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**POSITION PAPER ON IASB / FASB  
REVENUE RECOGNITION PROJECT**

**RESPONSES TO QUESTIONS SET OUT IN DISCUSSION  
PAPER ON REVENUE RECOGNITION**

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**AVIATION WORKING GROUP**

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## I. INTRODUCTION

This paper provides the IASB / FASB Boards (the **Boards**) and their staff with detailed views, responses and suggestions of the Aviation Working Group (**AWG**) relating to the Boards' revenue recognition project (the **Project**), and, in particular, on questions raised by the Boards in their discussion paper / preliminary views document issued 19 December 2008 (the **Discussion Paper**).

We reserve the right to modify or supplement the positions stated in this paper as the Project develops, and consequently these positions should be viewed as provisional. Nothing in this paper shall prejudice the right of any AWG member to express contrary views, though we intend to seek consistent input to the Boards regarding the Project.

AWG is a not-for-profit legal entity whose purpose is to 'contribute to the development and acceptance of policies, laws, regulations and rules that (i) facilitate advanced international aviation finance and leasing or (ii) address inefficiencies in aviation financing or leasing or that constrain these transactions'. AWG comprises comprised of the major aviation manufacturers and financial institutions, including most of the world's largest aviation leasing companies. More information about AWG, its members, and activities may be found at [www.awg.aero](http://www.awg.aero).

AWG has a specialized sub-group for accounting issues, which is focused on the Project. Its purpose is to develop consensus recommendations for submission to, and discussion with, the Boards.

This paper assesses the Project from our experience with revenue recognition in the aviation sector, and related accounting practice. However, we are not seeking special rules applicable to the aviation industry.

## II. EXECUTIVE SUMMARY

AWG supports the Boards' efforts to develop a general revenue recognition principle as described in the Discussion Paper. In addition to the responses set out in Part VII below, we have identified the following four key matters that require further consideration by the Boards. Our thoughts on them are set out in Parts II – VI below:

- Construction and production contracts to customers' specifications
- Warranty services
- Long term maintenance service contracts
- Financing and leasing contracts

The following summarises our comments on the questions from the Boards:

- AWG agrees with (i) the Boards' revenue recognition principle being based on changes in an entity's contract asset or contract liability; and (ii) the Boards' proposed definitions of a contract and a performance obligation.
- In our view:

1. Either (a) long-term contracts should be excluded from the scope of the Project or (b) the guidance in the Project should be revised to permit current percentage of completion method for revenue and cost recognition, including permitting revenue to be recognized as services are performed;
2. An entity should separate, recognize and measure performance obligations for the transfer of goods or services only where there is a stand-alone sales price therefor offered in the market;
3. An entity has a performance obligation if it allows a customer to return goods, and should estimate the likelihood that this performance obligation will need to be satisfied based on historical experience;
4. Offering free goods or services in a contract gives rise to performance obligations, but offering a discount on future sales of goods or services does not give rise to performance obligations; and
5. A performance obligation is satisfied when (a) goods or services are transferred, at once or continuously, to a customer or (b) the customer has an unconditional right to the produced or manufactured goods, directly or by separate compensation.

### **III. CONSTRUCTION AND PRODUCTION CONTRACTS TO CUSTOMERS' SPECIFICATIONS**

Current accounting practices relating to construction and production contracts (*long-term contracts*) falling within the scope of SOP 81-1 and IAS 11 are appropriate, and, thus, should be excluded from the Project. While the Boards seek to develop a new revenue recognition model applicable to most revenue recognition situations, including long-term contracts in the Project would not lead to decision-useful information, unless the current percentage of completion method for long-term contracts is permitted.

Current accounting practices relating to long-term contracts under AICPA Statement of Position 81-1 and IFRS 11 are long-established and have proven effective. Interpreted consistently with IFRIC Interpretation 15 – Agreements for the Construction of Real Estate, such practices would not be consistent with our understanding of the guidance provided in the Discussion Paper. Current accounting guidance allows revenue recognition using a percentage of completion method if the customer is able (a) to specify the major elements of the design of the asset before construction begins, or (b) to specify major changes once construction has commenced.

The Boards need also consider the following specific matters in relation to long-term contracts:

#### **A. Cost recognition**

The Discussion Paper should include guidance on cost recognition for long-term contracts. The Boards should provide clearer guidance as to whether current accounting guidance provided in SOP 81-1, IFRIC 15 and IAS 2 will change in

respect of (a) measurement and recognition of revenue, and (b) recognition of costs - that are incurred under long-term contracts. The Discussion Paper may lead to a fundamentally different model for cost and revenue recognition, including recognition in different periods than provided in current accounting guidance. For long-term contracts, revenue and cost recognition are closely linked, whether or not the constructed goods are continuously transferred. We do not support changes to current accounting guidance that would result in a pattern of cost and revenue recognition that differs significantly from the current model for long-term contracts, as the latter is consistent with the economics of such contracts.

**B. Performance obligations and customer specifications**

Production contracts as contemplated by SOP 81-1 and IFRS 11 include complex aerospace equipment produced to customer's specifications involving extensive research and development. Production of this equipment includes significant nonrecurring engineering, tooling and learning curve costs (i.e. early costs incurred in a production process, in excess of costs to be incurred when production techniques become more efficient). A manufacturer's performance obligations include highly specialized management and construction services and acquisition of long lead-time and product-specific materials. The goods to be transferred are subject to extensive government regulation for both military and commercial applications and involve specialized contracting and accounting practices.

A customer controls the contract specifications and has the ability to change those specifications, milestone targets and other objective performance tests to measure stages of completion. That is the case even when control of the goods is not continuously physically transferred by the manufacturer. By controlling specification and retaining continuous involvement during manufacturing and production, a customer has effective control of the goods despite the fact that legal title may not be transferred to a customer until delivery of the goods. Current revenue and cost recognition generally follow cost and schedule requirements imposed by customers in order to track the cost and schedule of progress against contractual requirements. These conditions support recognition that continuous transfer occurs during long-term contracts.

Long-term contracts often include performance milestones and other objective performance measures designed to measure the stage of completion and determine the timing of payment by the customer. Regardless of when title passes, the satisfaction of performance obligations measured using the level of services provided, the achievement of milestones or, in the absence of such reliable indicators, the level of costs incurred to satisfy the performance obligation, provides economic evidence that revenues have been earned. Moreover, a customer may have a right to assume responsibility for completion of a long-term contract. Such rights provide further evidence of the nature and satisfaction of performance obligations. The Boards have indicated that the timing of consideration is generally not relevant to measuring the satisfaction of performance obligations where the goods are not continuously transferred to a customer. In sum, revenue recognition for long-term contracts should occur when milestone performance is achieved or costs incurred, including milestone criteria that subsequently lead to progress payments.

Long-term contracts generally provide for settlement of damages in the event of non-performance by a manufacturer. Depending on contractual terms and local laws, settlement may include monetary compensation and/or transfer of the good to a customer. Such settlement provisions may provide another economic measure that may be used to measure satisfaction of a performance obligation.

Providing services in long-term contracts generally represents a substantial economic component of the overall performance obligation. In contrast, the final delivery of the goods may be incidental to the overall performance obligation. In order to meet a customer's specification, the measurement of the stages of completion will include service performance. ***In conclusion, the Boards have placed undue emphasis on the transfer of goods to a customer and have not provided adequate weight to the performance of services in a long-term contract. Revenue under long-term contracts should be recognized as services are performed even though an entity has not transferred the goods to a customer.*** Since the performance obligations in a long-term contract involve providing a significant level of services, deferring revenue recognition until the transfer of the goods will result in reporting revenue in a manner significantly different than the actual economic performance.

### **C. Value of Input Models**

The Boards have proposed that:

- (a) where a long-term contract involves linked transfers of services and transfers of constructed assets at the end of the contract, the manufacturer would generally not recognize any revenue until the constructed asset is transferred to a customer, but
- (b) where the manufacturer is able to transfer the constructed asset to the customer during the term of the contract, it would be allowed to recognize revenue as the asset is transferred.

This approach will give rise (to put it charitably) to engineering of contracts to achieve the desired revenue recognition. Due consideration of the economic substance of the transactions may become subsidiary. Such economic substance requires this conclusion: long-term contracts involve transfers of services during the term of a contract, and thus, revenue should be recognized as the services are transferred.

SOP 81-1 and IAS 11 permit the use of input models for measuring percentage of completion. SOP 81-1 indicates that output models are preferable but acknowledges that output models are not always available in the circumstances. This is true in many cases where construction takes place at the manufacturer's facilities. There are no fundamental economic differences between using input and output models. Companies have designed reporting systems, including use of input models, to measure their operating performance around completion of milestones or actual costs. This information is shared in various forms with customers and investors and is linked with financial results.

The Boards' proposal could be interpreted to require that no revenue be recognized during the entire construction period since title does not transfer until completion. Such an interpretation would not enhance current financial reporting, but would distort or reduce transparency to operating performance. Customers generally have

control of constructed goods due to their continuous involvement during long-term contracts. The revenue recognition model should allow for the equivalent of percentage of completion accounting consistent with SOP 81-1 because: (i) the substantive performance obligations in most long-term contract are those of providing services throughout the completion of the contract; and (ii) the capacity of customers to direct and amend the obligations of the parties to the contract represents a continuous involvement from customers. That provides customers with many of the characteristics of control, though legal title has not transferred.

**D. Significance of Average Cost**

SOP 81-1 and IAS 11 provide the ability to allocate costs to individual units to be delivered using an average cost method. Because of the nature of nonrecurring production engineering, tooling and learning curve costs, the cost of the initial unit may significantly exceed the selling price. Furthermore, the cost per unit generally decreases over the learn-out period. SOP 81-1 recognizes that deferral of such costs is allowable for purposes of “lot” accounting. IAS 11 recognizes that deferral of such costs is appropriate where there is an expectation that such costs will be recovered under a signed contract with a customer and when such costs qualify for capitalization under IAS 37 as intangible assets. This model provides more appropriate financial reporting because it is consistent with the economics of the arrangement and there is a contractual basis (e.g. termination provisions) for recovery. *The guidance provided in SOP 81-1 and IAS 11 relating to deferral and recognition of costs should be retained.* The treatment in the Discussion Paper (if resulting in recognition of such costs early in the contract with correspondingly disproportionate margins) would not enhance financial reporting.

**E. Variable Fees**

Many contracts, particularly with governmental entities, provide that a significant amount of profit is variable and remains at risk until the end of the contract. In some contracts, all profit is variable and at risk SOP 81-1 and IAS 11 properly provide for the recognition of such profit based on estimated amounts according to the circumstances. In contrast, the Discussion Paper would require deferral of such profit until all contingencies are resolved. That would distort the financial reporting model since it would not accurately reflect the satisfaction of performance obligations.

**F. Change orders, options and claims**

Change orders, options and claims are all common in long-term contracts. Current accounting principles provide useful guidance to recognize these variable contract attributes that historically have proven reliable. Change orders, options and claims also provide further evidence that a customer has control of the constructed goods during a long-term contract. The Discussion Paper does not adequately address these issues.

**G. Practical consequence**

Companies that operate under long-term contracts have invested significant resources in the creation and operation of information and reporting systems designed to provide decision-useful information under current accounting guidance.

Implementing the Boards' proposed revenue recognition model would require companies to invest significant resources to develop and implement systems which provide information which is less decision-useful.

#### **H. Summary**

The Boards' proposed revenue recognition method would result in a significant change in the way a manufacturer recognizes revenue under a long-term contract, where (through contractual engineering) it is not able to continually transfer constructed goods to the customer during the construction period. That was not the Boards' objective. For long-term contracts, the deferral of revenue recognition until the time of transfer to a customer is neither appropriate nor decision-useful. In short, it is 'form over substance' approach that does not reflect the economic realities of long-term contracts with customer specifications. Rather, such contracts involve a continuous transfer of the services and goods to a customer. The performance obligations are satisfied when the services are provided and milestones achieved, regardless of when title passes. Thus, requiring manufacturers to change from current percentage of completion revenue recognition to the equivalent of completed contract revenue recognition will not provide more decision-useful information to users of financial statements. It would place undue emphasis on the transfer of the asset (title might be held simply as security for payment) while ignoring the economic realities of long term construction and production services.

#### **IV. WARRANTY SERVICES**

The Discussion Paper's proposed treatment of warranties as a revenue generating activity is inconsistent with the nature of warranty coverage in the aviation industry. The cost for such coverage should be considered a *cost of manufacturing the goods*, since the manufacturing process itself gives rise to the liability (the cost to correct / enhance performance of the product) .

For a variety of reasons, including those linked to safety and regulatory aspects, manufacturers in the aviation industry customarily provide warranty coverage for new aircraft and engines delivered to their customers. The practice is so long-standing and widespread, that, while warranty coverage is contractual in nature, it is viewed as a requirement.

Such warranty coverage is not separately offered in the aviation market by a manufacturer or third parties. The services provided under warranty coverage are not the same as normal maintenance services offered by a manufacturer or by maintenance / repair organizations. Warranty services relate to correction of manufacturing defects, while maintenance services relate to use of the asset.

#### **V. LONG-TERM MAINTENANCE SERVICE CONTRACTS**

Companies in the aerospace industry offer separately priced product maintenance service contracts commonly referred to as 'power by the hour' type arrangements. The economics of these contracts allow customers to transfer the risk of maintaining all or a portion of the equipment to the manufacturer. In exchange for accepting that risk, the customer pays the manufacturer a fee based on the use of the equipment.

Currently, these contracts are accounted for using the guidance in FTB 90-1 Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts. This guidance allows for the recognition of fees on a straight-line basis, unless there is sufficient evidence that cost is incurred on something other than straight-line. Given that the maintenance occurs at irregular intervals and is variable in nature, most companies in the aerospace industry have chosen a methodology that recognizes revenues based on the cost incurred. This is consistent with the cost to cost input method allowed under SOP 81-1. The Boards' proposed revenue recognition project would change the timing for recognizing revenue for these contracts. That would not be appropriate: *a manufacturer must 'stand ready' to perform required maintenance services* including by retaining personnel and having other resources available. Recognizing revenue on a *straight-line basis* during the term of a maintenance service contract would be consistent with this stand ready condition.

## VI. FINANCING AND LEASING CONTRACTS

The Boards should expand their guidance on revenue recognition to address the case where an entity provides financing for a customer or leases goods to a customer. Notwithstanding treatment on the lease accounting project (on which AWG will submit comments), the Boards have not excluded leases from the scope of the Project. Thus, such clarifying guidance is needed.

The Boards have proposed that a net contract asset / liability should be recognized for a contract with a customer involving a transfer of goods and/or services. Manufacturing companies that own captive leasing / financing companies may arrange separate leasing / financing contracts upon delivery of goods.

When a captive lessor / financier provides debt financing for a customer in connection with the purchase of goods, it has two separate performance obligations: (i) delivery of goods to the customer, and (ii) provision of leasing / financing. Each performance obligation should and can be separately measured. Delivered goods may be measured at their fair value, based on cash and non-cash consideration received. The leasing / financing arrangement may be measured with reference to the expected cash flows discounted at a market interest rate or at the implicit rate in the lease / financing arrangement. Inherent in the estimate of the implicit rate is that the residual interest is measured at fair value.

When a captive lessor / financier enters into a lease which provides that a customer will return the goods at the end of the lease term, the aggregate consideration should consist of (a) the lease receivable at inception of the lease, and (b) the fair value of the residual interest in the leased asset. That conclusion is consistent with the Boards' proposal that non-cash consideration should be measured at fair value.

A manufacturer that owns a captive lessor / financier providing leasing / financing has separate and distinct contractual and performance obligations relating to (a) delivery of the goods, and (b) provision of the lease / debt financing. As a result, the manufacturer should recognize revenue when it delivers the good, while the captive leasing / financing company should recognize lease / financing revenue during the term of the lease / financing contract.

The Boards' proposed definition of a performance obligation is presented as "*an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer.*" A captive lessor / financier satisfies its performance obligation when the lease / debt financing is provided to a customer upon delivery of the goods.

The Boards' intention of including time value of money, credit risk and non-cash consideration in the measure of consideration to be received is appropriate.

## **VII. RESPONSES TO QUESTIONS IN DISCUSSION PAPER**

For each question asked in the Discussion Paper, we present our response and comments to the question as stated, our rationale for our comments and, where appropriate, alternatives which the Boards should consider.

### **1. A CONTRACT-BASED REVENUE RECOGNITION PRINCIPLE**

**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?*

With the exceptions set out in Parts III - VI, we agree with the Boards' proposal to develop a general revenue recognition principle based on changes in an entity's contract asset or contract liability. A general consistent revenue recognition principle will lead to improved decision-useful information for the users of an entity's financial statements. A contract between an entity and its customer is a sound and practical means to identify an entity's performance obligations and provides an objective basis for determining what obligations are to be measured.

As set out in Part II, we do not support the Boards' proposal for revenue recognition for long-term contracts that involve providing goods and services to a customer's specifications.

**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 these examples?*

The Boards' proposed principle will not provide decision-useful information for long-term production and construction contracts to customers' specifications. Long-term production and construction contracts and long-term maintenance service contracts should be excluded from the scope of this project. Alternatively, the Boards should not change the way these contracts are accounted for under current accounting guidance in SOP 81-1, IFRS 11 and IFRIC 15. Long-term maintenance service contracts are essentially risk transfer arrangements and excluding them would be consistent with the exclusion of insurance contracts that are in the scope of FASB Statement No. 60. International accounting guidance for such contracts is prescribed in IFRS 4 and IAS 18.

An alternative would be to permit an entity with long-term contracts to recognize revenue as construction and production services are performed, regardless of its retained control of, or title to, the goods during the construction or production process.

**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.*

We agree with the Boards' definition of a contract. Generally, we believe that the contract should be the unit of account.

In situations where there are multiple contracts that are entered into with a customer involving the delivery of a good or service (e.g., the leasing / financing of such good or service and subsequent performance of maintenance services for the delivered good), each contract should be recognized and measured separately. Current accounting guidance, including SOP 81-1, provides for these segmentation principles.

Manufacturing companies in the aviation industry account for multiple contracts for similar items (e.g., one engine model delivered in multiple units to one or more customers) as one unit of accounting for purposes of cost recognition. They are negotiated and finalized concurrently, with one overall profit objective. Under SOP 81-1's contract combining criteria, these contracts are accounted for and costs are recognized as if it were one contract.

The Discussion Paper requires (a) the identification and separation of distinct performance obligations within a contract, and (b) the recognition of revenue as each performance obligation is satisfied - with a transfer of control of the good or service. For purposes of cost recognition, a contract should be the unit of account; separating a contract into units of accounting defined by separate performance obligations is not appropriate. Typically, a contract is negotiated on an overall basis with the individual performance obligations in the contract used to define performance milestones, which generally establish events requiring payment from the customer.

## **2. PERFORMANCE OBLIGATIONS**

**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.*

Subject to earlier comments, the Boards' proposed definition of a performance obligation will allow entities to consistently identify the deliverables in (or components of) a contract - since that definition identifies that an entity is transferring an asset or service to a customer.

**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?*

We agree that an entity should separate the performance obligations in a contract on the basis of that entity's transferring the promised assets and services to the customer.

Improved guidance is required for long-term contracts to a customer's specifications. In these long-term contracts, a customer has rights to require specific performance, including refunds of progress or milestone payments or rights to possess work in production. A contract that includes performance milestones recognizes that the manufacturer will be transferring services to a customer during the construction and production of goods. The contract will reflect this economic performance by requiring attainment of performance milestones in order to receive progress payments. The transfer of control of the asset is continuous and occurs as the production and construction services are performed. The Boards should incorporate transaction economics and performance into their guidance for revenue and cost recognition under long-term contracts. Performance milestones in a long-term contract should be considered the equivalent of performance obligations. As performance milestones are attained, performance obligations should be considered satisfied. In such situations, an entity is able to separately recognize and measure each performance obligation. It should recognize revenue when it satisfies each performance obligation.

The Boards propose (a) that revenue should be recognized when an entity satisfies its performance obligations in a contract with a customer, and (b) that performance obligations should be separately recognized and measured. If the Boards do not allow for separate recognition and measurement of multiple performance obligations (and instead link the satisfaction of performance obligations to the transfer of a good), this would contradict the Boards' intentions to link revenue recognition with satisfaction of individual performance obligations in a contract with a customer. This method would disregard the satisfaction of separately measured service performance obligations.

Improved guidance is required regarding the appropriate unit of accounting. The proper unit of account for a long-term contract is the contract and not any specific good produced or service performed. The proposal to separate performance obligations should not result in the unit of account being one delivered item - when a single contract required delivery of multiple items unit. For example, a contract to design, develop and manufacture 100 engines should be the unit of account. The unit of account should not be any single engine.

Current contract accounting standards require that an estimate be made of a single gross margin for all production units expected to be delivered. The estimate relies on an average cost for all units; each unit shipped is allocated a pro-rata portion of the total contract price based on total expected shipments. This methodology is consistent with how contracts are negotiated with customers as well as customers' understanding of the economics of the deal.

A single profit margin estimate for all similar units delivered provides a better measure of actual contact level profit margins. The profit margin earned on the first unit delivered is the same as the profit margin that is expected to be earned on the last unit. The difference between actual and average margins are recorded in the balance sheet and amortized over the remaining units. To illustrate the point see example below:

Deliverables	Proposed Guidance			
	<u>Cost</u>	<u>Revenue</u>	<u>Margin</u>	<u>%</u>
Engine 1	35	29	(6)	-21%
Engine 2	33	29	(4)	-14%
Engine 3	29	29	-	0%
Engine 4	19	29	10	34%
Engine 5	19	29	10	34%
<b>Total</b>	<b>135</b>	<b>145</b>	<b>10</b>	<b>7%</b>
Average cost	27.0			

Deliverables	Current Guidance				<u>Deferred</u>
	<u>Cost</u>	<u>Revenue</u>	<u>Margin</u>	<u>%</u>	
Engine 1	27	29	2	7%	8
Engine 2	27	29	2	7%	6
Engine 3	27	29	2	7%	2
Engine 4	27	29	2	7%	(8)
Engine 5	27	29	2	7%	(8)
<b>Total</b>	<b>135</b>	<b>145</b>	<b>10</b>	<b>7%</b>	<b>0</b>

**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?*

An obligation to accept a returned good and refund the customer's consideration is a performance obligation. If a customer does elect to return goods as allowed under its contract, the manufacturer would have a performance obligation satisfied by accepting the return and refunding the consideration. However, an entity does not control a customer's decision to return the good, and is not receiving separate consideration for its obligation to accept returned goods. As a result, that an entity should defer revenue recognition until a customer's right to return has elapsed.

An entity can estimate: (i) the likelihood that a customer will return goods; and (ii) the refund amount. This estimate should be based on historical experience and known issues relating to the transferred good. An entity does not offer a return performance obligation in the market for a stand-alone price. However, since a performance obligation does exist and may be measured, an entity should measure its performance obligation based on the entity's estimate of the likelihood of a return and the estimated refunds that will be paid. This practice would be consistent with current accounting guidance.

We recommend deferring the recognition of revenue only for the revenue amount that is expected to be refunded based on historical experience.

- 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?*

An offer of free goods or services to a customer does give rise to a performance obligation. Since the offer is at no cost to a customer, the customer’s consideration can be measured - at zero - and an entity should expect a customer will require delivery of the free goods or services.

An offer of a discount on a future sale of a good or service does not constitute a performance obligation. It does not impose a contractual obligation (i) on a customer to purchase a future good or service, or (ii) on an entity to sell a good or service. It only requires an entity to provide a discount on future sales. An entity will not have a performance obligation relating to the discount on a future sale until it enters into a subsequent contract with a customer. That performance obligation should only be measured based on the existence of such a contract.

### **3. SATISFACTION OF PERFORMANCE OBLIGATIONS**

- 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.*

Broadly, an entity satisfies a performance obligation when it transfers an asset to a customer or performs a service for a customer. As noted above, an entity with long-term contracts satisfies a performance obligation when it performs the production or construction services, regardless whether the produced / constructed good is transferred to the customer during the term of the contract or at the end of the contract.

- 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.*

An entity should recognize revenue when a performance obligation is satisfied.

### **4. MEASUREMENT OF PERFORMANCE OBLIGATIONS**

- 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?*

We support initially measuring the performance obligation at the transaction price, as that provides verifiable, objective evidence regarding the value of the

performance obligation. As noted above, for warranty performance obligations, an entity should accrue for the cost of the expected warranty obligation and recognize the cost at delivery of the goods.

*(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?*

If a performance obligation is deemed onerous, an entity should remeasure its performance obligation at the expected cost of satisfying the performance obligation. That is justified since that cost represents the expected use of economic resources to satisfy the performance obligation. Otherwise, an entity would be deferring a known future loss for a committed obligation.

Additional guidance should be included to allow for estimates of award fees, change orders and claims where there is sufficient historical evidence to support the most probable outcome. This would involve remeasurement of performance obligations that arise in long-term contracts, but would not involve an onerous performance obligation.

*(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.*

When an entity determines that the costs of satisfying a performance obligation are onerous, it should not remeasure the performance obligation in a manner that would result in reporting profit in future periods. Satisfying the performance obligation will require an entity to incur costs that are equal to or higher than the original measurement of the performance obligation. Yet, if it reports profit on the future satisfaction of a performance obligation, this would imply that satisfying the performance obligation is not onerous. The fact that the performance obligation is onerous should mean that profit would not be realized upon satisfaction of the performance obligation.

As noted above, measurement of a performance obligation relating to legally required warranty coverage for new goods would 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 that measurement approach you would use.*

The measurement of an onerous performance obligation should include the expected future costs to satisfy that performance obligation.

**Q11** *The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amount 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 these 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 a contract should be included in the initial measurement of an entity's performance obligations? Why or why not?*

Where a contract provides for a customer to specifically compensate an entity for the costs of obtaining a contract (e.g., an award fee), such costs should be included in the initial measurement of the entity's performance obligations. If a contract does not include separate consideration for such costs, those costs should be charged to expense as incurred. An entity's efforts to market and sell its goods and services, including negotiating and obtaining a contract with a customer, are not revenue-generating activities for an entity.

*(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.*

Current U.S. accounting guidance in FAS 91 permits the capitalization of initial direct costs. Current international accounting guidance in IAS 18 and IAS 39 is similar, but less clear relating to internal costs. The Boards have indicated that costs involved with revenue recognition should be recognized, measured and reported following current accounting guidance. The Boards should consider whether the guidance in FAS 91 and related guidance in IAS 18 and IAS 39 should be harmonized.

In the aviation leasing / financing industry, entities include the initial direct costs for a leasing or financing transaction in their pricing models in order to obtain an implicit leasing rate or financing yield (that will provide for recovery of initial direct costs). Contracts are agreed prior to delivery of an aircraft or engine to the customer. Since the initial direct costs relate to the documentation of the contract, such costs will benefit the entity during the term of the financing or leasing contract. As a result, capitalization of these costs at inception and amortization over the term of the contract would be appropriate (if an entity also recognizes revenue over the term of the contract). If an entity recognizes these initial direct costs as expense as incurred, while recognizing revenue over the term of a contract, an entity would be providing less decision-useful information as the performance at the beginning of a contract would be negatively distorted.

**Q12** *Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone 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?*

With the exception of long-term contracts, we agree that the transaction price should be allocated to the performance obligation on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations. An entity's standalone selling price for goods or services provides objective, verifiable evidence. If an entity does not offer a good or service for a standalone sales price, another objective source would be

the standalone price for a similar good or service offered by market participants.

**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?*

No.

The Boards have indicated in the Discussion Paper that (a) an entity should estimate the market sales value for each performance obligation that is separately identified, and (b) where sales values are not available from market data or from an entity's normal sales activities, an entity should estimate the market sales values for these performance obligations.

An entity should not separately recognize or measure performance obligations if a service is not offered in the market. Estimating market sales values for such services would be neither practical nor provide improved decision-useful information. An entity's estimate would be significantly affected by judgment (and could be manipulated), may not be objectively verifiable, and would pose challenges for independent auditors. Current U.S. accounting guidance for measuring revenue, where multiple deliverables exist, requires an entity to use vendor-supplied objective evidence of fair value. Current international accounting guidance is less clear. If an entity is required to estimate the market sales value for services not offered in the market, this will represent a significant change to current accounting practice. That would be contrary to the Boards' stated intention. It would also imply that the provision of such services is a revenue-generating activity, which may not be the case.