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International Accounting Standards Board
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By email: commentletters@iasb.org

19 June 2009

Dear Sir or Madam

IASB DISCUSSION PAPER: PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

The Institute's Accounting Standards Committee has considered the above Discussion Paper and I am pleased to set out its comments below.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

General Comments

Revenue recognition is clearly an important area of financial reporting and one in which it is vital that users have confidence in the integrity of the figures being reported. A single model of revenue recognition is desirable, and we welcome the Boards' decision to take on this project, but the development of a single model is not an end in itself and we believe it is important to consider the problems that this project is seeking to address, and the goals it is trying to achieve.

Firstly, the discussion paper highlights that there are many different and sometimes conflicting sources of guidance on revenue recognition, particularly under US GAAP but also under IFRS. This leads to economically similar revenue transactions being accounted for differently. While this project creates a single model, we do not believe that it will address the issue of economically similar transactions being accounted for inconsistently – as we go on to explain below, the reliance on the contract will result in accounting based on the legal form of a transaction rather than its economic substance.

The introduction to the discussion paper states that it is in complex revenue transactions that the current principles under IFRS and US GAAP can be difficult to apply and therefore will lead to inappropriate accounting. While the proposed model gives the appearance of simplicity, we do not think that it will eradicate inappropriate accounting for complex transactions and may in fact exacerbate this problem since contracts may be structured to achieve a desired accounting treatment, and the model does not provide the means to look beyond the contract terms.

Furthermore, the discussion paper states that the current standards are deficient because they are inconsistent with the conceptual framework e.g. the IAS 18 focus on risks and rewards model is inconsistent with the IASB's definition of an asset. We disagree with this assessment as we do not see risks and rewards and control as competing models, rather risks and rewards is an element of control and therefore the two can be considered together. The IASB conceptual framework already states that an entity can control an asset without the existence of legal control, therefore we are concerned that this argument is being made in order to justify a move away from risks and rewards which we believe will be detrimental to the quality of revenue reporting.

ICAS would like to re-iterate our support for principles-based accounting standards as the only basis for developing a global accounting language that results in transparent, understandable and consistent financial reporting. Key elements of principles-based standards are the importance of economic substance over legal form; and the exercise of judgement by management, auditors and regulators. We are concerned that neither of these principles is given sufficient prominence in the proposed model and therefore we do not think that the model as currently stated will result in consistent, transparent or useful reporting of revenue.

We note that while the discussion paper acknowledges that some may find its focus on the contract and the transfer of control too legalistic, it concludes that the legal focus does in fact reflect the economic substance of a particular transaction. We strongly disagree with this conclusion which depends on the notion of a 'perfect' contract operating in a very specific legal context. For example, the legal terms of a contract will not reflect economic reality where the contract has been deliberately structured to achieve a particular accounting result, or where in a particular jurisdiction, a legal contract has a lower status than other factors such as custom and personal relations. Therefore, there is a need in all cases for a fall-back test to consider other factors to determine whether the contract does represent the underlying transaction accurately. This involves a requirement to assess the transfer of the risks and rewards associated with the asset as well as control.

We do not agree with the discussion paper's conclusion that the requirement for judgement when using a risks and rewards model will result in inconsistent accounting. On the contrary, a sole reliance on legal control may present the impression of consistency but will in fact result in economically similar transactions being accounted for differently. The proposed model will not remedy current known examples of revenue distortion and off-balance sheet financing, and will, in our opinion, only serve to legitimise such instances, since as long as the accounting treatment matches the terms of a contract, the entity will be in compliance with accounting standards.

Overall, we recommend that the proposed model be amended to include an assessment of the underlying economic substance of a revenue transaction, in effect, a testing of the contract to confirm that it accords with external evidence. The assessment of when an asset is transferred to a customer must also be amended to require consideration of the transfer of the balance of risks and rewards associated with ownership of the asset – this does not conflict with, but enhances the control test.

Our answers to the questions in the invitation to comment are set out below.

Q1: 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?

Response:

As noted above, we agree that a single revenue recognition principle is desirable, and that this should be linked to changes in the entity's assets and liabilities. However we have significant concerns regarding the focus on the importance of the legal contract and believe that this approach runs the risk that the economic substance of a transaction may not be represented in certain circumstances. The recognition of revenue should have regard to both the economic substance and legal form of a transaction or arrangement that results in an inflow of economic benefits to the entity from a customer. The focus on the legal contract means that a contract could be structured so as to produce a desired accounting outcome. In order for the model to work, the principle must also refer to economic substance and require this to be considered in assessing the validity of the contract.

Q2: 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?

Response:

The boards' proposed principle would not provide decision-useful information for any contracts that are structured to achieve a desired accounting outcome i.e. contracts that do not reflect the underlying economic reality. For example, since a performance obligation is satisfied when it is deemed to be satisfied under the terms of the contract, a contract could be structured to state that an obligation is satisfied earlier or later than is actually the case. This means that the principle would not provide decision useful information because it does not accurately reflect the inflow of economic benefit to the entity. A principle that requires consideration of the economic substance of the transaction would be more useful.

Q3: 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.

Response:

The definition of a contract is straightforward and therefore appears appropriate. There may be difficulties with the use of the term 'enforceable' as this may have different connotations in different legal jurisdictions. Furthermore, the reliance on the contract as the central element of the revenue recognition model depends on the assumption of a 'perfect' contract. In reality, the status of a legal contract may be very different in different jurisdictions around the world, and contracts will often be negotiated between parties of unequal power, meaning that one party may be able to dictate terms in order to achieve a desired accounting outcome. For these reasons, it is imperative that the model requires the contract to be tested against other evidence to confirm that it is a fair representation of the actual transfer of benefit between the supplier and customer.

Q4: 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.

Response:

The discussion paper defines a performance obligation as 'a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer'. We are not convinced that this definition will help entities to identify consistently the deliverables in a contract, since the performance obligation is understood as it is defined in the contract, and therefore may not bear much relation to the overall economic substance of the contract. The discussion paper also equates the satisfaction of a performance obligation with revenue recognition, which will mean that all obligations under a contract would result in revenue recognition. We do not believe that this is correct as we discuss below in relation to refunds and sales incentives.

Q5: 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?

Response:

Yes, we agree with this approach as long as it has regard to the overall economic substance of the transaction or group of transactions, so that revenue is recognised on a meaningful basis.

Q6: 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?

Response:

We think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation, but not one which generates revenue. The obligation is generally more of a marketing cost that the entity incurs in order to generate sales/obtain a contract. The fact that the customer has the right to return the good within a certain period does not negate the fact that control of and the risks and rewards of the asset have already been passed to the customer.

Q7: Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Response:

As with an entity's obligation to accept a returned good, we believe that sales incentives are a selling cost and do not give rise to revenue.

Q8: 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.

Response:

We agree that in many cases an entity transfers an asset to a customer when the customer controls the promised good or receives the promised service. However, the consideration of control should also be supplemented by an assessment of when the balance of risks and rewards has been transferred to the customer. If the risks and rewards are not also considered, contracts could be written so as to state that legal control has been passed to the customer, when in fact the supplier retains the risks and rewards of the promised asset until a later date (e.g. consignment stock). We do not agree with the discussion paper's conclusion that a focus on control rather than risks and rewards will result in more consistent decisions about when assets are transferred. If the only source of reference is the contract's definition of when control passes to the customer, this will provide ample opportunity for entities to manipulate revenue by structuring contracts accordingly. There must be an additional fall-back test of consideration of other factors in order to determine if the contract is a fair reflection of the underlying transaction.

Q9: 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.

Response:

The discussion paper states that a performance obligation is satisfied when an asset is transferred, and that an asset is transferred when the customer has control of that asset. A contract could be structured so that legal control is transferred, but the supplier retains physical possession and therefore the risks and rewards of the asset. The definition of satisfying a performance obligation needs to be widened to additionally reflect when the balance of risks and rewards associated with the asset has been transferred.

Q10: 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?

Response:

We agree that it makes sense for performance obligations to be measured initially at the transaction price. This is straightforward and provides understandable and useful information.

(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?

Response:

Yes, we agree that this will provide useful information to users of the accounts.

- (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.

Response:

No, we do not have any examples of obligations for which this measurement approach would not provide decision-useful information. We would note that performance obligations falling within the respective definitions of insurance contracts, lease contracts and financial instruments should be covered by those specific standards/projects.

- (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.

Response:

No, we do not believe that any other measurement approach should be used.

Q11: 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 (e.g. 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?

Response:

Yes, we agree that these costs should be treated as expenses.

- (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.

Response:

We do not have any examples of cases where recognising contract origination costs as expenses as they are incurred would not provide decision-useful information.

Q12: 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?

Response:

Yes, we agree with this approach where it is necessary to unbundle the contract into its various components.

Q13: 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?

Response:

We agree that an estimate should be used if this will provide meaningful information. The most important consideration is that the overall substance of the contract is reflected.

I hope our comments are useful to you in the development of this project, if you wish to discuss any of them further please do not hesitate to contact me.

Yours faithfully



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