

**INTERNATIONAL ACCOUNTING STANDARDS BOARD**

**DISCUSSION PAPER: REVENUE RECOGNITION**

**CBI RESPONSE**

**July 2009**

**I INTRODUCTION AND SUMMARY OF CBI POSITION**

1. The Confederation of British Industry (CBI) is pleased to respond to the Board's Discussion Paper (DP).
2. Whilst the Board's aim is for a single revenue recognition principle, we have significant reservations whether this can be achieved in practice, certainly on the basis of the current proposals. There could also be significant cost implications for many companies and industry sectors, such as telecoms.
3. At present there are two different principles applied under IFRS : the principle of transfer of the significant risks and rewards of ownership used for goods under IAS 18; the principle of the stage of completion of the transaction used under IAS 18 for services, and under IAS 11 for construction contracts.
4. Although these are different approaches, we believe these two Standards generally result in appropriate and understandable accounting treatment, and we do not see an urgent need to change IFRS in view of the Board's other priorities.
5. We note that this is part of a convergence project with US GAAP, where more clarification and rationalisation of the principles of revenue recognition under US GAAP might be appropriate, but we are concerned that efforts to cure the weaknesses of US GAAP, could also lead to unsatisfactory reform of IFRS.

6. The DP considers that IAS 11 and IAS 18 can be difficult to apply beyond simple transactions. The DP has 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.

7. 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.

8. We consider that the recognition of revenue should reflect the performance of economic activities occurring under the contract as that activity occurs, and decision-useful information for shareholders and for management decision-making should reflect underlying economic activity. A revenue recognition principle which is solely based on contract terms without an assessment of the contract's commercial substance will not lead to decision useful information for shareholders and users. Indeed such an approach could lead to contracts being drawn up to achieve a desired revenue recognition profile, which may not fully reflect the commercial and economic substance.

9. We consider that that the most useful information provided by the reporting of revenue is when it is a measure of activity or of value added, rather than just as a measure of obligations fulfilled. In many cases the two approaches would give the same result, but the DP's approach would result in much later recognition of revenue than at present for long term construction contracts and some services, for example, consultancy, audit and software projects. This would not result in enhanced decision useful information compared with existing IFRS.

10. Indeed the DP fails to address the questions of the definition of revenue and how it is decision useful. This is necessary because the Boards have made a judgement in the DP that a revenue recognition principle based on the satisfaction of performance obligations is more useful than a principle which recognises revenue taking into account the entity's activity in the period.

11. We set out overleaf our detailed responses to the specific consultation questions.

## **II RESPONSES TO CONSULTATION QUESTIONS**

**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?**

Whilst the Board's aim is for a single revenue recognition principle, we have significant reservations whether this can be achieved in practice, certainly on the basis of the current proposals. At present there are two different principles applied under IFRS : the principle of transfer of the significant risks and rewards of ownership used for goods under IAS 18; the principle of the stage of completion of the transaction used under IAS 18 for services, and under IAS 11 for construction contracts.

Although these are different approaches, we believe these two Standards generally result in appropriate and understandable accounting treatment, and we do not see an urgent need to change IFRS in view of the Board's other priorities.

On the basis of the current proposals, there could also be significant cost implications for many companies and industry sectors, such as telecoms.

The recognition of revenue should reflect the performance of economic activities occurring under the contract as that activity occurs, and decision-useful information for shareholders and for management decision-making should reflect underlying economic activity.

A revenue recognition principle which is solely based on contract terms without an assessment of the contract's commercial substance will not lead to decision useful information for shareholders and users. Indeed such an approach could lead to contracts being drawn up to achieve a desired revenue recognition profile, which may not fully reflect the commercial and economic substance.

Our view is that that the most useful information provided by the reporting of revenue is when it is a measure of activity or of value added, rather than just as a measure of obligations fulfilled. In many cases the two approaches would give the same result, but the DP's approach would result in much later recognition of revenue than at present for long term construction contracts and some services, for example, consultancy, audit and software projects. This would not result in enhanced decision useful information compared with existing IFRS.

**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?**

Yes. For example, the application of the proposals on long-term and construction type contracts does not enable the economic substance of performance and the changes in value arising from that performance to be shown.

The principle should reflect the pattern of economic activity under the contract which would be decision-useful information for shareholders and users.

The DP already highlights three types of contract in relation to which the Boards are currently questioning the usefulness of the proposed model: financial instruments in the scope of IAS 39; insurance contracts in the scope of IFRS 4 ; and leases in the scope of IAS 17.

The DP does not articulate a clear case for where the boundaries should be set between this model and others in development. The contracts addressed in the DP have characteristics that are similar to contracts that are outside the proposed scope. In particular, 'right-of-use' licensing agreements such as those commonly seen in software contracts are similar to arrangements in the scope of the leasing project. Also, 'stand-ready' obligations such as warranty contracts are similar to insurance contracts within the scope of the insurance project.

The principle for revenue recognition within the scope of this project should reflect the performance of economic activities occurring under the contract as that activity occurs.

**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.**

Broadly, yes. However the definition in IAS 32 Para13 is worded differently, and there should be consistency in the wording, with the aim of there being only one definition of a contract in IFRS.

Also, it would be helpful to clarify the intended meaning of "enforceable" in the definition, which could otherwise be open to varying interpretations.

**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.**

The definition of a performance obligation needs further guidance, and as it might apply to different types of contract.

It is also not clear what is meant by use of the word "promise", and it might well be interpreted differently in different jurisdictions. The promise or commitment needs to be reciprocal to enable revenue to be recognised.

We are also not clear how warranties are intended to be treated, but we consider that that general or statutory warranties forming part of the contract should not be identified as separate elements of potential revenue. In contrast, enhanced warranties sold separately should be recognised at the appropriate time.

**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?**

Yes. A performance obligation can be performed /completed without the passing of legal title to the other party. For example, this would most frequently occur in long-term construction contracts where stages of completion are specified and when satisfied value transfers occur, even though legal title has not changed. However the principle may not easily applicable to some types of contract where there are not explicit points at which control is transferred.

Guidance would be helpful on how to identify individual assets and performance obligations; when control of an asset passes; and how contracts should be unbundled into separate performance obligations.

**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?**

We consider that that 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.

We do not agree that a right of return indicates a failed sale. The customer has accepted the terms of the contract, which may 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.

In connection with faulty goods, 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.

**Q7. Do you think that sales incentives (for example, 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?**

We consider that these elements do represent performance obligations. This issue is, in part, addressed in IFRIC 13 'Customer Loyalty Programmes', which generally seems to provide an acceptable approach, which could be applied more widely to the transactions referred to here.

**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.**

In our view, the DP has not demonstrated the superiority of control as set out in Chapter 4 over risks and rewards. 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.

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.

Control cannot be decoupled from risks and rewards. Risks and rewards 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. 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. Risks and rewards and control are not different approaches. They are

aspects of the same approach. In SIC 12 and IAS 18, for example, risks and rewards are used as indicators of where control lies.

There is a problem in applying the approach of the DP to long term contracts where there are no formal intermediate customer acceptance stages. We consider that a customer receives a service continuously, even when there is no formal intermediate stage. If revenue recognition is not based activity, an irregular revenue recognition pattern results which we consider is not decision useful for users. This represents a fundamental weakness of the DP's rigid approach compared with existing IFRS.

We are also unclear 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.

**Q9. The Boards propose that an entity should recognize 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.**

This will depend on how the performance obligations under a contract are interpreted. If the performance obligation is interpreted as delivery of control of the asset to the purchaser upon completion the proposed approach would not provide decision-useful information in respect of long-term construction type contracts and service agreements. In these cases the economic substance is that value accrues as performance occurs during a contract.

**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?**

Yes. The entity earns revenue by undertaking activities in performance of its obligations under the contract.

**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?**

Yes. Remeasurement will be necessary in order to reflect the effect of impairment and/or the onerous nature of a contract on the margin on the contract.

**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.**

Yes. Contracts involving long-term construction type arrangements, some oil and gas production arrangements, and some types of warranty obligations.

**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.**

We agree with the proposals regarding initial measurement. However, our concerns relate to subsequent measurement particularly in respect of the satisfying performance obligations at various stages of long-term construction type contracts.

A principle-based regime should be sufficiently robust to deal with a variety of contracts and circumstances. If exceptions are necessary this is indicative that the principle needs further consideration.

**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 (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize 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?**

Yes. These costs form part of the total amount of the contract costs which the entity will seek to recover from the contract and should be recognized as an asset if they meet asset recognition criteria.

**b. In what cases would recognizing 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.**

These costs should be recognized as an expense where they do not meet asset recognition criteria.

We believe that the treatment of these costs should be addressed in the context of a review of IAS 38 'Intangible Assets' because of difficulties arising in interpreting its requirements relating to contract origination or customer set-up costs.

**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?**

We consider that the stand-alone price could be an appropriate basis of allocation where such prices are readily available for the separate performance obligations in a contract.

However more information is needed about how the proposals might work in practice.

For example, a mobile phone provider might sell the phone for a nominal sum as part of a contract. If sold alone, the price of the phone would be much higher. Is the stand - alone price the price to the customer or the full retail price ?

**Q13. Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone 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?**

Yes. However if a service cannot be sold separately, then no value should be allocated to it.

The use of estimates should not be constrained, but there should be guidance on unbundling a contract into appropriate elements.