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June 19, 2009

International Accounting Standards Board
30 Cannon Street, 1st Floor
London, EC4M 6XH
United Kingdom

Dear Sirs

Re: Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*

The AcSB does not believe the revenue recognition model proposed in the Discussion Paper would provide decision-useful information about the performance or sustainability of earnings for a significant number of entities. Moreover, the proposed model would not result in an improvement in practice for transactions that are challenging under existing GAAP requirements and would require a substantial conversion effort for reporting entities.

The AcSB believes an improved revenue recognition model would take the reporting entity's point of view rather than that of the customer. It should focus on the effect on the entity of what it has provided to or for the benefit of its customers. In some cases, users would be better served by a model that measures the value added to the entity by a contract as it progresses to completion; in others, fair value measurement might be appropriate to faithfully represent the effect of the contract on the reporting entity.

AcSB staff has consulted with a number of individuals representing a broad spectrum of Canadian entities. Responses to the questions posed in the Discussion Paper reflect comments gathered from these constituents as well as opinions of AcSB members.

We would be pleased to elaborate in more detail if you require. If so, please contact Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email peter.martin@cica.ca) or Kate Ward, Principal, Accounting Standards (+1 416 204-3437 or email kate.ward@cica.ca).

On behalf of the Board

A handwritten signature in black ink that reads "Patricia O'Malley".

Patricia O'Malley
Chair, Accounting Standards Board

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?

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?

The AcSB and many Canadians agree that a single revenue recognition principle based on changes in assets and liabilities would improve financial reporting. However, many are concerned that the model outlined in the Discussion Paper would not result in reporting decision-useful information for a number of industries. It is not clear why the model presented in Paragraph 2.5 was rejected.

The AcSB believes that a single model may not be achievable for all products and services. Improvements in revenue reporting may require more than one model and clear guidance on when each model applies.

The AcSB does not believe that a customer perspective model communicates decision-useful information about entities engaged in more complex transactions. The proposed model does not provide information about the performance of the entity during the period or its ability to generate cash flows in the future. Markets respond favourably when an entity obtains a new contract and information about the progress of long-term contracts is essential to users. Accordingly, the model should capture the change in assets and liabilities that are due to its activities during the period. Specific concerns include the following:

- The proposed model would fail to provide information to users about the status of contracts that are outstanding at each reporting date. This will affect entities in the aerospace and real estate industries, manufacturers of customized transportation equipment, construction contractors and professional service firms such as auditors, engineers and architects. The Canadian construction industry has developed practices to ensure progress of a project is objectively determined; accounting standards that ensure the consistency of cost allocations would help improve financial reporting for this industry. Elements of value added during the period will provide better information about the ability of the business to generate cash in future periods.
- The proposed model is inconsistent with current accounting for financial instruments. The definitions in the model could be read to produce a nonsensical result if applied to financial contracts. It is not clear that a bank's loan customer would be considered a customer for revenue recognition purposes while a swap counterparty might meet the definition of a customer whenever the contract is in a loss position but not in a gain position. Further, the measurement provisions would not assist financial statement users in understanding the effect of some of these contracts on the reporting entity. Financial instrument contracts should be explicitly scoped out of the proposals.

- The proposed model is also inconsistent with the international project to amend insurance accounting. Insurers note that users are interested in information about new policy acquisitions and the sufficiency of assets to meet expected policy obligations. Canadian insurance industry representatives believe the proposed model would not provide decision-useful information for insurance products other than certain service businesses and possibly for the preclaim period of certain short duration insurance contracts.
- The proposed model would fail to provide useful information about businesses that are not dependent on contracts with identified customers. This would include agriculture and some extractive industries. In these businesses, the viability of the entity is determined by its ability to produce a product in a cost-effective manner; customers are virtually guaranteed and the transfer to the customer does not represent a significant step in the revenue generation process.
- It is not clear how or whether the model will work for contracts where the revenue is contingent on other factors, including some consulting assignments, lessors' accounting for some property leases, licensing, franchise or royalty contracts. Although Board discussions subsequent to the release of the paper propose the use of estimates, Canadians are not sure estimation of contingencies will provide information that is commensurate with the effort required to produce the estimates. Regardless of the model chosen, disclosure of the estimation process, parameters used and variability of the estimate will be an important component of the standard.

Many Canadians believe that there are fewer problems with existing IFRS than would result from the proposed model. Implementation of the proposed model would require significant effort and resources that is unlikely to improve the quality of revenue information.

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.

The definition of a contract is a reasonable start. However, further guidance on the following issues would be necessary to ensure consistent application:

- Multiple contracts connected with large projects. The guidance currently in IAS 11 is useful in this regard. Some constituents speculated that entities might 'engineer' multiple contracts for a project to achieve a particular pattern of revenue recognition without guidance on the matter.
- Contract renewals.
- Cancellation options.
- Modifications in a contract's terms and conditions after the inception of the contract.

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.

There will be several challenges in applying the definition of a performance obligation. In many professional service contracts (auditors, engineers, architects), it will be difficult to argue that the activities leading to provision of a report or completed project are services that are provided continuously throughout the project. Several constituents are concerned that revenue recognition will be manipulated by engineering customer contracts to achieve particular revenue patterns.

In some cases, it will be difficult to identify the point at which control of the asset associated with a performance obligation transfers. If this point cannot be identified, the model would require the obligation to be grouped with other deliverables. In this case, the purpose of identifying individual performance obligations becomes lost in the application. This challenge will affect contracts that straddle reporting period ends.

It will not be possible to estimate in advance the nature or extent of the work that might be required under some contracts providing for ongoing servicing. Examples include in-service modifications to installed computer systems or software. While it makes sense to allocate a portion of the contract fee to these obligations, there will be practical difficulties in accounting for these contracts.

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?

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.

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.

The notion of tying revenue recognition to control of an asset has conceptual appeal in that it is broadly consistent with other current projects. However, there will be several complications with recognizing revenue on the basis of transfer of control of an asset. As previously noted, when the control transfer point cannot be established, there will be difficulty attaching revenue to the discrete asset to which it relates. In the proposed model, the control notion is stretched to a point that will be difficult to implement consistently.

The Discussion Paper appears to suggest that custody of an asset presumes control but this would be tempered by the laws of whatever jurisdiction governs a transaction. Legal control of many constructed assets does not transfer until the point determined as substantial completion of the asset. Many constituents believe the transfer of control notion needs to include elements of transferring risks and rewards.

The Canadian construction industry assesses project progress through a payment certifier, usually an engineer or architect, who determines the value of work performed and materials delivered to a

site in a period. The payment certificate creates a legally enforceable obligation on the customer to render payment. It also triggers revenue recognition for the contractor based on a value-added notion of the progress of the contract. Users such as bonding insurers require contractors to provide percentage-of-completion information as a condition of providing surety bonds. Transfer of control will not provide information about the progress of projects.

It might be possible in some cases to identify intermediate performance obligations by applying the definition in the Discussion Paper. However, the notion of transferring control of work in progress is likely to frustrate any revenue recognition until the project is considered substantially complete and fit for its intended use.

Many have reacted to the proposal with an assumption that multiple contracts would be created for long-term construction projects to trigger revenue recognition at milestone points. Guidance on combining multiple contracts similar to that in IAS 11 would be necessary to prevent abuse.

Additional guidance on the following issues would also be necessary to ensure consistent application:

- The effect of using the asset as collateral.
- The effect of liens registered against the asset.
- How a subcontractor recognizes revenue when control of the asset it provides to a project will not transfer to the customer until the project is substantially complete.
- How to determine transfer of control when the contractor has an ongoing interest in the finished asset.
- How to determine transfer of control when physical control passes before transfer of title. Examples include sales of condominium units prior to registration of the condominium corporation and sales that permit a developer to commence construction prior the title transfer.

Several constituents expressed concern that the proposed model does not address the treatment of costs incurred during the period. Without advocating any notion of matching revenues and expenses or deferring costs as if they are assets, users need to know whether the activities represented by costs incurred during a reporting period contribute to the profitability of the entity. In many industries, including property development and construction, margin and profitability are key performance indicators. The guidance currently in IAS 11 is considered helpful.

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?

The AcSB agrees in principle that a vendor sells the customer a put option in providing a right of return and that this represents a separate performance obligation. However, measurement of the obligation created will be extremely complex and the usefulness of information provided by a model that only remeasures obligations when onerous will be questionable. This measurement should be consistent with the approach to estimating uncollectable accounts.

Entities that offer customers the right to return goods do so with an expectation that a certain portion of sales will fail. Users are more interested in trends in return patterns; increasing levels may be indicative of deterioration in product quality that, if uncorrected, will affect the viability of the entity. The reporting model needs to communicate information that helps users assess the riskiness of the business. This is not reflected in a model that only recognizes revenue when the return period expires. In addition, some businesses offer the right of return in perpetuity; the probability that this right will be exercised diminishes over time but never disappears. It is not useful to recognize a liability for an unexpired right of return with a static measurement attribute.

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?

Post-sale obligations that affect the current transaction such as warranties are performance obligations but are similar in nature to insurance contracts. Discounts on future sales are contingent obligations that should not attach to the current sale. Guidance will be necessary for post-sale deliverables. Even with additional guidance, there will be situations that will require judgement and present opportunities for an entity to subjectively influence the pattern of revenue recognition depending on the initial estimate of standalone price and the model for measuring onerous contracts.

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?

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?

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?

Measurement of individual performance obligations on the basis of allocating the transaction price is the most logical approach. Many Canadian constituents state that using stand-alone selling prices would be easier to implement than measurement on a fair value basis.

However, the AcSB believes that using estimates to allocate a transaction price to individual performance obligations will not be workable in many cases. The most difficult transactions will be those for which there are no observable prices for individual performance obligations. The process of estimating prices will allow an entity to engineer a pattern of revenue recognition

provided the control transfer point can be identified. If the transfer point cannot be identified, revenue would be back-end loaded.

There is support for the view that the measurement model should recognize the value to the reporting entity of obtaining the contract and this will only result from a model that measures performance obligations at fair value using exit prices. We acknowledge the concerns raised in the Discussion Paper about fair value measurement and note that Canadians are not unanimous in their views on recognition of gains or losses at the inception of a contract.

It would seem that the model needs a hierarchy to guide users through the estimation process with disclosures of methods and assumptions required for the least objectively determined estimates.

The model needs to explicitly provide for discounting of future cash flows. Failure to do so reduces comparability of results between entities with short collection cycles and those that generate cash flows over more extended periods. The model also needs to provide guidance on uncertainty of collection of future cash flows.

(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?

The AcSB agrees that if outstanding performance obligations are measured at original cost, the model needs to provide for impairment of those contracts. However, we believe the impairment model for liabilities should be consistent with that for impaired assets. We believe there is much work yet to be done to reconcile varying models for the recognition and measurement of impairment losses.

Many Canadians are attracted to fair value measurement but acknowledge the challenges of applying fair value measurement to onerous contracts. The AcSB has also not considered whether the appropriate unit of account should be individual unperformed obligations or all of the remaining obligations under a given contract collectively.

(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.

(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.

Constituents noted that although fair value measurement provides the most decision-useful information for many assets and liabilities, it is not practicable for many performance obligations.

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?*
- (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.*

The AcSB disagrees with deferring recognition of revenue associated with obtaining contracts when contract-generation activity is significant. A newly negotiated, completely executory contract often has value that another party would be willing to pay for in order to avoid incurring contract origination costs itself. Revenues in some such cases are determined on a basis designed to reimburse the entity for the origination costs.