent times. These prices could change with more than 50 % over just a few months. Often, these price increases or decreases in input goods do not result in changes in the transaction prices (customer prices). Furthermore, it is common with customer options for additions and changes in the contracts.

We think that a cost test is the most appropriate test for remeasurement. As in accordance with IAS 37 the test should be made for the entire contract and not for individual performance obligations. Consequently a full provision for an expected loss of the entire contract should be made immediately. The provision should not include a margin.

Remeasuring individual performance obligations even though the entire contract is not onerous could reduce understandability of the entity's financial performance, especially when using the current price approach. Under this approach, expected price increases of commodities like steel could significantly reduce the recognised margin in one period, but increase the margin with a remeasurement gain in the subsequent period although there is no additional consideration from the customer. Furthermore, in our opinion it is better to recognise any onerous contracts as another component in the statement of comprehensive income other than revenue.

Another concern is that transaction prices in contracts with highly variable outcomes have to be estimated and therefore the carrying amounts of the performance obligations are built on estimates decided at contract inception. Therefore, any remeasurement of individual performance obligations may not provide decision-useful information when uncertainty is a significant characteristic of the contracts. We do not believe that an allocated transaction price approach can handle the most complex projects. We refer to our comments to question 2 regarding the need for preserving the POC method.

The DP does not cover how potential reversals of re-estimated onerous performance obligations should be treated.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

See our comments to question 2.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

See our answer to question 2.

Question 11
The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.
(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

No, they should be expensed as they occur, prior to contract signing.

(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

No, see the answer to question 11 (a).

Question 12
Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

We agree.

There is however one critical concern in relation to this question. A company consists of segments related to different product/service markets. When allocating rebates and discounts the normal profit margins of the involved markets must be considered. Rebate allocation should not only be based on the same percentage deduction of gross revenue for all segments. Such a requirement would not reflect the performance of the different segments of a company and could result in divesture due to IFRS-reasons.

Question 13
Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

We agree and regard this as a much better alternative than awaiting recognition until a stand-alone selling price is established.

We are pleased to be at your service in case further clarification to our comments will be needed.

Yours sincerely,

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