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Response of the Accounting Committee of the Institute of Chartered Accountants in Ireland

Discussion paper: Preliminary Views on Revenue Recognition in Contracts with Customers

Dear Sir/Madam,

The Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland welcomes the opportunity to comment on the proposals contained in the above discussion paper (DP). The appendix to this letter provides answers to the detailed questions asked in the document.

AC supports the Boards' intention to develop a single principles-based standard for revenue recognition that can be applied to all industries. However, as noted in our detailed responses, we have concerns around certain areas, in particular the determination of when control of a good or service has passed to a customer. Furthermore, views among AC members were divergent on certain matters regarding the transfer of control, as noted in our responses to questions 5 and 8 with particular regard to the transfers of the right to use an asset for a period less than its useful life.

In addition, AC considers that additional application guidance will be required in many areas, such as the identification of performance obligations, to ensure that the proposed model is applied consistently in practice.

Should you wish to contact us about any of our comments please feel free to do so.

Yours faithfully,

Mark Kenny

Secretary, Accounting Committee

Appendix

CHAPTER TWO: A CONTRACT-BASED REVENUE RECOGNITION PRINCIPLE

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?

Overall, AC supports the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability. However, as noted in the responses below, AC considers that additional guidance and clarification is required in certain areas to ensure that the proposed model is applied on a consistent basis. Such application guidance should also include industry specific guidance, for example for mining and software to name just two. AC considers that this would help to avoid the need for future interpretations from IFRIC.

As the Boards develop the exposure draft (ED), we recommend that the link between the Conceptual Framework and the decisions made in the revenue recognition project be made clearer. For example, in paragraph 6.16 of the DP, the Boards state that they are considering whether entities currently accounting for their inventory under IAS 41 *Agriculture* should record increases in the value of inventory as another component of comprehensive income instead of revenue. The basis for this decision is not explained by reference to the Conceptual Framework or as a differentiation between revenue and other gains. We recommend that such decisions be explained by reference to the Conceptual Framework.

AC notes that the segmenting of contracts has not been addressed. We recommend the Boards clarify if they believe a single contract with a customer should be segmented in some instances, as accounting for each party's role as a vendor and a customer in one measurement and allocation may yield reporting results that do not represent the relationship between the parties. Similarly, the Boards' decision on combining contracts is also a key decision.

AC considered that it is not clear whether executory contracts fall within the scope of the DP. For example, an entity may enter into an agreement which requires it to pay royalties for a specific period of time. AC understands that such an executory contract would be within the scope of the DP. However, AC recommends that the Boards clarify whether such executory contracts are within the scope of any final standard.

AC recommends that unit of account will need to be more explicitly defined within the standard. It is somewhat unclear from the DP whether it is intended that each contractual relationship should be accounted for separately, or that each element of such contracts should be accounted for separately.

AC notes that the Boards have yet to decide whether the rights and obligations under each contract will be presented on a gross or net basis. AC believes that, that under the frameworks of both IFRS and US GAAP, an asset or liability does not exist until either party has performed. Consequently, AC considers that contracts should be recorded on a net basis, as recording gross assets and liabilities at contract inception is inconsistent with the frameworks and would not provide decision-useful information.

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?

It appears from the DP that the transfer of control is ultimately determined by legal transfer of title. If this is the Boards' intention, then AC feels that the proposed model would not provide decision-useful information for long term construction contracts. AC believes that the model should not be based on the transfer of legal title, but rather on the transfer of risks and rewards. Transferring control involves provision of access to a good or service and in substance amounts to transfer of risks and rewards rather than just legal title.

While the DP notes that non-refundable progress payments from customers is an indication of control transferring continuously, AC does not believe that recognising revenue by reference to customer payments is appropriate, particularly in view of the variation of legal and commercial practices in different jurisdictions. For example, in many countries a party can sue for repayment of progress payments, but may not be able to enforce completion of the product and therefore progress payments are not an indicator of control transferring continuously. Accordingly, AC feels that further guidance is required on the concept of continuous transfer. In addition, AC feels that specific guidance and examples relating to the application of the transfer of control principle to long-term construction contracts should be provided.

In AC's view, performance obligations that would be within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* ("IAS 39") should be measured by reference to the requirements of that standard; however, the timing of recognition should be dealt within the revenue recognition standard. Further AC noted that specifically in relation to trail commission, application of the principles of the DP might not arrive at the accounting which would result from current practice, a matter which has already been considered by IFRIC.

Whilst AC acknowledges that the circumstance peculiar to an industry might need to be considered, AC considers that the Board should have an aspiration that the concepts underpinning the revenue recognition project should be consistent with those underpinning the insurance and leasing projects and that effective communication between the various project teams would be important.

AC considers that the Boards should clarify how the proposed model should be applied to arrangements involving the transfer of licenses for, or the rights to use, intangible assets. AC believes that the proposed model could provide decision-useful information for users of the financial statements of lessors, and that lessor accounting should be included within the scope of any final standard based on the DP.

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.

AC has concerns around the interpretation of the term "enforceable obligations" used in the definition of a contract in the DP. In certain jurisdictions, under an executory contract, the customer cannot generally compel an entity to perform. If an entity breaches a contract and does not perform, the customer could sue for damages but may not be able to legally compel the entity to perform. In practice, different interpretations of "enforceable" exist across various jurisdictions. This could be interpreted as legally enforceable by the courts or it could be taken as having a broader meaning and including economic compulsion. Therefore, AC encourages the IASB to clarify what it means by "enforceable obligations".

AC notes that the Boards are considering contingent revenues, renewal options and cancellation provisions. AC considers that without appropriate guidance on these issues, significant diversity in practice may result with respect to whether such terms are included in the original measurement and allocation of a contract's transaction price.

Paragraph 2.21 of the DP defines a customer as "a party that has contracted with an entity to obtain an asset (such as a good or service) that represents an output of the entity's ordinary activities." In order to ensure that the model is implemented as the Boards intended, AC recommends that the Boards either clarify or define what is meant by the term 'ordinary activities'. For example as currently worded, this might suggest that if an entity was to sell a by-product which resulted from the main output of a process that such amount could not be recognised as revenue. Furthermore, AC suggests that the Board should indicate whether they consider that, similar to the financial statements presentation project, it would be incumbent upon management to define what 'ordinary activities' means within the context of a particular entity.

CHAPTER THREE: 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.

While AC does not disagree with the definition of a performance obligation, AC considers that there will be difficulty in practice in identifying the performance obligations, particularly for service contracts, for example audit or legal services, as it may be difficult to determine whether and when there is a transfer of assets under such service contracts. Some activities may transfer intellectual property over the term of a contract and may result in the delivery of a report at the conclusion of the service period. It is unclear whether such activities should be viewed as services that are providing a continuous transfer of assets to the customer over the contract term or if the service firm's activities are in support of the deliverable of a good at the end of the contract. AC would encourage the Board to provide more application guidance with respect to the identification of performance obligations contained in a contract in order to ensure consistent application of the proposed model in practice.

AC considers that, as currently drafted, the DP addresses activities which are currently addressed in IFRIC 13. If this single standard is to replace all existing guidance including that issued by the IFRIC, then AC considers that this should be explicit in the wording of any exposure draft. The proposed definition is also likely to capture certain activities of an entity that are not accounted for under the revenue recognition process under current practice. Such activities include standard warranties and other post delivery services. If the Boards ultimately conclude that such activities are in fact performance obligations, sufficient implementation guidance should be provided to address implementation issues that are likely to arise and to ensure consistent accounting practices for such deliverables.

AC believes that guidance will need to be provided with respect to the level at which performance obligations are identified. For example, in Example 4 within Appendix A of the DP, the Boards have indicated that a single, three-year warranty contract should be disaggregated into three separate one-year performance obligations with revenue allocated amongst the three years based on the expected claims (i.e., costs). It is unclear as to why the Boards have disaggregated the single three-year warranty obligation, and why into three separate one-year performance obligations (instead of, for example, 1,095 daily performance obligations of equal allocation). We believe this emphasises the need for appropriate guidance with respect to the level at which performance obligations should be identified and, if appropriate, disaggregated. This comment also applies to multiple element arrangements as outlined in example 2 of Appendix A of the DP. Indeed, AC questions whether elements which are not sold separately should be separately considered, or whether they should simply be accounted for as a single bundle.

The DP states that entities will be required to account for performance obligations that are both explicit and implicit in the contract. While AC agrees that an entity should be accounting for performance obligations that are implicit in their contracts, guidance is needed to ensure that implicit obligations are accounted for appropriately and consistently. For example, there may be practical difficulties when a right of return is not stated in a contract but is accepted in practice and guidance will be required to determine when an entity's past practice becomes a performance obligation.

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?

AC members were divergent in their views on this matter and indeed that considered in question 8. Some AC members 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, as this will ensure that an entity's revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

Other members, however, argue that the transfer of promised assets to a customer is not, of itself, sufficient to permit the recognition of revenue. Some members consider that passage of time, or more specifically, ensuring that an asset continues to be available for a period of time, is an important factor in the recognition of revenue and that such revenue would be recognised over the period for which the asset is available.

AC considered the example of a lease of an aircraft by a lessor on terms which called for the lessee to be fully responsible for the maintenance of the aircraft over the least term. The lessor simply delivered the aircraft on day 1 and thereafter collected lease premiums until the end of the lease. Some members considered that if the lessor had transferred all the risk and rewards of ownership on delivery that the full amount of revenue was available for recognition. Others argued that, notwithstanding the delivery and the passing of the risks and rewards, the lessor had to continue to keep the asset available to the lessee (i.e. not sell it) over the lease term and hence should only recognise the lease premium over that lease period rather than recognising the full revenue on the transfer of the right to use the asset.

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?

AC believes that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation. However, as noted above, there may be practical difficulties when a right of return is not stated in a contract but is accepted in practice.

AC also has concerns about the measurement of the right of return, particularly in situations where an entity has not implemented a differential pricing policy depending on whether a right of return is included in the contract or not.

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

AC considers that sales incentives give rise to performance obligations if they are provided in a contract with a customer but envisages practical issues in measuring this obligation depending on whether the entity offers the same incentives to other customers or whether it is possible to negotiate an incentive. Furthermore, such difficulties will also arise if the sales incentive spans a number of reporting periods.

CHAPTER FOUR: 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.

AC members consider the issues addressed in this question to be similar to those addressed in question 5 and hence views on this question were also divergent.

As noted earlier in the response, AC is concerned that the concept of control has not been clearly defined.

The current work on the conceptual framework project is removing the concept of control from the asset definition. There are different views on the concept of control, as noted in the FASB's Conceptual Framework project update, where it states that among the shortcomings of the current frameworks definition of an asset is that fact that some users misinterpret the term "control" and use it in the same sense as that used for purposes of consolidation accounting. We recommend that the Boards clarify how the decisions made in the conceptual framework project on the asset and liability definitions relate to the decisions in the revenue recognition project, in particular, with respect to the reintroduction of the concept of control. Similarly, the Boards should also explain how control in the context of satisfying performance obligations differs from the definition of control proposed by the IASB in ED 10 *Consolidated Financial Statements*.

As the concept of control is not clearly defined, it will not be easily applicable in practice, particularly in service contracts. AC believes clarification should be provided on how control transfers in a service arrangement.

AC also considers that the distinction between the transfer of control and the transfer of risks and rewards is important in understanding the proposed model, but does not feel that this distinction has been clearly articulated in the DP. As indicated in question 5, some members of AC consider that the transfer of risks and rewards in an asset should satisfy revenue recognition criteria. However, other members consider that it is not appropriate to only consider risks and rewards transfer but that it is important to also consider the need to keep an asset accessible for a period of time, i.e. in some revenue contracts it will also be important to consider the element of time.

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.

AC agrees that an entity should recognise revenue only when a performance obligation is satisfied but as noted above, we feel that there will be difficulty in practice in identifying the performance obligations, particularly for service contracts and those that involve making a good/asset available over a period of time.

CHAPTER FIVE: MEASUREMENT OF PERFORMANCE OBLIGATIONS

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?

AC agrees that performance obligations should be measured initially at the original transaction price. The Boards have not expressed a preliminary view on how an entity would measure contract rights but notes that any measurement of the rights should be based on the amounts of the promised consideration (i.e. the transaction price). Therefore, it is appropriate to measure performance obligations initially at the original transaction price.

AC considers that any exposure draft arising out of the discussion paper should also deal with origination costs. AC acknowledges that this is a cost issue but it arises from the origination of revenue and hence should be covered here also.

(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?

AC believes that a performance obligation should be remeasured but considers that the re-measurement principles should be considered by reference to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ("IAS 37") or other future liabilities guidance.

(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.

Whilst the views of AC members are divergent with respect to the timing of recognition, they are unified on the measurement aspect. AC considers that there are no performance obligations for which the measurement approach does not provide decision useful information.

- (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.***

AC considers that the Board should aspire to have one set of principles for the measurement of performance obligations, but recognises that there will be specific issues to deal with for financial assets and liabilities, insurance contracts, leasing and agricultural assets.

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 (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?***

AC considers that costs must be an integral part of the performance obligation to be included in the initial measurement of the performance obligation. Thus, the costs must be incurred to assist in the delivery of the performance obligation rather than merely incurred to originate the performance obligation or related sale.

- (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.***

AC believes that origination costs should be capitalised if they meet the definition of an asset, as defined in the Framework.

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?

AC agrees 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.

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?

AC agrees that if an entity does not sell a good or service separately, it should estimate the standalone selling price for allocation purposes. However, we believe that a final standard should clearly indicate that entities should use the most objective and reliable information to estimate these selling prices, in order to reasonably allocate the transaction price among the various goods or services. We believe that the Boards should include a hierarchy in any final standard, as some methods of estimation provide more objective evidence than others. We believe that the entity's stand alone selling prices provide the most reliable evidence, followed by the selling prices of third parties selling comparable goods or services, with the least reliable evidence being an entity's own estimates of the standalone selling price (e.g., a price determined using the cost plus a margin approach). We believe that any exposure draft arising out of the DP should indicate that before using an entity's own estimates of the standalone selling price, the entity should firstly be required to reconsider whether unbundling is appropriate at all in those circumstances. We recommend that the Boards include a hierarchy in the final standard that reflects the objectivity and reliability of the various measurement approaches.