DRAFT COMMENT LETTER
Comments should be submitted by 3 June 2009 to
Commentletter@efrag.org

XX June 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Preliminary Views on Revenue Recognition in Contracts with Customers

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* ('the DP'). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

Currently in IFRS we have two main standards on revenue recognition—IAS 11 *Construction Contracts* and IAS 18 *Revenue*. However, they appear to be based on inconsistent principles, and experience shows they cause of a lot of implementation issues. In the US there are more than 100 standards and other pronouncements on revenue and gain recognition, many of which are industry-specific and some of which are conflicting. The IASB and FASB have decided to develop a fully converged revenue standard based on a single set of principles for recognition and measurement that would be applied to all types of revenue-generating activities. The DP focuses on revenue recognition in the context of contracts with customers only. In summary, it proposes that:

- If a contract comprises more than one performance obligation—in other words, more than one promise to transfer an asset to a customer—the performance obligations should be accounted for separately if the assets are transferred to the customer at different times. This approach is different from for example the current approach in IAS 11 which among other things focuses on whether the different parts of a contract have been negotiated separately. IAS 18 is largely silent on when and how to sub-divide contracts for revenue recognition purposes.

- Revenue should be recognised when an entity has satisfied a performance obligation arising under a contract with a customer. Such satisfaction will occur when control of the asset (a good or a service) involved is transferred to the customer. This proposal will result in a significant change in the timing of revenue recognition when contracts for construction and/or services are involved and no continuous transfer takes place. The DP acknowledges this difference in the case of the construction contracts, but seems to suggest that service contracts typically involve a continuous transfer. In our view there are many service contracts where the deliverable is delivered at the end of the contract (ie where there is no continuous transfer), and for those contracts revenue would be recognised later than under the current standards. Examples of such contracts include contracts for the provision of expert opinions, including audits.

- At contract inception both the rights arising out of the contract for the entity and the performance obligations involved are measured at the transaction price (that is the promised consideration) and that measurement is not updated unless the performance obligation is deemed onerous. If a contract comprises more than one performance obligation and the obligations are required to be accounted for separately, the transaction price should be allocated based on the stand-alone selling prices of the goods and services underlying those performance obligations.

EFRAG welcomes work being carried on this subject because we believe that revenue recognition is the cause of many practical problems and that it will help all the IASB's constituents if the existing material on the subject could be enhanced. Furthermore, we recognise through our own work on the subject that it involves a number of extremely difficult issues and we are grateful to both Boards for considering those issues so thoroughly.

However, we have a fundamentally different view as to when revenue should be recognised to the one proposed in the paper. The DP proposes that revenue should be recognised only when a performance obligation is satisfied. We think it is unfortunate that the DP does not explain why the IASB regards revenue as an important figure because, had it done so, we might have had a better understanding of what it is that the IASB thinks revenue should represent and why it thinks that. EFRAG believes the financial statements would be most decision-useful were revenue a measure of activity carried out to fulfil a contract with a customer; in other words, if revenue was recognised as the entity progresses towards performance obligation fulfilment, rather than just on fulfilment. The model EFRAG favours is described in more detail in Appendix 2.

Putting that fundamental concern aside and focusing on the model proposed, we agree with much of what the DP proposes. Our detailed comments on the DP—which are set out in Appendix 1 to this letter—can be summarised as follows:

- We agree that a single, universally-applied set of revenue recognition and measurement principles is desirable—although whether it is achievable at the moment is another matter.

- We agree with the proposed definition of a performance obligation and the proposals on the separation of performance obligations. However, we think they will need to be supplemented by some carefully targeted further guidance if entities are to be able to apply the definitions and principles, and identify the deliverables in (or components of) a contract, in a consistent way. This concern about the consistency of application of this part of the proposals is illustrated by the fact that EFRAG members interpreted the definition in different ways when discussing whether return rights and sale incentives are performance obligations related to the existing contract. However, we think that return rights are separate performance obligations and that their existence should not in themselves prevent a sale from being recognised.

- We agree that the rights arising under the contract and the performance obligations should both be measured on initial recognition at the original transaction price.

- We also agree that, if there are separate performance obligations involved, the transaction price should be allocated to performance obligations on the basis of the entity's stand-alone selling price of the goods or services.

- We agree that performance obligations should be measured initially at the transaction price.

- We agree that performance obligations should not be remeasured, unless they are onerous. If they nevertheless are to be remeasured, we believe that this remeasurement should not affect revenue. We also agree with the paper's proposals on the identification and measurement of onerous performance obligations.

- As already mentioned, the proposal in the DP could result in a significant change to existing practice, with the recognition of revenue occurring much later than at present on some (but not all) construction-type contracts and service contracts. We think this would downgrade the decision-usefulness of the information provided to users of financial statements from existing requirements.

Our comments should be read in the context of existing IFRSs. We recognise that future developments in standards—for example derecognition of financial instruments, insurance contracts and the Framework—will have implications for the principles on which a general standard for revenue recognition in contracts with customers should be based.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX 1:
EFRAG's responses to the questions asked in the discussion paper

GENERAL COMMENTS

1 As is apparent from our response to questions 1 and 9, EFRAG has a fundamentally different view as to what revenue is and when it should be recognised to the one proposed in the discussion paper. However, rather than making this point continually in our responses to individual questions, EFRAG has chosen to answer the questions asked in the discussion paper on the basis that the revenue recognition model proposed in the discussion paper—that revenue is recognised only on satisfaction of a performance obligation—would be applied. The model proposed by EFRAG and the main differences and similarities between this model and the model in the discussion paper are discussed in Appendix 2.

A CONTRACT-BASED REVENUE RECOGNITION PRINCIPLE

Question 1—*Do you agree with the board's 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?*

A single, universally-applied revenue recognition principle

Notes for EFRAG's constituents

2 *There are more than 100 standards and other pronouncements on revenue and gain recognition in US GAAP, many of which are industry-specific and some of which conflict with each other. In IFRS, there are only two main standards, but they appear to be based on inconsistent principles: the principle in IAS 11 is that an entity should recognise revenue as the activities required under a contract take place. This is also the principle in IAS 18 when it comes to recognising revenue related to services. When it comes to recognising revenue from sale of goods, IAS 18 requires that revenue should be recognised only when an entity fulfils its obligations under the contract. Having many standards on the same subject and/or having standards on the same subject that are based are differing principles makes the financial reporting framework difficult to apply and to understand.*

3 *To address these problems, the IASB and FASB are proposing to develop a single revenue recognition model for revenue arising from contracts with customers using a recognition principle that can be applied to all types of revenue-generating transactions.*

EFRAG's comments

4 EFRAG agrees that a single, universally-applied revenue recognition principle is conceptually preferable to having two or more different revenue recognition principles. Under existing IFRS, it is not always clear which standard should be applied and the existence of two different principles makes it difficult to find accounting solutions for issues not explicitly dealt with in either standards.

5 Having said that, EFRAG also thinks that for pragmatic—principally cost-benefit—reasons that it might be necessary to operationalise that single universally-applicable principle differently for different types of transactions. If that proves to be necessary, the aim should still be, however, to approximate to the single revenue recognition principle.

A focus on the contract asset or liability

Notes for EFRAG's constituents

6 *According to the existing IASB Framework:*

(a) 'income' is increases in economic benefits during the accounting period in the forms of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants (paragraph 70(a) of the Framework);

(b) the definition of income encompasses both 'revenue' and 'gains' (paragraph 74 of the Framework).

7 *The discussion paper therefore proposes to focus revenue recognition on changes in assets and liabilities.*

8 *The IASB and FASB have considered what should be the relevant assets and liabilities to consider for a single revenue recognition model. They noted that the existing definitions suggest that revenue arises from changes in the assets and liabilities arising in connection with the sale of goods or services that constitute an entity's ordinary or ongoing major or central activities. They considered various possibilities including, for example, focusing solely on the cash assets (in which case revenue would be recognised when the customer pays), on the goods involved being made (in which case revenue would be recognised on the basis of the enhancement in the value of the good being produced), or on more than one asset or liability. Eventually they decided to focus on an entity's contract with a customer. They did so for the following two reasons.*

(a) *Contracts to provide goods and services are important economic phenomena and the lifeblood of most entities.*

(b) *Most revenue recognition standards in IFRSs and US GAAP focus on contracts with customers.*

The discussion paper does, however, not state that revenue could not arise outside a contract with a customer (for example as biological assets grow); merely that the discussion paper deals only with revenue recognition in contracts with customers.

9 *When an entity enters into a contract with a customer, that contract will involve rights (typically a right to receive consideration if certain things are done) and obligations (typically obligations to do things (ie perform)). The IASB and FASB have decided that their revenue recognition model should focus on the 'net' asset or liability that the contract represents as those contractual rights and contractual obligations change over the life of the contract.*

10 *The IASB and FASB have further decided that being paid by a customer is not in itself a revenue-generating event (although it might be evidence that a revenue-*

generating event has occurred). Therefore, changes in the entity's rights under the contract will not be revenue-generating; the focus should be on the obligations under the contract (ie the performance obligations). Revenue should be recognised when there is a change in those performance obligations.

11 *Finally, if remeasurement is ignored for a moment, the IASB and FASB have concluded that the performance obligations arising under a contract with a customer will change—and therefore revenue will be recognised—only at the point at which a performance obligation is satisfied. Remeasurement is discussed later in this appendix.*

EFRAG's comments

12 EFRAG does not agree that:

(a) revenue should be recognised only when a performance obligation is satisfied; in other words, that revenue is a measure of the fulfilment of performance obligations arising under contracts with customers; or

(b) the revenue recognition principle should be based on changes in an entity's contract asset or contract liability.

13 EFRAG accepts that the discussion paper's focus on the contract asset or liability and its proposal that revenue is a measure of the satisfaction of performance obligations arising under contracts with customers is consistent with the Framework. However, in EFRAG's view there is another model that would result in more decision-useful information being provided to users and also would be consistent with the existing Framework. Under that model, revenue would be a measure of activities carried out to fulfil contracts with customers. From this conclusion, EFRAG has deduced that the focus of the revenue recognition principle should not be on the satisfaction of a performance obligation (that is changes in the contract asset or liability). The assets and liabilities EFRAG believes should be considered and EFRAG's preferred model for revenue recognition are explained more fully in response to Question 9 and in Appendix 2.

14 Because EFRAG believes revenue is a measure of activities carried out to fulfil contracts with customers, it follows that we believe revenue arises only when a contract with a customer is in place. That is also different from the view expressed in the discussion paper which, though only dealing with revenue recognition in contracts with customers, does not state that revenue could not arise outside such a contract.

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?

Notes for EFRAG's constituents

15 *As mentioned above, the result of the proposals in the discussion paper is that revenue is recognised only when a performance obligation arising under a contract with a customer is satisfied.*

(a) *When the obligation is to provide a service, that will mean that revenue is recognised when the customer has access to the economic benefits embodied in the service, (that is the service is controlled by the customer).*

(b) *When the obligation is to transfer a good, it will mean that revenue is recognised only when the good has been transferred to the customer (that is the good is controlled by the customer).*

EFRAG's comments

16 EFRAG agrees that there are many types of transactions where the proposed principle would provide decision-useful information. However, we do not think that the proposed principle would provide decision-useful information for construction-type contracts in which the asset under construction is not transferred to the customer on a continuous basis. Nor in our view would it provide decision-useful information in the case of a contract for services where there is no continuous basis (in other words, when the service is delivered after a period of activity by the seller). In both cases the revenue recognised would cease to reflect the activity undertaken pursuant to contracts with customers, and we think that activity is what the revenue number should be seeking to measure.

17 For example, EFRAG understands that it is currently the case that, under some construction-type contracts consisting of only one major performance obligation, control of the contracted asset is transferred to the customer at a single point in time—at the end of the contract. Often that single point in time is in a later accounting period than the period in which most of the activities relating to the contract have been carried out. Under the revenue recognition model proposed in the discussion paper, no revenue on such contracts would be recognised until the end of the contract. And that would mean that no profit on the contract would be recognised until the end of the contract either, unless some other type of credit entry is made in the income statement (see the discussion in the next paragraph). That would be the case even though the entity has in fact been very busy on activities being carried out pursuant to contracts with customers prior to that. We do not think this will result in decision useful information. We think that an entity very close to satisfying a performance obligation is 'better off' than an entity that for example has not even begun the fulfilment and that this fact should be reflected in the financial statements.

18 As the discussion paper focuses on revenue recognition, it does not consider the possibility that, even though revenue is not to be recognised in the above example until the end of the contract, some other type of credit entry (or entries) might be made in the income statement prior to that. For example, one possibility might be to recognise the value of the activities of the period undertaken pursuant to a contract with a customer on a line other than revenue to ensure that profit is recognised during the life of the contract. However, we think such an approach would introduce additional complexity into the financial statements and, in any case, it would mean that some key figures and ratios will no longer provide the useful information that they currently provide. EFRAG therefore does not think this solution would be very satisfactory. It is our concerns about construction contracts in which the asset under construction is not transferred on a continuous basis that have caused us to question the fundamental principles on which the discussion paper's proposals are based. In EFRAG's view, the ultimate test of any principles for revenue recognition is whether they will result in the most decision-useful information of all the principles that are consistent with the

Framework. We do not think the principles proposed in the discussion paper meet that test. That leaves us with two alternatives:

(a) retain the principle proposed for most types of transaction, but develop a different principle for construction and service contracts in which the asset under construction is not transferred on a continuous basis; or

(b) develop a different principle that passes the 'ultimate test' and can be applied to all transactions.

As stated in response to Question 1, EFRAG would prefer that revenue recognition be based on a single principle. Therefore, EFRAG favours alternative (b). As mentioned already, EFRAG favours a revenue recognition principle that involves recognising revenue as the activity to fulfill a contract is carried out. In our view, such a principle will result in a useful measure of revenue both for construction and service contracts where no continuous transfer takes place and for other types of contracts. In practice though, recognising revenue at point of delivery (i.e. when control of the asset passes) may be—by proxy—an acceptable implementation of such a principle, for cost/benefit reasons, in industries where, for example, manufacturing processes are short.

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.***

Notes for EFRAG's constituents

19 *The IASB and FASB propose to define a contract as "an agreement between two or more parties that creates enforceable obligations".*

20 *According to the IASB and FASB this definition is consistent with the definition of a contract in IAS 32 Financial Instruments: Presentation, which is that a contract is "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts [...] may take a variety of forms and need not be in writing".*

EFRAG's comments

21 We think the IFRSs should have only one definition of a contract. It would be confusing otherwise. That would be the case even if the two definitions are believed to be consistent with each other. Therefore, either the current definition in IAS 32 or the proposed new definition should be eliminated.

22 EFRAG notes that, although the discussion paper describes the two definitions as consistent, they are worded differently. It is not clear to us how the IAS 32 definition's reference to "clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law" could be the same as the discussion paper's reference to "that creates enforceable obligations". Therefore, if the two definitions are to co-exist or if it is going to be argued that they are the same, we think it is important that the IASB explains why that is the case despite this apparently significant difference in wording.

23 Also, during its discussions EFRAG has noted that different interpretations of the term 'enforceable' exist. Whilst some think it represents what would be recognised as enforceable by the courts, others think the meaning is broader and could include economic compulsion or illegal threats. EFRAG would therefore encourage IASB to clarify this aspect of the definitions.

24 In response to the second part of the question, EFRAG is not aware of any jurisdictions in which the proposed definition would be difficult to apply.

25 Question for EFRAG's constituents: We would like to know of any difficulties constituents think there might be in applying the proposed definition in particular jurisdictions.

PERFORMANCE OBLIGATIONS

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.*

Notes for EFRAG's constituents

26 *The discussion paper defines an entity's performance obligation as "a promise in a contract with a customer to transfer an asset (such as a good or a service[1]) to that customer". The promise underpinning a performance obligation is usually stated in the contract but may also arise from the operation of law (for example a warranty).*

27 *According to the discussion paper, assessing whether a good could be sold separately in a contract with a customer is a useful way of identifying a performance obligation. Even simple contracts can involve more than one performance obligation. For example, the discussion paper explains that, in the case of a computer manufacturer selling computers, those computers consist of many parts (for example central processing unit, monitor, keyboard and mouse) that can be bought and sold separately. Moreover, the manufacturer provides the services of procuring the components that make up these parts (for example motherboard, hard drive and plastic housings) and assembling them to customer specifications. All these components and services are, in theory, separate performance obligations.*

28 *The discussion paper explains that, although in theory each performance obligation should be accounted for separately, in practice this will make a difference to the accounting only when the performance obligations are satisfied at different times. So it is only in those circumstances that separation is required to depict faithfully the changes in the performance obligations over the life of the contract.*

29 *It follows that, in the computer example above, it would not be necessary to unbundle the computer into its components or to separate out the services of procuring the components and assembling them because the manufacturer delivers the entire computer to the customer at a single point in time.*

1 For simplicity, we will generally hereafter use the word 'good' to mean 'good or services'.

EFRAG's comments

30 Although EFRAG does not disagree with the discussion paper's definition of a performance obligation, we do not think that the definition and supporting material in the discussion paper would be sufficient to enable entities to identify the deliverables in a contract on a consistent basis. For example, when EFRAG discussed the issues raised by questions 6 and 7 (that is, whether return rights, and sale incentives are performance obligations related to the existing contract) different EFRAG members interpreted the definition in different ways.

31 EFRAG members also had difficulties applying the notion to warranties. For example, if a customer goes into a hi-fi shop, buys a CD player and agrees at the same time to buy the shop's extended warranty service, EFRAG is in no doubt that two things have been purchased. Perhaps the position becomes a little less clear if, rather than buying an extended warranty, the customer buys a CD player to which is attached a statutory one year warranty, although EFRAG's tentative view is that again two things are being purchased. But what if no formal warranty terms are attached to the purchase except for a general statutory requirement that the goods should meet the specifications of the contract? It could be argued that the requirement that a good should meet the specifications of the contract is just other form of statutory warranty, although EFRAG tentatively believes that it is a necessary part of the sale of the CD player (and therefore has to be met if the transaction is not to be a failed sale). These are difficult issues and the discussion paper does not make proposals on all of them, although it does not speak of all warranties—regardless of whether they are statutory warranties or extended warranties—as separate performance obligations.

32 EFRAG's tentative view is that, conceptually, there is no difference between an extended warranty and a statutory warranty. They are both terms of the contract and they both involve separate performance obligations. However, EFRAG thinks that a line has to be drawn somewhere to distinguish a warranty from an uncompleted or failed sale, but is not sure how (or where) to draw that line.

33 For example, assume that an entity provides cleaning services and it promises that, if the work is not carried out properly / a customer is not satisfied with the job, it will be done again at no extra cost. We do not believe this guarantee is a separate performance obligation. Rather an unsatisfactory job is a failure in sales. On the other hand, assume a car manufacturer sells high quality cars that it and its customers expect will not need to be repaired for at least five years. Assume also that the manufacturer guarantees that, should the car require repairs in the first five years, they will be done for free. This sounds like a warranty arrangement (and EFRAG tentatively believes that warranty arrangements are separate performance obligations), yet EFRAG is not convinced there is really a difference of substance between this transaction and the cleaning transaction.

34 EFRAG members also had problems applying the paper's notion of performance obligations to audit and legal services, primarily because they were unsure whether there would be a continuous transfer of assets to the customers during such services. According to the discussion paper paragraph 4.38, a good is typically an asset that is transferred to a customer at a point in time, whereas a service is typically a continuous transfer of assets to a customer over a period of time. However, EFRAG is not convinced that is the case; rather we believe that there could be many exceptions to this —in other words there are many service contracts that involve a transfer of an asset to a customer only at one point in

time. Furthermore, EFRAG suspects that it will not always be clear whether and when a service is being transferred.

35 It also concerns EFRAG that IASB itself, when rejecting the so-called current exit price approach (see the discussion paper paragraphs 5.23 – 5.25), seems to acknowledge that there is a potential risk that under the proposed model entities will fail to identify performance obligations at contract inception.

36 For all these reasons, we do not think that the IASB's proposed definition of a performance obligation—including the focus on what has been promised—would by itself help entities to consistently identify the deliverables in (or components of) a contract. However, we think some carefully targeted further guidance and the development of practice in the area over time could eventually result in a consistent application of the proposed model. We think it would be particularly useful to explore further through additional guidance the difference between a sale where the entity has not transferred an asset meeting the requirements of the contract (which in our view, at least in some cases, should be regarded as a failed sale) and a sale with a statutory warranty attached where the warranty is later invoked (which we think would—at least in some cases—be treated as a (successful) sale).

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?

Notes for EFRAG's constituents

37 *As already explained (in paragraph 27 above) the discussion paper explains that, although in theory each performance obligation should be accounted for separately, in practice this will make a difference to the accounting only when the performance obligations are satisfied at different times. The objective of separating performance obligations is to ensure that an entity's revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract and it is only when the performance obligations are satisfied at different times that separation is required to depict faithfully the changes in the performance obligations over the life of the contract.*

EFRAG's comments

38 EFRAG agrees that, under the model proposed in the paper, the objective should be to depict faithfully the changes in the performance obligations over the life of the contract. EFRAG also agrees that, although in theory an entity should always separate performance obligations in a contract and account for them separately, this is necessary in practice only when non-separation would mean that changes in the performance obligations over the life of the contract would not be depicted faithfully.

39 EFRAG also agrees that one circumstance in which the changes will not be depicted faithfully if there is non-separation is when the separate performance obligations are not all satisfied in the same period.

40 However, EFRAG thinks another circumstance in which separation might be necessary to achieve a faithful depiction is when onerous performance obligations might be involved. Much depends on the level at which the onerous

contracts test is to be performed but, under some scenarios where the onerous test is carried out on a performance obligation level, profit would be affected if performance obligations are not separated.

41 Although we think it would be preferable were the position made clear, our assumption is that the IASB's intention is that the onerous contract test should be carried out at the contract level for the remaining part of the contract. If that is the case, profit would be unaffected by whether or not performance obligations had been separated, so we would support the paper's proposals on the separation of performance obligations. (Onerous contracts are discussed further under Question 10(b).)

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?*

Notes for EFRAG's constituents

42 *Goods sold with a right of return are discussed in paragraphs 3.34 – 3.42 of the discussion paper. The paper notes that some regard a customer's right to return the goods 'bought' for any reason (as long as they are still in good condition) as a separate performance obligation and some others regard it as not involving a sale unless and until the right lapses.*

43 *In support of the view that return rights are separate performance obligations, it can be argued that the right of return is a service that is transferred to the customer. In some transactions it is clear that customers pay a premium for that service.*

44 *If a return right is a separate performance obligation, part of the consideration received from the sale that includes the return right would need to be allocated to the performance obligation relating to the right to return and should not be recognised as revenue until that performance obligation is satisfied (ie until either the right expires or is exercised).*

45 *In support of the view that a sale does not arise unless and until the right lapses (the 'failed sale approach'), it can be argued that an extant right of return is an indicator that the customer has not yet accepted the entity's proposed contractual terms or the goods or services themselves because the customer still has the ability to unwind the transaction with impunity. If an extant return right means that a sale has not yet taken place, to account for transactions that include a return right it would be necessary to:*

(a) determine or estimate whether and when each return right has elapsed, because it is only then that the sale has taken place. According to the discussion paper, it may be possible (if many homogeneous goods are involved) to estimate the proportion of the goods that is likely to be returned. Revenue could then be recognised for those transactions for which the right of return is expected not to be exercised.

(b) determine whether—until the right of return expires, lapses or is exercised—the goods involved should be recognised on the seller's balance sheet or the customer's balance sheet.

46 *The discussion paper does not reach a conclusion on whether a return right is a separate performance obligation.*

EFRAG's comments

47 EFRAG recognises that this is a very difficult issue and there are good arguments both for the failed sale approach and for the separate performance obligation solution. However, on balance EFRAG thinks that return rights will usually and perhaps always be separate performance obligations.

(a) Firstly, we believe that, if control of the good has passed to a customer, a performance obligation has been satisfied and revenue should be recognised—even if there is a return right. In that case the related return right should be treated as a sold option (in other words, as a separate performance obligation). (We discuss the issue of when control passes—and whether the existence of a return right can in some circumstances prevent control passing—further in our response to Question 8.)

(b) We are unconvinced by the argument that the existence of a return right is some sort of indication that the customer has not yet accepted the entity's proposed contractual terms. If this was the case, no contract would exist until the unexercised right expires or lapses and in that case the entity would also be able to require the customer to return the goods. The fact that the entity is not able to do so is evidence that a contract enforceable on the entity exist.

48 In the view of EFRAG, the return right is an option – a term included in the contract associated with the asset transferred (a sub-contract) that should be accounted for as a separate performance obligation if the service inherent in the option is transferred to the customer at a different point in time than the main asset of the contract. The fact that the performance obligation related to the return right represents the service of the option, the performance obligation does not for example reflect costs associated with putting returned goods back on the inventory shelves or handling the cash for reimbursement.

49 On the other hand, EFRAG is also concerned about some of the practical implications of regarding return rights as separate performance obligations.

(a) We have already mentioned that a key issue for us is whether control of the goods has passed from the entity. Therefore, for us much depends on how the term 'control' is interpreted. (This is an issue discussed briefly in our response to Question 8) In this context, some would argue that the existence of return rights can affect the existence or otherwise of control, and if that is the case generalised comments about return rights could not be made.

(b) We have during our debates explored various types of consignment stock arrangement, which are standard practice in some industries (including for example car sales and book sales). It seems to us that these transactions often do not involve sales, yet if the return rights are separate performance obligations that is how they will be treated. We think this too might be about the meaning of control.

(c) We mentioned earlier (in our response to Question 4) that we believe that, if a good is delivered and found not to meet the specification of the contract, no sale has taken place. In which case no revenue should be recognised. In our view that should be the case regardless of whether the rejection is achieved by exercising return rights that exist. It follows that it is important to differentiate effectively between the use of return rights because the goods do not meet the specification in the contract and the use of return rights for other reasons.

Question 7—*Do you think that sales incentives (eg 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?*

Notes for EFRAG's constituents

50 *The discussion paper discusses two examples of sales incentives. In the first example, an entity gives a customer purchasing a music player a gift card to download music worth a specified amount from its website. In the second example, the entity offers a customer that purchases a music player a fixed per cent discount on its online music for purchases up to a specified amount.*

51 *So in both cases, the entity is entering into a contract to transfer online music at a discount (indeed, in the first case the transfer price will be zero) to the customer should the customer request such a transfer.*

52 *The issue here is that, if the sales incentives are separate performance obligations, part of the consideration received from a sale including the incentives should be allocated to those separate performance obligations and accordingly not be recognised as revenue until those performance obligations are met.*

53 *While most would probably agree that the gift card to download music worth a specified amount would be a separate performance obligation, different views exist in relation to the discount.*

(a) *Some think the promise to offer a discount is not a performance obligation as the customer must pay an additional amount to obtain the online music. Under this second view, some argue that it follows that the promised discount relates only to a future contract, and is therefore not a performance obligation in the existing contract.*

(b) *Others think that a promise to transfer online music at a discount is a performance obligation. They think that the right to be able to receive a future discount is an option and that this option is an asset as it could be sold separately. However, the measurement could differ from the measurement of the free gift cards.*

EFRAG's comments

54 EFRAG thinks that in the gift cards example, the gift card is a separate performance obligation. EFRAG's reasoning is that, when purchasing a music player, the customer at the same time receives an unconditional and enforceable right to download a certain amount of music. That right could be sold separately. It follows that the transaction involves two performance obligations: one relating to the music player and one relating to the download right.

55 However, EFRAG members have differing views on how to account for the discount in the example. We agree that the offer of a discount on future

purchases is part of the contractual terms related to the first purchase and this part of the contract has been accepted by the customer. We therefore believe that the first transaction does involve two elements: the sale of the music player and the sale of an option (the right to buy future downloads at a discount). We note that this option is not a contract (an obligation for the customer) to buy the music as this offer has not yet been accepted by the customer. The issue is therefore how to account for the option sale. We believe the sale of the option involves a separate performance obligation. The entity would have a performance obligation to give the customer a discount on future music purchases. We are, however, not sure whether or not to recognise—or measure at an amount different from nil—this performance obligation unless it is onerous.

(a) On the one hand, we can see that many practical issues would arise in trying to recognise and measure the obligation. This is partly due to the fact that it is often possible to negotiate a discount. Furthermore, sometimes the discounts offered are discounts from a price that no transactions ever take place at. It can also be difficult to determine when exercised options have lapsed (and thus when the performance obligation can be derecognised). When this is said, we would recognise a performance obligation if the offer would be so beneficial that this part of the contract would be loss generating.

(b) On the other hand, when the option has a value, we think that it would be in line with the requirements of the discussion paper dealing with how to allocate the transaction price to recognise a performance obligation for the offered discount. Furthermore, we note that the effect of not recognising a performance obligation would appear to be that the entire transaction price is recognised as revenue when the first transaction takes place. Thus, the sale of the music player with the offer of future discounts attached would be treated as being as profitable as a sale of the same music player for the same total contract price; even though the sale with the discount offer attached will compel the entity to sell the downloads more cheaply. Furthermore, the subsequent sale of those downloads would seem less profitable—even though the discount on the music was necessary in order to be able to sell the music player. In other words, it could be argued that it would front load revenue and profit recognition if no performance obligation is recognised in relation to the offered discount.

56 Question to EFRAG's constituents: We would particularly welcome comments on this issue. How would you analyse the transaction and why? And what are the consequences for the way it should be accounted for?

57 The issue discussed above is whether particular types of sales incentives involve separate performance obligations, but we think it is also important to consider whether sales incentives represent revenue generating activities or should be regarded as marketing. If it is marketing, EFRAG's view is that it should not lead to the deferral of revenue.

SATISFACTION OF PERFORMANCE OBLIGATIONS

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

Notes for EFRAG's constituents

58 *According to the discussion paper, revenue is recognised when a performance obligation is satisfied. A performance obligation is deemed to be satisfied when the asset in question has been transferred to the customer. An asset is said to have been transferred to a customer when the customer controls it (because that will mean the entity no longer has control of it). Usually, though not always, that will be when the customer takes physical possession of the good.*

59 *In the case of a service, an entity satisfies the performance obligation when the customer has received the promised service. The approach for assets (described in paragraph 58) is different from that in existing IAS 18, where whether the sale of goods has taken place depends largely on when the risks and rewards of ownership of the goods are transferred to a customer. The discussion paper argues that a test based on who has the preponderance of the risks and rewards can be difficult to apply, and a focus on control results in more consistent decisions about when assets are transferred.*

60 *The different approach could, for example, affect when to recognise revenue related to sales with a right to return. The discussion paper contains an example where an entity, to encourage customers to make purchases allows the customers to return the goods bought within 30 days of purchase and to receive a full refund of the purchase price. In this example the transfer of controls takes place when the goods are delivered. In contrast, the risks and rewards of owning the goods are not entirely transferred at that time. The entity still bears the risk that goods that will be returned will have a reduced value for the entity.*

EFRAG's comments

61 EFRAG notes that, in the existing Framework, an asset is defined as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." It follows from that, that a resource will cease to be a particular entity's asset when that entity no longer has control of the resource.[2] EFRAG therefore agrees with the discussion paper that, under the existing definition of an asset, an entity should derecognise an asset when it no longer has control of that asset. We also agree that the point in time in which an asset is derecognised (as a result of a transfer) is the point at which the performance obligation has been satisfied and revenue should be recognised.

62 However, we think that stating that derecognition should take place when control is lost will only take us so far, because the notion of 'control' is not well understood—and is not viewed in the same way by all people. We can foresee some problems arising if the proposal as currently drafted is implemented. For example:

2 It will also cease to be a particular entity's asset when it ceases to be a resource, but we are only discussing sales here and a resource ceasing to be a resource—because for example it has expired—is not an issue that is relevant in this context. Also, the Framework says that an item that meets the definition of an asset should be recognised if (a) it is probable that any future economic benefit associated with the item will flow to the entity and (b) the item has a cost or value that can be measured with reliability. It could be argued that an asset should cease to be recognised if either (a) or (b) is no longer met, but again that is not an issue that has particular relevance to the issue being discussed.

(a) Some argue that the risks and rewards test in IAS 18 is simply an attempt to implement a control-based test. They would therefore argue that the discussion paper is wrong to see control and risks and rewards as alternatives. We suspect that the IASB is hearing a similar argument from some constituents commenting on the control notion in ED 10 *Consolidated Financial Statements*. It is certainly a view we share to some extent.

(b) The recent ED *Derecognition* raises a number of issues about the control notion described in this Discussion Paper. For example, in the ED if one entity transfers a financial asset to a second entity in circumstances that mean that the second entity does not have the practical and unilateral ability to dispose of the transferred asset, the first entity still has control of the asset and should continue to recognise it. One circumstance in which the second entity might not have control of the transferred asset is when the entity has a valuable put option. We think this is analogous in many ways to a transaction in which an entity transfers goods to a customer as part of a sales transaction, but also grants that customer return rights. Yet paragraph 4.12 appears to argue that in such circumstances the second entity/customer has control of the transferred asset.

(c) We mentioned earlier in this letter the consignment stock arrangement that is a common transaction between car manufacturers and car dealers. We also mentioned the sale-or-return arrangement that is common between book publishers and bookshops. In both these transactions, if control of the inventory has deemed to have past to the car dealer/bookshop, the discussion paper would appear to concluding that a sale has taken place and revenue should be recognised. However, at least some of these arrangements are not in our view in substance a sale. We are not sure whether that means that control has not actually passed, or whether control is not the ultimate test.

Notwithstanding the above, we agree that, unless and until IASB changes the definition of an asset, the test has to be control-based. It is just that we think the basic principle will need to be supplemented by guidance that illustrates the principle if it is to be applied consistently.

63 It is common for a sales transaction to involve the entity delivering, on the customer’s instruction, the goods or services to a third party. In such circumstances, it might be that the customer controls the goods or services just before they are transferred to the third party or it might be that, although the goods or services are being delivered to the customer’s instructions, the customer never actually controls them. We think it important that the wording the IASB uses in the ED to describe the control notion takes into account such possibilities.

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.

Notes for EFRAG’s constituents

64 *As previously explained, the discussion paper proposes that the new revenue recognition principle should focus on net increases in the contract asset and net*

decreases in the contract liability. A change in the net contract position (the contract asset minus contract liability) can occur because of:

(a) *some act of performance by the customer (for example the contract asset and the net contract position decreases when a customer pays some or all of the contract price). However, the discussion paper argues that such acts of performance by the customer do not result in revenue being generated (because they would result in a decrease in the net contract position),*

(b) *some act of performance by the seller (for example when the entity provides goods or services the contract liability decreases and the net contract position increases). The discussion paper argues that an act of performance by the seller will cause the contract liability to decrease—and therefore the net contract position to increase—only if that act results in a performance obligation being satisfied, because it is only then that the performance obligation in the contract will decrease, or*

(c) *remeasurement (if the contract asset/liability is subject to remeasurement).*

Depending on the measurement of the contract asset and contract liability, the net contract position could also be positive on initial recognition if the contract asset exceeds the contract liability at contract inception. However, measurement and remeasurement are discussed later in this letter, so it is not considered further here.

65 *Thus, the model proposed in the discussion paper is that revenue is recognised only when an entity satisfies a performance obligation in a contract.*

(a) *In the case of a contract to sell a good, the entity satisfies its performance obligation when it transfers control of that good to the customer.*

(b) *In the case of a service, an entity satisfies its performance obligation when the customer receives the promised service (or access to the promised service).*

66 *Consequently, activities that an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer economic resources to the customer. In a construction-type contract for the creation of an asset for a customer, the performance obligation is satisfied during construction only if resources are transferred to the customer as construction progresses. This would be the case only if the customer has or acquires control of the asset as it is being constructed. In other cases, revenue would not be recognised only at the end of the contract.*

EFRAG's comments

67 EFRAG agrees that an act of performance by the customer (for example, paying the contract price) does not result in revenue being generated. However, as mentioned earlier, EFRAG has some fundamental concerns with the approach proposed in the discussion paper.

68 EFRAG notes that the proposal could result in a significant change to existing practice, with the recognition of revenue occurring much later than at present on some (but not all) construction-type contracts and service contracts. As the objective of financial statements is to provide decision-useful information to users

of financial statements, we have been considering whether this accounting effect would result in more decision-useful information than existing standards. It has been difficult to do this because the paper itself does not discuss the issue. Nor does it explain why the line 'revenue' of the income statement/statement of comprehensive income is important and what purpose it is intended to fulfil. We think this is a weakness of the paper.

69 Our tentative view is that the proposed model results in a reduction in the usefulness of the revenue number for construction-type and service contracts that do not involve a continuous transfer of the asset being constructed to the customer. As already mentioned, we recognise that the value of the activities of the period could be reported on another line than is not revenue but we think that approach would be problematical and would address some of the issues that would arise concerning the effect the paper's proposal would have on some key figures and ratios.

70 In EFRAG's view the revenue number is at its most useful when it measures the activity undertaken in fulfilling a contract with a customer (see our response to Question 2). For that reason we believe that the activity undertaken pursuant to a contract with a customer should be the underlying revenue recognition principle. This revenue recognition model is further explained in Appendix 2.

71 We have so far expressed our concern solely in terms of those types of construction contract in which the asset under construction is not transferred on a continuous basis, because in those cases revenue recognition in accordance with the principles in the discussion paper will be significantly out of line with the activity carried out pursuant to the contract. Our concern though is a generic one; we think the most decision-useful revenue number is one that represents a measure of activity in fulfilling a contract with a customer; in all circumstances in which the discussion paper's proposals do not approximate to that number, they are unsatisfactory.

MEASUREMENT OF PERFORMANCE OBLIGATIONS

Question 10(a) -- Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

Notes for EFRAG's constituents

72 *The discussion paper proposes that the rights arising under the contract should be measured at an amount equal to the transaction price. In other words, the rights to consideration should be measured at the value of the consideration to be received.*

73 *The discussion paper also proposes that the performance obligations should at contract inception be measured at an amount equal to the transaction price. This measurement approach is referred to in the paper as the 'original transaction approach'.*

74 *Thus, at contract inception (that is, before either party has performed), the rights and performance obligations in the contract will be measured at the same amount and will therefore offset each other; meaning that no revenue would be recognised at that point.*

75 *The discussion paper discusses an alternative approach to the measurement of the performance obligations, the so-called current exit price approach. Under this approach, performance obligations would be measured on initial recognition at the amount the entity would be required to pay to transfer those obligations to an independent third party at the reporting date. The IASB and FASB rejected this approach for three main reasons.*

(a) First of all, it might result in the recognition of day one revenue; something that the IASB and FASB would be uncomfortable about, bearing in mind at that point no contract activity has taken place and nothing promised in the contract has been transferred to the customer.

(b) A second, and related, concern was that, if some performance obligations were not identified, day one revenue would be recognised.

(c) The third reason was that the current exit price approach would be more difficult to implement than the original transaction price approach, and the benefits that would arise were unlikely to be sufficient to justify the resulting additional costs.

However, although the majority of IASB members favour the original transaction price approach, the IASB is somewhat divided on this issue.

EFRAG's comments

76 We have stated previously that we believe that revenue should be some sort a measure of activity carried out in fulfilling a contract with a customer. It follows from this that no revenue should be recognised on contract inception as a result only of the fact that a contract is profitable, which in turn means, under the proposal in the discussion paper, that on contract inception the contract asset and contract liability should be measured at the same amount. We agree with the proposal that the contract asset should be measured at the original transaction price. It follows from all of this that we believe that the performance obligations should be measured initially at the original transaction price.

77 We recognise however that the issue raised in this question is part of the broader issue of how to measure liabilities. We think that, in order to make the use of IFRS less complicated, it is important that IFRS standards are consistent and that issues are treated in the same way from standard to standard (cross-cutting issues). We have therefore discussed the measurement of performance obligations on initial recognition (and subsequently) in the context of liability measurement generally.

(a) Therefore, a key issue that needs to be addressed is whether a liability that represents a performance obligation arising from a contract with a customer should be measured on the same basis as other liabilities; for example, a financial liability or a litigation liability or a liability arising from an insurance contract. This issue is not discussed in the discussion paper, which is probably a missed opportunity to discuss a fundamental cross-cutting issue that underlies a number of active projects. We encourage IASB to tackle this issue.

(b) We would nevertheless note that, at least on the face of it, the proposals in the discussion paper are rather different from those set out in the IASB's 2007 Discussion Paper *Insurance Contracts*. That paper, for example, proposed an approach to liability measurement that was a type of current exit price approach. When we responded to that discussion paper, we did not express a view on the exit value approach proposed because we thought it difficult to comment on the proposal without getting into profit recognition issues, and we did not believe the paper provided a satisfactory basis for such a discussion. It needs also to be recognised that the Insurance Contracts paper did not deal with revenue recognition (although it did address profit (or income) recognition). We recognise that recognition of income and of revenue is not the same thing.

78 In reaching the view that the performance obligations should be measured initially at transaction price, we have focused primarily on the conceptual arguments and the decision-usefulness of the resulting information; we have not considered the practical implications. Nor have we debated what a current exit price approach would provide in terms of information to the users. However, we agree with the comment in the discussion paper that the current exit price approach appears to be more complex than the original transaction price approach—we think it appears to be much more complex.

79 Incidentally, we are concerned about the second argument the boards have used in favour of the original transaction price approach (see paragraph 75(b) above); that the exit price approach would mean day one revenue if all the performance obligations are not identified. We think that, if there is a real risk of not identifying a performance obligation, there are bigger problems with the model proposed than just measurement. This issue is discussed further in our response to Question 4.

Question 10(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?

Notes for EFRAG's constituents

80 *According to the model proposed in the paper, the initial measurement of a performance obligation should not subsequently be updated unless the performance obligation has been satisfied (in which case it would be derecognised) or the obligation is deemed onerous.*

81 *The discussion paper then considers when a performance obligation should be treated as onerous. It considers two main triggers for identifying an onerous performance obligation:*

(a) *A cost trigger (see IASB's discussion paper paragraphs 5.61 – 5.66). Under this approach a performance obligation is onerous when the expected costs of satisfying that performance obligation exceed its carrying amount. This is the current approach in IAS 11. It means that an obligation is not impaired as long as it is not expected to result in a loss; and that the fact that the expected amount of profit will not be earned does not necessarily mean that there is an impairment.*

(b) *A current price trigger (see IASB's discussion paper paragraphs 5.68 – 5.72). Under this approach a performance obligation is onerous if the obligation's carrying value is lower than the lower of (a) the amount to transfer the obligation to a third party at the financial statement date and (b)* *the amount to settle with the customer at that date. This is the approach currently adopted in IAS 37. As the transfer value would include a profit margin, this trigger will more often lead to a contract being deemed onerous than when a cost trigger is used.*

82 *Paragraph 5.64 of the discussion paper expresses the concern that a consequence of a cost trigger is that any margin in the measurement of the performance obligation acts as a buffer to absorb adverse changes in the performance obligation. As a result, an adverse change in expected costs first reduces future profits rather than current profits. The paper notes that the current price trigger approach does not have this problem, but is likely to be complex and costly to apply. Indeed, the paper concludes that a current price trigger approach would be unnecessarily complex for most contracts with customers and therefore favours the cost trigger approach.*

83 *The discussion paper also proposes that, if a performance obligation is deemed to be onerous, it should be re-measured to the expected cost of performance.*

EFRAG's comments

84 EFRAG believes that both of the triggers discussed in the paper have weaknesses. The fact that a cost trigger can result in an entity recognising adverse changes in circumstances in periods after the period in which the changes occur means that it might not result in timely information being provided to users of financial statements. On the other hand, the current price trigger approach is likely to be costly to apply.

85 For those reasons, EFRAG has discussed other possible models for identifying an onerous performance obligation. However, none of the other models discussed seemed any better. Therefore, the choice does indeed seem to be between the two approaches discussed in the paper. Of those approaches, EFRAG favours the cost trigger approach, because it is practicable; in other words we agree that a performance obligation should be deemed onerous if the expected cost to satisfy the obligation exceeds the carrying amount of the obligation.

86 Bearing that in mind, we also agree with the proposal in the paper that a performance obligation that is deemed onerous should be remeasured to the entity's expected cost to satisfy the performance obligation.

87 In our response to question 5, we discussed briefly the level at which the onerous 'contract' test should be performed. For example, should it be at the level of the performance obligation or at the level of the contract. We stated then that we were assuming that the paper intends it to be applied at the level of the remaining contract. Finally, we think it is important that, whatever model IASB chooses, there is consistency between it and the model in the revised version of IAS 37.

Question 10(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 characteristics of the obligation make that approach unsuitable? Please provide examples.

Question 10(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.

Notes for EFRAG's constituents

88 *As stated above, the discussion paper proposes that the initial measurement of a performance obligation should not subsequently be updated unless the performance obligation is satisfied (in which case the performance obligation would be derecognised) or is deemed onerous. However, some IASB members do not think that this measurement approach will provide useful information for all contracts/performance obligations.*

89 *The IASB's debate has considered whether some of the following types of contract should be measured differently on initial recognition and/or subsequently remeasured, for example, at their current exit price.*

(a) *Long-term, fixed price contracts for goods and services having volatile prices (for example a take-or-pay contract for power or a commodity).*

(b) *Contracts in which the eventual outcome depends on specified uncertain future events (for example many guarantees, warranties, contracts with customer options and other stand ready obligations, particularly if longer-term).*

(c) *Long-term contracts involving big ticket items, such as large construction projects, where relatively small variations in circumstances can be significant to an entity's cash flows and perhaps therefore should be reported as they arise and not just when they result in an onerous performance obligation.*

90 *For similar reasons (and other reasons), the IASB has also considered whether some or all of the following contracts should be excluded from the scope of the standard:*

(a) *Financial instruments and some non-financial instrument contracts that otherwise would be in the scope of standards such as IAS 39 Financial Instruments: Recognition and Measurement. In the IASB's view, because of the potential volatility in the value of those contracts, the proposed revenue recognition model might not always provide decision-useful information about them.*

(b) *Insurance contracts that are in the scope of IFRS 4 Insurance Contracts. The IASB/FASB have an active project on the agenda for insurance contracts. In the IASB's view, the proposed revenue recognition model might provide decision-useful information for some contracts that the insurance project is considering, but not all of them.*

(c) *Leasing contracts that are in the scope of IAS 17 Leases. IASB/FASB have a joint project on the agenda for lease accounting, but one concentrating initially on developing an improved lessee accounting model. The boards have not yet decided how the proposed revenue recognition model would apply to lessor accounting.*

91 *The boards have not reached a preliminary view as to whether and if so how to apply the methodology proposed in the paper ('the allocated transaction price model') to the types of contract mentioned in paragraphs 89 and 90 above.*

EFRAG's comments

92 It is perhaps worth starting by reminding ourselves that a key objective of this project is to develop a single, universally-applicable revenue recognition principle. EFRAG supports this objective, as we explained in our response to Question 1.

(a) In a principles-based financial reporting system, it would be odd to have more than one notion of what revenue represents and when it arises.

(b) There are also good practical reasons to have a single principle. In particular, if there is more than one principle, it will be necessary to draw some sort of line between those transactions that should be accounted for using one principle and those that should be accounted for using the other. Boundaries of this type seem almost inevitably to lead to complexity and to comparability issues. It can also be difficult knowing which principle to apply to new types of transaction.

93 If it is decided that the principle in the paper does not work well for certain types of contract, we either have to find a 'better' principle or accept that the goal of a single, universally-applicable revenue recognition principle is not achievable in practice, at least for the time being. And, if we conclude that it is not possible at the current time to have a single, universally-applicable revenue recognition principle, we need to consider whether it would be better, in the circumstances, to continue to use the existing IFRS model (with two principles), perhaps supplemented by additional guidance.

94 We have already explained that in our view it would have been preferable to adopt a revenue recognition principle that involves recognising revenue as the contract progresses. We think that principle could deal with some of the concerns underlying the types of contract listed in paragraphs 89 and 90 above. However, we accept that the principle would not eliminate the concerns.

<u>Paragraph 89 items</u>

95 EFRAG's understanding is that the concerns underlying the contracts listed in paragraph 89 relate to whether the approach proposed in the paper, with its focus on original transaction price and remeasurements only if obligations become onerous, is able to cope satisfactorily with contracts where there is significant uncertainty as to the outcome (in terms of overall contract profitability). It is, we understand, these types of contract that have led some IASB and FASB members to argue for a current exit price model and remeasurement of performance obligations rather than an original transaction price.

96 We should also state that we are not persuaded that, in every circumstance in which there is significant uncertainty, the approach that results in the most useful information will always involve remeasurement. Indeed, we think that remeasurement can sometimes have the effect of obscuring the uncertainty that exists. Furthermore, we think it is important to differentiate, on issues such as this, between revenue recognition and income (or profit) recognition. For example, it might be that changes in expectations about future outcomes are an income recognition event, but not a revenue recognition event. Thus, the

measurement approach that might be best for the performance obligation might not be the measurement approach that is best for revenue recognition because, although all these issues have tended to be related in the past, it does not follow that they should continue to be related—or at least related in the same way.

97 Bearing all these things in mind, we are not convinced that any of the types of contract mentioned in paragraph 89 above raise concerns that cause us to believe that a different revenue recognition and measurement model to the one proposed in the discussion paper is necessary. On the other hand, we think it worth exploring whether the performance obligations themselves would in these circumstances be more usefully measured using a different alternative measurement basis. We think they may.

98 However, again, even though a different basis of measurement for some performance obligations would be necessary in order to provide decision-useful information, this should not affect how revenue is measured. In the view of EFRAG, the measurement of revenue should reflect the amount an entity receives in consideration for its transfer of an asset to the customer. Revenue should therefore for example not reflect increases or decreases in the costs to satisfy a performance obligation. In other words, if a performance obligation is measured using a different approach than the original transaction price, this measurement should not be used for revenue recognition purposes. Instead revenue recognition should be as if the performance obligation had been measured at the original transaction price. This approach would require that an entity record (but not necessarily present or disclose) the original transaction price for revenue measurement purposes even when it measures it performance obligation at another amount.

Paragraph 90 items

99 We see the items listed in paragraph 90 above (financial instruments, insurance contracts and lease contracts) in very different terms to the paragraph 89 list (contracts with significantly uncertain outcomes). That is primarily because the paragraph 90 items are industry-specific and the IASB is currently carrying out major projects to develop comprehensive standards for those contract-types. We believe, as we have said already, that for conceptual and practical reasons it would be best if a single approach applied to all transactions, regardless of industry, but we also think it would be wrong simply to assume—or to take quick decisions without considering the issues in a comprehensive way—an approach developed with more generalised types of contract will necessarily also work for these industry-specific transactions. More work is needed on the industry-specific areas first.

100 On the other hand, we recognise that it could be argued that, if one wants a single, universally-applicable principle, decisions in this revenue recognition project should be deferred until the insurance, leasing and financial instruments projects have got further—because otherwise we run the risk of developing principles that will need to be changed when those projects are complete. The existence of cross-cutting issues of this type is of course a fact of life for all standard-setters, and they just have to find a balance that enables them to achieve progress and at the same time an increasing degree of consistency.

101 Bearing all this in mind, our tentative view is that for the time being the following performance obligations should not be within the scope of a revenue recognition standard:

(a) *Performance obligations that would be within the scope of IAS 39 Financial Instruments: Recognition and Measurement*. Although many financial instruments would not meet the definition of a performance obligation as defined in the discussion paper—for example because the contract is not with a customer as defined—we think some performance obligations could be financial instruments. We do not think that it would help the understandability and decision-usefulness of the information to account for financial instruments differently depending on whether they meet the definition of performance obligation.

(b) *Insurance contracts*. As we have already mentioned, the IASB has a major project on the accounting treatment of insurance contracts, and one of the key issues being considered in that project is how to measure insurance liabilities and what implications this has for the income statement. We think that, until that work is further advanced, all performance obligations relating to insurance contracts should be scoped out of the revenue recognition standard.

(c) *Leasing contracts.* Again, a major project on leases is underway and our view is that, until this work is further advanced, performance obligations in relation to leasing contracts should probably be excluded from the scope of a revenue recognition standard.

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.

(d) ***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?***

(e) ***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.***

Notes for EFRAG's constituents

102 *According to the proposed model, a performance obligation is at contract inception measured at an amount equal to the transaction price. That is also the amount at which the rights are measured. At least two implications arise from this. First of all, at contract inception (i.e. before either party has performed), a contract is measured at a nil amount (because the contract asset and contract liability are measured at the same amount) and no revenue is recognised at that point. Secondly, it means that the whole of the revenue will be attributed to the fulfilment of future obligations; in other words, no revenue will be attributed to the recovery of pre-contract costs or to contracts incurred on entering into the contract (ie commission payments). Such costs would be expensed immediately.*

EFRAG's comments

103 As already mentioned, EFRAG agrees with the paper's proposals that, on contract inception, both the contract asset and contract liability should be measured at the original transaction price. We further agree that an entity should recognise pre-contract costs and any costs involved in obtaining the contract (including commissions) as expenses as they are incurred unless they qualify for recognition as an asset in accordance with other standards.

104 However, we understand why some are concerned about the proposal that, even though the original transaction price will have been set so as to recover certain pre-contract costs and contract acquisition costs, none of that price will be recognised immediately to 'match' those costs. It means, for example, that losses could arise in the early years of a profitable contract. It also means that an entity that is expanding will seem less profitable than one that is shrinking. However, in the view of EFRAG, regardless of how the price has been calculated, it is being earned by satisfying performance obligations and should therefore be recognised only as those obligations are satisfied. To do otherwise would be inconsistent with the view that revenue is some sort of measure of activity undertaken in pursuant of a customer contract.

105 EFRAG has specifically considered if, for example, revenue could in some way be allocated to commissions paid to an agent in relation to the acquisition of an insurance contract. EFRAG does not think that this would be in accordance with the model proposed in the discussion paper, because no performance obligation is fulfilled at that point. Some believe that this is another reason why basing revenue recognition on the fulfilment of performance obligations is not appropriate.

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 price of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Notes for EFRAG's constituents

106 *The discussion paper proposes that, if there is more than one performance obligation in a contract and it is necessary under the proposals to unbundle the contract into the underlying performance obligations, the total transaction price should be allocated to the individual performance obligations.*

107 *This could be done on a number of different bases. It could, for example, be on the basis of the current exit price of the promised goods and services or on the entity's expected cost of the promised goods and services. However, the discussion paper proposes that this is done on the basis of the relative stand-alone selling prices of the promised goods and services underlying each performance obligation at contract inception.*

108 *If the entity itself sells the good or service separately, the relative stand-alone selling price would equal the price charged in those circumstances. However, when neither the entity nor any other entity sells the good or service separately, the entity would have to estimate the relative standalone selling price (see Question 13).*

EFRAG's comments

109 EFRAG agrees with this proposal. We also think that, generally speaking, stand-alone selling prices ought also to be readily available and the method ought to be relatively simple to apply.

110 We have, though, debated at some length what the reference to the entity's stand-alone selling price might mean in certain circumstances. For example, we think that in many cases a stand-alone selling price would depend on the customer, so it is necessary to decide whether to account for this 'customer' effect. We think the stand-alone selling price is referring to the price the entity would have charged the customer, if that particular customer—and not any other customer—would have bought the good or service separately. We have reached that conclusion because in many cases it is likely to be impossible to estimate a stand-alone selling price without taking the customer into account. However, we think it would be useful if the ED could clarify the IASB's intentions.

111 We have also considered the situation in which the stand-alone selling price does not fully reflect the cost associated with providing an unbundled good or service. For example:

> Assume a translator works for an entity under conditions where the control of the work performed is transferred to the customer on a continuous basis (for example because the customer owns the computer the translator is working on). The translator charges a fixed price per page to be translated no matter how many pages are to be translated. This price is therefore the translator's stand-alone selling price per page. If a customer has more than one page to be translated, the translator will not receive payment until all pages have been translated. However, the translation of each page could be sold separately, so the proposals in the discussion paper would require revenue to be recognised on a page by page basis. In this situation the model of the discussion paper would allow the translator to choose to translate the easiest pages first (ie those that involve the lowest cost) and to recognise revenue related to the translated pages based on the fixed stand-alone selling price per page even though all pages have to be translated before the translator would receive payment.

112 In exploring this example we have asked ourselves whether the paper's proposal would provide decision-useful information under these circumstances. We think it would. Even though the translator will also have to translate the more difficult pages before receiving the payment related to the more easy pages, the revenue on the easier pages has to be recognised at the time when these pages are translated and that the profit margin is higher when these pages are translated. Accordingly, this higher margin should also be reflected in the income statement /

statement of comprehensive income when the translation of the easy pages occurs.

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?

Notes for EFRAG's constituents

113 *According to the discussion paper, if an entity does not itself sell a good or service separately, it should estimate the price for which it would sell the good or service to its customers. Various methods can be used, and the paper does not preclude or prescribe any particular method as long as it is consistent with the stand-alone selling price basis. The paper suggests, however, that observable inputs should be maximised regardless of the estimation method.*

114 *The paper also describes two suitable estimation methods: 'expected cost plus a margin approach' and 'adjusted market assessment approach'.*

(a) *The expected cost plus a margin approach is an approach where the entity forecasts its expected costs of satisfying a performance obligation and then adds the margin that the entity typically requires on other similar goods and services.*

(b) *The adjusted market assessment approach is an approach where the entity examines the market in which it regularly sells goods and services with the purpose of estimating the price that customers in that market would be willing to pay for those goods and services. The approach could also include referring to quoted prices from the entity's competitors and adjusting them as necessary.*

EFRAG's comments

115 EFRAG agrees with the discussion paper 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.

116 EFRAG thinks that what the paper then goes on to propose is reasonable and pragmatic. Indeed, we think the only practical alternatives to the proposal would be to either prohibit—or at least not require—unbundling of contracts consisting of goods and services that are not also sold separately or to base unbundling on expected cost. EFRAG does not find these alternatives more attractive than the proposal.

Other issues

Notes for EFRAG's constituents

117 *IASB/FASB have chosen not to address all issues related to the topic in the discussion paper. The issues not included may have quite a significant influence on the model to be proposed as a future standard. The IASB has started deliberating those issues in March and is expected to deliberate more issues in the following months. Also the list of open issues is provided as an appendix to the discussion paper.*

EFRAG's comments

118	Appendix C of the DP contains a list of issues not covered in the DP. As we expect these issues to be addressed in any ED developed from the DP, we would welcome any comments constituents have on those issues at this stage.

APPENDIX 2
Revenue recognition model proposed by EFRAG

In Appendix 1 EFRAG explains that it has a fundamentally different view as to when revenue should be recognised to the one proposed in the discussion paper. The discussion paper proposes that revenue should be recognised only when a performance obligation is satisfied, which means that revenue will be a measure of performance obligation fulfilment. EFRAG believes the financial statements would contain more decision-useful information were revenue to be a measure of activity carried out pursuant to a contract with a customer. The purpose of this appendix is to expand on that statement and provide an outline of how a revenue recognition model along the lines we favour might look.

Key principles

1 Revenue arises and is recognised as a result of activity carried out by an entity in order to keep a promise in a performance obligation arising under a contract with a customer; in other words as the entity progresses towards the fulfilment of a performance obligation. Therefore:

(a) If there is no contract or no activity by the entity under the contract, there can be no revenue to recognise.

(b) No revenue is recognised in respect of a particular performance obligation before work commences on fulfilling it or after it has been satisfied.

2 The model involves allocating total revenue to the activities performed, so a measure of the progress of the entity towards the fulfilment of a separate performance obligation shall be used that best reflects the relevant fair value of consideration for the part of the performance obligation performed. Often this could be estimated as the total consideration allocated to the performance obligation minus the cost plus the original profit margin related to the activities yet to be performed in order to be able to satisfy the obligation. Therefore, if an entity has already produced an item before a contract is obtained all revenue related to producing this item is recognised when a contract is obtained – even though the item has not been transferred to the customer at that point in time.

3 The proposed model would in addition use many of the concepts developed in IASB's discussion paper. For example:

(a) 'a contract' shall be defined either in the way IAS 32 defines it or in accordance with the discussion paper;

(b) the total amount of revenue recognised on a contract shall equal the transaction price of that contract;

(c) if a contract comprises more than one performance obligation, those performance obligations that are expected to be satisfied at different times from the others should be treated as separate performance obligations and accounted for separately. For this purpose, the definition of a performance obligation shall be as set out in the discussion paper and the transaction price of the contract shall be allocated between the separate performance obligations in the way proposed in the discussion paper;

(d) the carrying value of a performance obligation shall be re-measured only as proposed in the discussion paper.

(e) the requirements for, and treatment of the satisfaction of performance obligations will be identical to the discussion paper.

However, contrary to the model proposed in IASB's discussion paper, the satisfaction of a performance obligation would not be the event that would trigger revenue recognition in EFRAG's proposed model, although revenue recognition may coincide. In that model, the satisfaction of a performance obligation will result in the recognition of a receivable (or the decrease in the liability to the customer) and derecognition of a non-financial asset representing the asset transferred including a profit margin, while revenue may have been recognised earlier.

Asset/liability approach

4 As the discussion paper says, revenue arises because there have been certain increases in the net assets of the entity. EFRAG believes that, as an entity carries out activity pursuant to a contract with a customer, the entity builds up/ enhances the asset (good or service) that it ultimately (or continuously) is to transfer to the customer. Revenue should measure that progression.

5 At the satisfaction of a performance obligation, the asset to be transferred will be derecognised (satisfaction of a performance obligation is met when the promised asset transfers to the customer) and a receivable (or a decrease in the liability to the customer if the customer performed first) will be recognised instead. Those movements would reflect in the balance sheet but do not have any impact on the income statement (unless revenue recognition coincides with the satisfaction of a performance obligation as in a retail sale, for example).

Measurement

6 Performance obligations and contract assets are measured in accordance with the discussion paper subject to EFRAG's comments or in accordance with a specific standard.

7 The asset that is built up pursuant to a contract with a customer is measured at the fair value of the consideration for the part of the performance obligation performed. Often this could for example be approximated as:

(a) the fair value of the consideration received/receivable from the customer for satisfying the performance obligation less

(b) the estimated cost to completion plus the original profit margin relating to the activities yet to be performed in order to be able to satisfy the performance obligation.

The original profit margin is based on the entity's estimated profit related to the contract at contract inception (or the margin built up in the estimate of a stand-alone selling price, if that has to be estimated at inception).

Implications

8 Compared to the model proposed in the discussion paper, revenue will be recognised earlier in many cases under the model proposed by EFRAG. For example:

(a) If a theatre group is contracted to perform at an event a performance that is prepared specifically for the event, the theatre group would, according to the EFRAG model, recognise much of the revenue during the preparation for the event (ie the rehearsals etc). According to the model proposed in the discussion paper revenue would not be recognised until the group had performed the play at the event. (If the contract was for the private performance at an event of some show otherwise open to the public, it is likely that the performance obligation would be limited to the one time private show).

(b) If an entity has partly constructed a machine and then signs a contract with a customer for that machine, revenue related to the part of the machine that has already been constructed is under the EFRAG model recognised at contract inception. According to the model proposed in the discussion paper no revenue would be recognised until the control of the machine has been transferred to the customer.

(c) If a customer orders a widget, and that widget is on an entity's stock, the entity recognises the revenue related to the widget at contract inception Only costs and a related margin related to the delivery of the widget is deferred.

9 In a cash sale, for example when a customer buys things in a supermarket, the proposed model will not result in a different pattern of revenue recognition than the model of the discussion paper because the time span of the transaction is so short.

10 The proposed model is not an IAS 11 model. Compared to the model of IAS 11, the model results in more unbundling than the requirements in IAS 11, paragraphs 8 and 9, would require. Under the model EFRAG is proposing a contract that covers a number of assets that are transferred to the customer at different points of time and could be sold separately would include more performance obligations. These performance obligations should be accounted for separately