THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND AND WALES

8 July 2009

Our ref: ICAEW Rep 73/09

Your ref:

Sir David Tweedie
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

By email: commentletters@iasb.org

Dear David

REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

The Institute of Chartered Accountants in England and Wales pleased to respond to your request for comments on the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, published by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in December 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

Desmond Wright
Senior Manager, Corporate Reporting
T +44 (0)20 7920 8527
E desmond.wright@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 73/09

PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

Memorandum of comment submitted in July 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* published by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in December 2008.

Contents	**Paragraph**

Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX DX 877 London/City

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* published by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in December 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms and public sector bodies.

MAJOR ISSUES

Welcome for the Discussion Paper

5. We agree with the boards that it is appropriate to try and establish a single principle for revenue recognition. We therefore welcome publication of the Discussion Paper (DP) as a move towards developing a single principles-based standard for revenue recognition under IFRS and US GAAP. However, we have significant reservations about how any future standard might be developed based on the current proposals, and we believe it will be necessary to publish a further DP before moving to an exposure draft.

6. We accept that if the boards had developed the proposals in too much detail at this stage, they would have been open to the criticism that they were not opening a true debate. However, we fear that the DP fails to explain the implications of the basic principle in too many key areas to enable any firm conclusions to be reached on the suitability of the proposals. We would need to have a better understanding of how complex long-term contracts would be dealt with before we could provide informed comment on the proposals. In fact, we suggest that financial instruments, insurance contracts and leases may need to be dealt with separately, although parallel work on these projects should inform the revenue recognition project, and vice versa.

7. Our response is developed primarily in the context of IFRS. Our perception of US GAAP is that it has been developed piecemeal and contains many

detailed exceptions to the basic principle. It does not therefore represent a suitable model for a future standard.

8. As noted below, we are concerned that the DP is not sufficiently developed for us to conclude whether or not we agree with the fundamental principle underlying the proposals in the DP - that revenue should be recognised only when a performance obligation is satisfied. In particular, whilst we can see that recognising revenue on the basis of satisfying performance obligations could be consistent with the current Framework, given the lack of sufficient detail on how the model would be applied we can also see that the proposals could lead to significant changes from current practice. We include in the annex to this response a short series of examples showing how the proposals might be interpreted to help the board consider the issues any standard will need to address.

9. The DP considers revenue recognition where there is a contract between a supplier and a customer. There is no guidance on how, if ever, revenue should be recognised where a contract is not in place (which will often be the case in not-for-profit situations), and this should be clarified within any standard developed to ensure any standard designed only for situations where there is a contract in place is not inappropriately applied to alternative scenarios: for example, in a government context the receipt of statutory licences, fines, regulatory fees or even taxation and even certain awards of damages. It might be helpful if such items were specifically excluded from the standard.

The nature of revenue

10. We agree that high-level principles for revenue recognition are necessary, and should be as universally applicable as possible. Because of the complexity and variety of business models, these principles need to clearly articulated and pitched at a high level. Nevertheless, in an exposure draft and final standard, consideration will also need to be given to formulation of underpinning explanatory and application guidance, based on the high level principle, for more complex types of revenue transactions, without which there is a risk of too much variation of application in practice.

11. We agree in principle that, in profit-oriented entities, revenue should be based on the completion of obligations arising from a contract. Under current standards this is usually seen as measuring the *activity* underlying the performance of a contract, whilst the DP measures specific *fulfilment* of identified contractual obligations as a driver for the recognition of profit. We would want the revenue recognition model to reflect the economic substance of the transactions. Thus, while we do not necessarily disagree with the boards, we are not sure yet whether the 'control passing' model will adequately reflect the economic substance of the contract in all circumstances.

12. We see a distinction here between contracts which require the delivery of general 'off the shelf' goods; those goods which are extensively built to a purchaser's explicit or implicit specification; and to service contracts which are generally bespoke. For the first we see that control can be seen to pass when the goods are provided to the customer. For more complex goods and services, however, the customer may directly specify what is delivered. In this case it can be argued that they control the assets or services from the

outset as from that point the supplier does not have free unfettered use of the asset or services. As a result we do not believe that the boards have yet made a convincing case at a conceptual level for a specific fulfilment model, and they have failed to provide a sufficiently comprehensive explanation of how the fulfilment model would work in practice.

13. These issues might have been easier to resolve if the boards had discussed what they see as the function of revenue in the financial statements. We believe it would have been helpful if the boards had included more of a discussion about why they believe that 'Revenue is a crucial part of an entity's financial statements', and, more particularly, what information they believe the revenue number is imparting to users.

Overall approach

14. We agree with the proposals in the DP that:

- goods and services are assets, and may be distinguished by the way in which the transfer of deliverables satisfies the performance obligations under the contract (see paragraphs 4.38 et seq);

- the boards are correct to reject the current exit price approach. While the original transaction price approach gives a suitable basis for many types of simple contract, we have concerns about its application to more complex contracts where there is uncertainty within the contract, for example, because the volume or final price is unknown.

Changes in an entity's contract asset or liability

15. Although the DP refers to inconsistencies between IAS 11 and IAS 18, in our view the accounting under the two standards often works well enough in practice. The perceived inconsistencies are generally the result of different fact patterns requiring different accounting. The major deficiency is that IFRS provide insufficient guidance on transactions involving multiple components or deliverables ('unbundling'). The proposals may have the potential to improve the accounting under IFRS, but unfortunately we do not believe that there is enough explanation in the DP to decide whether it should be based, as proposed, on changes in an entity's contract asset or contract liability.

16. The DP notes that IAS 11 and IAS 18 can be difficult to apply beyond simple transactions. The DP has exactly the same failing, in that it deals with easy transactions that are short term in nature, but does not provide sufficiently clear answers in respect of contracts that are complex, long-term or uncertain. Having proposed a simple principle, the boards need to test it against a range of more complex and difficult contracts, to see how effective it is in providing clear and consistent answers to the problems they pose.

Control

17. The fundamental principle set out in the DP is that revenue should only be recognised on the fulfilment of a performance obligation under a contract. Fulfilment is evidenced by the transfer of control. We do not think that the DP contains sufficient information about how control would be determined in practice to decide whether the principles of the DP can be applied consistently to complex transactions such that their substance is articulated.

We note that the DP considers control to pass only when the goods or services are delivered to the customer, but it is arguable that, for bespoke and customised items, the specification and output of these items may be controlled from the outset by the customer, and so the customer is able to restrict the control the supplier has over the asset. In these circumstances, it is perhaps more appropriate to argue that control passes immediately to the customer. Based on the boards' model we think that transfer of control will be difficult to determine even in many quite simple service contracts, and it is apparent that users of the DP have interpreted the control notion in very different ways.

18. In assessing the potential effects on present practice, the DP notes that revenue for construction-type contracts would be recognised during construction only if the customer controls the item as it is constructed. This could lead to revenue being recognised later than at present. However, if construction activities continuously transfer assets to a customer (or the customer is considered to control the asset from the outset as outlined above) then the proposed model would not significantly change the present IFRS based practice of recognising revenue for construction-type contracts during the construction phase.

19. This example highlights the problems of the DP, in that timing of revenue recognition could be close to current practice or considerably different depending on the application of key concepts - such as when an asset is transferred and when the customer has control of the asset - that are not fully explored in the DP. Clear and principled guidance on the transfer of control would need to be provided in order to operationalise the principle. We are concerned that a single, contract-based revenue recognition model is always likely to allow entities the scope to manage the timing of revenues by the simple expedient of changing the contract terms (particularly as this may not be disadvantageous legally and commercially as even if the supplier reneges on the contract, contract law would allow the customer to take delivery of whatever had been completed, plus damages for the remainder). Moreover, strict adherence to the legal form of the contract will result in differing treatment over contracts that are economically the same by companies in different jurisdictions.

Remeasurement

20. We agree that for simple contracts the rights and obligations under the contract should be measured at inception at the original transaction price. We agree that it is generally appropriate to preclude remeasurement (except in the case of contracts that become onerous). However, reallocating the amount of the transaction price to be recognised in respect of specific performance obligations within the contract is appropriate where there has been a change in the contract terms or where the original assumptions were in error.

Obligation to deliver to a third party

21. The definitions of customer and control do not deal with circumstances in which the cost is met by the customer, but delivery is to a third party. Guidance is needed on when and how control can be said to be transferred in these circumstances.

Contracts where there is significant uncertainty

22. As noted above, we believe that the contract-based revenue recognition model advocated in the DP will be difficult to implement where there are significant uncertainties as to the contract liability or revenue. For certain businesses, insurance being the main example, the liability representing the performance obligations to customers is an important component of the balance sheet. If there is uncertainty around the eventual cost of fulfilling those obligations, then remeasurement at the balance sheet date to the latest best estimate is key information for both management and users. The impact of uncertainty for revenue recognition therefore needs to be investigated in more detail.

Not-for-profit entities

23. Not-for-profit entities are effectively scoped out, but the eventual IFRS may well be applied in certain jurisdictions. The boards perhaps need to consider to what extent to refer to charities. The issue of, for example, contracted payments to charities by the state and similar authorities may be relevant.

Economic consequences (including for SMEs)

24. The boards should be cognisant of the substantive economic consequences of changing the requirements for recognising revenue, particularly in relation to the timing of tax payments. We accept that accounting standards should be set according to sound principles without regard to the tax consequences. However, the cash flows of smaller entities in particular may be hard hit by any standard that results in the earlier recognition of revenue for tax purposes. The IASB will need to consider carefully how to update the IFRS for SMEs for changes to the revenue recognition. Indeed, for all entities, a long lead time up to the effective date for implementation of a new revenue recognition standard will help to deal with tax and other practical difficulties, including systems changes.

SPECIFIC QUESTIONS

Chapter 2 Chapter 3

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

25. We agree that it is appropriate to try and establish a single principle for revenue recognition, but we would need to have a better understanding of how it would apply in practice to complex long-term contracts before we could endorse the proposals in their entirety. We also believe that financial instruments, insurance contracts and leases may need to be dealt with separately, although parallel work on these projects should inform the revenue recognition project and vice versa.

26. The proposals contain a conceptual basis which nets off the total right to assets against the total performance obligations to arrive at a net contract asset or net contract liability, with the changes representing the revenue

recognised in the period. In the context of a contract fulfilment model or in an activity based model, we agree that the 'net contract' basis is an appropriate method for recognising revenue in contracts. Recognising gross assets and/or liabilities would not accord with the Framework. We agree that a net asset should not be recognised at inception. The net opening position will generally be nil, although there may be a net liability in the case of, for example, onerous or social contracts (ie, contracts entered into on non-commercial terms in order to meet a social or public need).

27. A contract-based model is broadly consistent with current IFRS and has the potential, subject to measuring the fulfilment of performance obligations, to lead to greater clarity and certainty as to the recognition (and measurement) of assets and liabilities in practice. This in turn may well ameliorate some of the associated audit problems. However, we are concerned about the focus on the form of the contract, which potentially runs counter to the concept of economic substance over legal form. We are concerned that an IFRS based on the proposals in the DP may lead to contracts being drawn up to achieve a desired revenue recognition profile, which may not be consistent with commercial substance.

28. Different treatments might be needed at the standards level in respect of certain complex long-tem contracts. We would expect any such refinement of the basic principle to apply to types of transactions, not to specific industries. It will be important to limit the number and scope of any such exceptions to avoid undermining the basic principle.

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?

29. We consider that, depending on the definition of 'performance obligation' and 'control', it is possible for the proposed principle to provide decision useful information in many cases. However the further the standard moves away from a recognition principle that looks at the economic activity underlying the contract, the more likely it is that the proposals will fail to provide decision useful information.

30. We would welcome clarification in any future discussion paper of how to consider:

- fixed contracts vs uncertain or demand led contracts, because of, say, volume or price uncertainty;
- how a range of possible outcomes should be factored into the measurement - for example, should it be the likely or worst outcome - including the treatment of revenue that is contingent on a future event?;
- how portfolio concepts, such as those in relation to customer loyalty schemes, can be incorporated.

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.

31. We note that the definition in the DP differs from that in IAS 32 *Financial Instruments*, but that the boards consider the definitions to be consistent with each other. We therefore question why the boards felt it necessary to introduce a different definition in this DP.

32. However, we do not see that the definition of a contract in the DP adequately deals with the many of the specific problems of revenue recognition. A future document will need additional explanatory material, dealing with the following matters, in addition to those that the Boards identify in Appendix C to the DP:

- to clarify whether an implied or constructive contract is included within the definition;
- to clarify whether there must be an enforceable obligation for both parties, and what happens in multi-party transactions;
- to deal with contracts that confer a payment without an enforceable entitlement;
- to clarify whether a contract is still regarded as enforceable even though it would never be enforced in practice;
- to deal with contracts involving nominee parties to a contract where it is not clear who has ultimate control of the contract asset / liability. There may also be dual control in some contracts and again it may not be clear who has over-riding control.

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.

33. We have found it difficult to understand what the proposed definition of a performance obligation will entail in practice, or how it relates to the concept of control. We cannot therefore determine whether it would allow consistent identification of deliverables by entities. For example, if a performance obligation in a service contract is to provide a single support service, the elements within that contract (for example the provision of necessary infrastructure at the start of a contract, with services provided thereafter) might suggest it is appropriate to unbundle the performance obligations into provision of infrastructure and provision of support thereafter. However from the customer perspective they are purchasing a monthly service, which is delivered seamlessly over time. On the one hand, it may seem inappropriate to recognise significant levels of revenue at the start of the contract, with less revenue spread over the remaining life of the contract as it progresses. However, if the performance obligations are considered to be the delivery of a monthly service, then revenue would be recognised on an even basis over the life of the service contract.

34. In short we see a need for further guidance on how to identify and measure the fulfilment of the performance obligation. The DP envisages recognising revenue when the entity fulfils parts of a contract. But there is not enough

guidance or discussion in the DP to know where the line separating different deliverables under the contract would be drawn. Nor is it clear precisely what activities should form part of the performance obligation: for example, essential preparatory work such as clearing a workshop or essential pre-training of staff before work on the contract can begin.

35. We consider difficulties in identifying the appropriate performance obligation and the appropriate level of granularity in our response to question 9 (see paragraphs 53 - 58 below).

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?

36. We agree in principle that, for contracts for the sale of simple goods an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer. However, for complex goods and services we consider that a more sophisticated understanding of when the asset transfers is required. For example, guidance would be helpful on:

- how to identify the individual assets and performance obligations;
- when an asset passes (see paragraphs 47 - 52 below in relation to control), particularly where these are bespoke goods or services;
- how contracts should be unbundled into separate performance obligations.

37. In our view it is important that any unbundling of the performance obligations should reflect the substance of the arrangement from the perspective of the customer and not be open to manipulation.

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?

38. We believe that on balance an entity's obligation to give a refund for a returned good is a separate performance obligation. Once control of the good has been transferred, then a performance obligation has been satisfied and revenue should be recognised. The right to return the good is a separable performance obligation that should be accounted for separately. We expect that measurement of the provision for returns would be based on expected returns on a portfolio basis.

39. We do not agree with the argument that a right of return indicates a failed sale, in that the customer has not accepted the terms of the contract. The customer has indeed accepted the terms of the contract, which include a term conferring a right of return. Control has passed, because the customer has unfettered use of the good without reference to the seller.

40. We would distinguish the return of faulty goods from the right to return at whim. In our view, the delivery of faulty goods does not meet the test of

satisfying a performance obligation, as the goods do not meet the specification required under the contract. It would therefore not be appropriate to recognise revenue on delivery of faulty goods. Otherwise, taken to the limit, an entity could purport to deliver products that were manifestly incomplete in order to boost revenue, while knowing that the goods would be rejected.

41. We would also distinguish consignment and sale-or-return arrangements. We question whether an initial sale has actually occurred in these circumstances (see paragraph 52 below).

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?

42. Taking the two examples offered in the DP, we agree with the analysis in the DP that the option to purchase online music at a discount is an asset because it could be sold separately, and so gives rise to a separate performance obligation. We believe that this analysis would apply generally to sales incentives.

43. In the case of Tuneco's gift card, we are comfortable that the separate performance obligation is part of the contract for the purchase of the player.

44. The question of Songco's discount is perhaps more difficult, but we still believe that it is part of the contract for the purchase of the player. We do not see a conceptual difference between the sale of a player with an option to download tunes at 100 per cent discount and the sale of a player with an option to download tunes at 40 per cent discount. We note the argument that the two are substantively different because consideration will be required to pass from the purchaser in the case of the 40 per cent discount, implying that this is a future contract. However, the effect of accepting this argument would be that the same revenue would be recognised for the sale of a player without the discount as for a player with the discount, when the profitability of the sales is clearly different. Of course, the boards have not discussed what they see as the function of revenue in the financial statements, so they might regard this as an acceptable outcome, but in our view it would be a distortion of the commercial reality of the transaction.

45. The nature and function of revenue are also important in considering whether gross revenue should, in fact, be booked in both cases, and the discounts treated as marketing costs. We have not addressed this issue.

46. We have not addressed the practical measurement problems involved in valuing the gift card or the discount, but note that they would be substantial.

Chapter 4 Chapter 5

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.

47. In our view, the DP contains insufficient information on ‘control’ to allow for a meaningful discussion of whether the principles can be applied in practice and to complex transactions. More discussion and guidance are needed on control and transfer of control to clarify how the principle would operate in practice. However, we emphasise that a mere list of factors or indicators of control or transfer of control would be counter-productive and only serve to undermine the principle.

48. Most importantly, we believe the DP needs to consider whether control passes when the customer is able to fully control and bring into use the asset or service, or when the supplier is no longer able to fully control the asset. We support the second definition, which would lead to an earlier recognition of control passing to the customer in respect of bespoke goods and services which are provided to the customer’s specification. Further details on this point are given below.

49. We have previously responded to the IASB in other contexts to the effect that we do not believe that control can be fully decoupled from risks and rewards. This is implicit in the Framework, which defines an asset 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*’ (emphasis added). Risks and rewards will generally derive from control, and therefore provide a strong indicator of where that control lies. We believe that it will often be necessary to use risks and rewards as an indicator of where control might lie.

50. Moving from a risks and rewards approach can lead to problems; for example, control can be manipulated. In our response to ED 10 *Consolidated Financial Statements* we distinguished actual (exercise of) control from the right to control. This distinction is equally applicable in the context of this DP. Arguably, a customer who specifies a contract outcome controls the eventual asset. This would be analogous with auto-pilot and similar arrangements for structured entities, where control is determined by the terms of the original arrangement. Contracts could be formulated to, for example, transfer control more or less continuously over the life of the contract. This would allow revenue to be recognised over a long-tem contract much as it is under current practice (see paragraph 17 above). Guidance would be needed on continuous transfer of control and similar issues.

51. We are also concerned that recognition of revenue under the proposals may be too ‘lumpy’ to represent faithfully the entity’s commercial and economic circumstances, while accepting that revenue may be volatile when that reflects the underlying economics of the entity’s transactions. We would need to know more about how the model would work in practice, particularly with regard to the relationship between activity and recognition, before we could reach a view on whether the potential lumpiness of revenue would be a problem, ie, whether or not it reflected economic activity under a contract in a way that produced useful information.

52. We are concerned about how consignment stock and sale-or-return arrangements would be dealt with under the proposals. It would appear that the assumption is that under such arrangements control of the inventory has passed from the producer to the dealer, so a sale has taken place and revenue should be recognised. However, we question whether these arrangements are in substance a sale, at least in most circumstances. Clearly, the problem lies in control, and some refinement is required in order

to determine whether transfer has occurred. Possibly, risks and rewards point to a solution. If the dealer does not bear the risk of not being able to resell the good, is it appropriate for the producer to recognise a sale?

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.

53. As we have already noted, we are as yet unclear about whether the proposals will lead to decision-useful information where revenue recognition follows contractual form rather than commercial and economic substance. This could apply in the case of many long-term contracts.

54. More specifically, we see difficulties arising in deciding what constitutes the most appropriate performance obligation to be recognised in a complex contract, and the appropriate level of granularity. Paragraphs 55 et seq below consider an IT outsourcing contract.

55. Take a contract for a multi-year delivery of the IT services previously undertaken in-house by a client but now outsourced to an IT services company, which takes control of the existing IT assets of the client and preserves the terms and conditions of employment of all the staff.

56. Deliverables under the contract at one level are to provide a full IT outsource, so it could be argued that revenue would be recognised pro rata over time, as the performance obligation could be taken to be the provision to the client of the IT service.

57. However it would also be possible to identify specific deliverables at a lower level that could result in a different revenue treatment. Deliverables under the contact would include for example: providing a helpdesk and field service engineers, maintaining a data-centre, managing applications etc. One specific deliverable would include refreshing the IT equipment that the client uses. The refresh requirement is likely to be determined by a need to maintain the average age of the equipment within a certain band and by the need for the equipment to meet Service Level Agreement for service reliability. The risk of managing the refresh programme would be likely to fall to the outsourcer. As this is a separately identifiable performance obligation, should this be separated from the rest of the performance obligations, valued and then recognised against a different schedule associated perhaps with the amount of refresh that takes place in a specific year? Similarly, should other sub-deliverables be separately identified?

58. The DP as currently drafted does not provide guidance as to which approach an IT outsourcer should take in this instance, and the level of granularity required in identifying performance obligations. Hence there is the possibility that two organisations with similar contracts could interpret the instructions in different ways resulting in different revenue recognition results.

Question 10: In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

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

59. We agree that performance obligations should generally be measured initially at transaction price. We do not support the use of a current exit price. Where obligations are measured and financial statements are prepared on a modified historical cost basis, we do not consider it would be appropriate to depart from this convention when measuring performance obligations, as it would produce information that is not decision-useful.

(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?

60. We agree that:

- a test of whether the contract has become onerous is necessary if the rights and obligations under the contract are measured and fixed at inception;
- a performance obligation should be deemed onerous if the expected cost of satisfying it exceeds the carrying amount; and
- a performance obligation that is deemed to be onerous should be remeasured to expected cost. This is consistent with the Framework.

61. We note that the boards intend to consider at a later date which costs should be included in the 'onerous' test at what unit of account the test should operate. However, more analysis in the DP would have been helpful.

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

62. We believe that it is possible that measuring performance obligations at original transaction price is unlikely to provide decision useful information in respect of contracts subject to significant uncertainty, such as insurance contracts and many investment contracts. For this type of contract the measurement of the contract assets and liabilities depends upon assumptions of future uncertainties, for example the timing of an insured event and the extent of loss arising. As time passes the estimate of the cost of fulfilling the performance obligations will change. For this type of contract and indeed any contract where there is a significant degree of uncertainty around the cost of fulfilling the obligation, remeasurement of the performance obligation may be desired by users. For any long term contract with uncertainty, a current best estimate of the obligations is essential to provide meaningful information to users. As already stated, it may be best to scope insurance contracts out of a general revenue recognition standard.

(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.

63. In the absence of detailed consideration in the DP, we cannot say whether the measurement approach to performance obligations would be appropriate for financial instruments, insurance contracts or leases. We note the boards' own concerns. We believe that, at this stage in the development of IFRS, such contracts will need to be excluded from the scope of a revenue recognition standard and dealt with in dedicated standards.

Question 11: The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

64. We agree that including recoverable costs of obtaining the contract in the initial measurement of performance obligations is consistent with the principles in the DP.

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

65. We have some concerns about the effect of this approach. Origination costs will usually be taken into account in the contract price and users may feel they should be accounted for as part of the overall contract. We accept that accounting for these costs as an asset, and writing them off over the length of the contract, would represent an income statement 'matching' approach, which would be inconsistent with the proposed model and the Framework. However, expensing them could lead to a loss of information for users. We therefore believe that the boards need to think further about origination costs, possibly in terms of disclosure.

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

66. Allocating the transaction price to the performance obligations on the basis of the entity's stand-alone selling prices is a reasonable approach when the resulting information is based on objective, verifiable information, which can be readily obtained.

67. However, we would need more information about how the proposals might work in practice, including in circumstances where stand alone selling prices

for components of a contract are not readily available, for example a bespoke construction or service contract. In particular we see that it is important that the transaction price of each performance obligation should reflect the substance of the transaction, so that it is linked to the 'price relevance' of the element within the contract - ie, the price of the element in the specific context of the contract. For example, a mobile phone service provider might sell the phone itself for a nominal sum as part of a contract. If sold alone, the price for the phone would be much higher. Is the stand-alone price the price to the customer or the full retail price? In this case we suggest that it is the phone's price-relevance to the contract that should dictate the stand-alone selling price. The boards need to make their intentions clearer.

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?

68. We agree that this is an acceptably pragmatic solution, for circumstance where the components of the contract are clearly separable, provided that it is the stand-alone price relevant to the contract (see paragraph 67 above) that is estimated. Alternative solutions would distort the unbundling process. However, in circumstances where separating the components of the contract could only be done on an arbitrary basis then we would not support unbundling and the use of estimates should be constrained. As part of development of this project, this issue will need to be investigated further.

ANNEX: Examples for considering the revenue recognition model

Background

These examples are based on two companies, one undertaking an equipment contract and one a service contract. The treatments under existing IFRS are contrasted with possible interpretations of the proposed new standard. The interpretations are not definitive, but highlight some of the potential problems of attempting to implement the proposals as currently drafted.

Revenue recognition under the current standards

Revenue from the sale of goods is recognised when the risks and rewards of ownership have been transferred to the customer, which is usually when title passes. Revenue from services is recognised in accounting periods in which the services are rendered, by reference to completion of the specific transaction, assessed on the basis of the actual service provided as a proportion of the total services to be provided.

Revenue is measured at the fair value of the consideration received, net of trade discounts and sales taxes.

Revenue is split into sale of goods, contracts, and services.

Interpretations of the revenue recognition model contained in the Discussion Paper

Under the proposed model, the deliverables under a contract are identified, and revenue is recognised as control of these goods and services is transferred to the customer.

Revenue is recognised as activity proceeds only if control is continuously transferred to the customer.

Two interpretations of ’continuous transfer of control’ have been considered. Interpretation one takes a restricted reading, with the customer only controlling the asset if they have physical possession of the asset. This would occur if the asset was constructed at the customer’s premises, or each stage of work was only carried out with specific authorisation. Interpretation two takes a generous reading, with the customer controlling an asset if it is being constructed because of an order placed by the customer.

Example 1: Equipment contract

Background

Company A sells machinery to airports to scan baggage. This equipment is customised for each contract, but the core technology has been developed by Company A. For a typical contract, the installation of the equipment on site is the responsibility of Company A, and the customer accepts delivery on completion of the site acceptance tests.

Revenue recognition under new and existing standards

	Current treatment	Interpretation 1	Interpretation 2
Customer places order ▼	No split of revenue	Split revenue into: • equipment and installation • warranty	Split revenue into: • equipment • installation • warranty
Existing inventory is allocated to the contract ▼	No revenue recognised	No revenue recognised	No revenue recognised – these items were not manufactured in response to the customer order
Equipment is manufactured ▼	No revenue recognised. Manufacturing costs are deferred in inventory	No revenue recognised Manufacturing costs are deferred in inventory	Equipment revenue recognised based on the proportion of manufacturing activity completed
Equipment is delivered to the customer and installed on site ▼	No revenue recognised. Company A retains the risks and rewards of ownership	No revenue recognised Installation costs are deferred in inventory	Equipment revenue recognised for standard inventory items Installation revenue recognised based on installation activity
Customer completed site acceptance tests ▼	Contract revenue is recognised in full and a warranty provision set up based on historical experience	Equipment and installation revenue recognised when customer accepts equipment	No revenue recognised at this stage Unbilled revenue becomes a trade receivable
Warranty period ▼	If any costs are incurred, these are set against the warranty provision. If necessary, the provision is increased	Warranty revenue recognised straight line over the period	Warranty revenue recognised straight line over the period
End of the warranty period	Any remaining balance on the warrant provision is released	No action – all revenue and costs have been recognised	No action – all revenue and costs have been recognised

Challenges

Contract revenue will need to be split either between equipment and warranty activity or equipment, installation and warranty activity. The company has very little objective evidence to use as a basis for this allocation because all the suppliers of this type of equipment routinely offer similar installation terms and warranties.

The distinction between items manufactured to order, and those made for stock, required for the second interpretation of customer control is not always clear cut. We do not consider the process of allocating stock items to specific contracts to be sufficient for the asset to be controlled by the customer, since the company can change this allocation without authorisation from the customer. However, if the stock items were built into a larger contract specific assembly, that may be sufficient to trigger recognition of the revenue.

Example 2: Oil services contract

Background

Company B, provides specialist technical services to the international oil and gas industry including evaluating the fluid chemistry and physical characteristics of oil wells.

Revenue recognition under new and existing standards

	Current treatment	**Interpretation 1**	**Interpretation 2**
Customer places order ▼	A schedule of instalment payments is agreed with the customer	The final report is identified as the main contract deliverable	The report is prepared as a result of the customer order, so revenue is recognised as the report is generated
Work is carried out, including site visits and laboratory work ▼	Revenue recognised based on the proportion of the total contract activity completed	No revenue recognised	Revenue is recognised in line with contract activity
Report is drafted, and (possibly) circulated in draft ▼	Revenue continues to be recognised in line with contract activity	No revenue recognised (This would change if the circulation of a draft report was identified as a contract deliverable)	Revenue is recognised in line with contract activity
Report is finalised and issued	All the contract revenue will have been recognised before this point, and frequently, all the customer payments will have been made	Contract revenue is recognised in full at this point	No revenue recognised at this stage

Challenges

If the first interpretation is adopted, it will eliminate the need to estimate the proportion of contract activity completed. However it will represent a considerable change in the accounting for these contracts, so a long implementation period would be required to allow management and investors to familiarise themselves with the new accounting.

Email: desmond.wright@icaew.com