



International Accounting Standards Board  
First floor  
30 Cannon Street  
London  
EC4M 6XH

19 June 2009

Dear Sir/Madam

### **Preliminary Views on Revenue Recognition in Contracts with Customers**

With a membership in excess of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales (ICAEW). London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to bodies such as yourselves.

We welcome the work that the boards have done to date on revenue recognition, and support the concept of a single standard in principle. We are also cautiously supportive of the boards' focus on a single principle to drive the recognition of revenue insofar as it focuses on the extent to which a promised good or service has become the asset of the customer, though we have some concerns over how this concept may be developed and expressed at the next stage of the project.

We believe the next output from the project should be a more comprehensive discussion paper. As the boards acknowledge, most of the detailed issues (which, in practice, are often fundamental to revenue recognition) have not yet been addressed. Moreover, the boards' core concept, the transfer of control, has been expressed only in very high level terms, and will need to be developed considerably before an accounting standard can be drafted. Because of the importance of revenue recognition for financial reporting, it is essential that the boards take whatever time is necessary to produce a coherent and robust standard, rather than rushing for an unrealistic deadline.

At present, one of our key concerns is that the 'transfer of control' concept is not sufficiently clear and might be applied very differently by different preparers. Although this concept may inform the boards' thinking, we believe it is essential that any accounting standard is drafted using terminology that is more directly related to the practicalities of revenue transactions. Otherwise, there is considerable danger that users will focus, wrongly, on title or physical possession as the key drivers for revenue recognition. In our view, it is both possible and desirable for the boards to preserve the existing concept of a distinction between goods and services and to develop detailed guidance for each that is consistent with the 'transfer of control' concept. In essence, a 'good' will be an item for which control is transferred at a point in time, whereas a 'service' will be an item for which control is transferred continuously.

We would also emphasise the need for robust and clear guidance to be drafted at the next stage. The recognition of revenue is a very complex subject and one which

requires a considerable degree of judgement. It will not be sufficient for an accounting standard merely to outline a high level principle (e.g. the 'transfer of control'). The issues that exist in practice today will not disappear merely because of a change in the terminology used in accounting standards. With that in mind, we encourage the boards to consider the existing guidance on revenue recognition that is reflected in IFRSs and in other GAAPs, with a view to retaining and developing the best material in a manner that is consistent with the core approach. We note above that we believe the existing concepts of goods and services should be retained and developed by identifying those characteristics that distinguish one from the other. Some work has already been done in this area in IFRIC 15. Another key issue for revenue recognition is the treatment of multiple elements, and we encourage the boards to develop the idea of 'standalone value' that can be found in other GAAPs. This typically focuses on whether an undelivered element is an 'optional extra' or, if not, whether it could be obtained from a different supplier.

Summing up, if a standard on revenue is to be effective in practice, it needs to balance, on the one hand, being sufficiently simple to understand and apply and, on the other, being sufficiently sophisticated to reflect properly the economic substance of a very wide range of revenue-generating activities. To achieve this, it is important the standard uses concepts and terminology that will be clear to users. We do not believe that references to 'control' in the context of a contract will achieve this, and we urge the boards to retain (but develop) the existing concepts of goods and services. We note also that consistent interpretation of a standard is likely to be greatly enhanced if illustrative examples with rationale are attached.

Our responses to the individual questions in the discussion paper are attached as an appendix to this letter.

We trust you find our comments helpful in the consultation process and please do not hesitate to contact our Chairman, Brian Creighton on +44 (0) 207 893 3415 if you wish to discuss any of our comments further.

Yours sincerely

A handwritten signature in black ink that reads "Brian Creighton." The signature is written in a cursive, slightly slanted style.

**Brian Creighton**  
LSCA Technical Committee Chairman

### 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?**

In principle we agree, but we note that the DP does not contain sufficient explanation of how the boards will implement this proposal in practice. Without the guidance that will need to be developed at the next stage (e.g. on the distinction between goods and services and the approach to multiple element arrangements), it is too early to judge whether the DP's proposals are appropriate.

### 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?**

Where an entity sells assets that are already reported at a current value and for which there is a deep and liquid market (e.g. some financial instruments), revenue from contracts is not particularly decision-useful information. Instead, the change in value of those assets is more decision-useful. But this does not suggest that there is a flaw in the way that revenue from contracts is defined. It would not be misleading to report as revenue the proceeds from selling such financial instruments – it is simply that a figure for revenue relating to such transactions may not be worth reporting.

### 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.**

Yes, though we think it might be better to have a single definition of a contract that applies to all IFRSs. Some guidance would be useful on identifying the point at which a contract exists. This might explain, for example, that an offer does not become a contract until there is acceptance by the customer, and might point out that offer and acceptance will establish a contract even if a written agreement will be signed only at a later stage. We believe that it may also be helpful for an accounting standard to clarify whether, or in what circumstances, the following are within the scope of the intended revenue standard:

- where an entity will receive a grant that is conditional on it meeting certain obligations; and
- where an entity's transactions are governed by statute rather than contract (as is the case for some utility companies in the UK).

### 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.**

We do not disagree with the definition, but users will not be able to apply it consistently in practice unless additional guidance is given. That additional guidance should deal with scenarios such as multiple element arrangements, because concepts such as unbundling and standalone value will often be key in determining whether control of a particular deliverable has passed to the customer.

The DP may seem to suggest that a warranty will always be a separate performance obligation, but we do not believe that this is the case. In our view, a warranty that the quality of goods supplied is as specified in the contract is not a separate performance obligation: it

forms part of the performance obligation to supply goods of the agreed quality. Conversely, we agree that 'extended warranties' should be regarded as separately identifiable components of a revenue transaction if they create potential obligations to the customer that will not exist if the customer chooses to buy goods without taking an extended warranty.

#### **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?**

Broadly yes, but we are not convinced that it is always appropriate to use the word 'transfer' in this context, because in the case of some services we do not think the seller will necessarily have an asset to transfer. We think it is better to say that an entity should separate the performance obligations in a contract on the basis of when the promised assets become assets of the customer.

#### **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?**

We do not support the 'failed sale' approach, because it would seem not to allow any revenue to be recognised until a return option has expired. However, we find it difficult to comment further until we see how the boards develop their thinking on this subject.

#### **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?**

Yes. We note that this is consistent with IFRIC 13 *Customer Loyalty Programmes*.

#### **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.**

We believe that an entity satisfies a performance obligation when (or to the extent that) the promised asset is an asset of the customer. As noted in our response to question 5, we do not think it will always be appropriate to use the word 'transfer'. We also suggest that the boards avoid using the verb 'to satisfy' in relation to a performance obligation, as it is potentially ambiguous. For example, under a contract to paint a customer's room, the painter 'satisfies' the obligation over a period of time as paint is applied, and we would expect revenue to be recognised over that period. But it is possible to say that the performance obligation to paint the room is not 'satisfied' until the end of that period.

To the extent that a promised asset is an asset of the customer, it follows from the definition of an asset that the customer must 'control' the promised asset. However, we do not believe that it is helpful for a revenue standard to be drafted around the concept of 'control', because it is too ambiguous and too far removed from the day to day practicalities of accounting for revenue transactions. Users may misunderstand the concept and, wrongly, focus only on legal title or physical possession. They may focus, again wrongly, only on changes that can be made once the contract is in progress, without considering the extent to which the contract was driven by the customer in the first place. (We expand on this point below.) Or, based on some of the guidance in the DP, they may focus on whether the customer has the right to take work in progress from the seller. We believe that in most cases the existence or not of

such a right will be of very little economic significance, and that it is not a good indicator of control.

Rather than draft a standard by reference to 'control', we believe the boards should develop the existing idea of a distinction between goods and services. That distinction should focus on those factors that determine whether an incomplete item is an asset of the seller (goods) or of the customer (services). We believe that this distinction can be drawn by focusing on whether, in substance, the item is a 'standard' item made by the seller (goods) or is bespoke for the customer (services). We note that IFRIC 15 already draws a similar distinction.

We believe that it is possible to develop additional guidance on goods and services that is entirely consistent with a concept of 'control', i.e. focusing on who has an asset. As in the case of subsidiaries, we think it is important to distinguish between 'control' and 'day to day management'. Control is about shaping what will be done, i.e. devising operating and financial policies, rather than the day to day execution of those policy decisions. Thus, where a customer specifies the design of an item, and the seller agrees to manufacture to the customer's design, it seems to us that the customer has control of the item as it is manufactured, so that revenue should be recognised as the item is manufactured. Even if the contract does not allow the customer to modify the design once construction has started, the customer will generally be able to request that construction ceases at any time, and the seller will typically be entitled to be paid for any construction work done to date.

Conversely, where an item is manufactured to a seller's existing design, we believe that control of any work in progress will generally remain with the seller. In most cases, the ability of the buyer to take possession of that work in progress will not be of economic relevance and will not affect the seller's control of the asset.

#### **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.**

See the answers to questions 1 and 2.

In addition, we are not convinced that it will be practical or helpful to apply this approach to insurance contracts or exchanges of financial instruments.

#### **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?**

Yes.

**(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?**

No. We believe that an onerous contract provision should be recognised only if the expected cost of satisfying the outstanding performance obligations in aggregate exceeds the carrying amount of those performance obligations in aggregate. Applying an onerous contract test at the level of individual performance obligations is inappropriate, and might require a provision to be recognised at inception for a contract that is profitable overall, merely because some components within the contract will be loss-making.

**(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.**

The DP rightly notes that the approach taken needs to balance the benefits of using up to date measures against the difficulty and expense of obtaining reliable up to date measures for many contracts. In many cases, the approach proposed by the DP of 'freezing' the original allocation will be both cost-effective and decision-useful. But this may not be the case for contracts where there is considerable uncertainty over the value of performance obligations, or where the value of those obligations may be expected to change very significantly during the course of the contract.

In addition, we think it is important to distinguish between changes that occur after a contract has been entered into and improvements to estimates. Where no external selling prices are available for individual performance obligations, it may be necessary at the start of a contract to estimate those selling prices by predicting the associated costs and adding a reasonable margin. Where better information becomes available about the costs that should have been predicted, we believe it is appropriate to allow an entity to revise the original estimates and, hence, to revise the allocation of the contract price to individual performance obligations. To insist on retaining the original allocations, even though they were based on relatively poor information, may result in financial reporting that does not properly reflect the relative profitability of different performance obligations. But it is important that an entity is not required to reconsider the original allocation at subsequent dates unless there is reason to think that failing to revise the original allocation would lead to significant distortion of the reported figure for revenue.

See also our comments at the end of this appendix in relation to royalties receivable.

**(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.**

Yes, for example it may be necessary to remeasure obligations relating to contracts with considerable estimation uncertainties, such as insurance contracts, for the reasons discussed above.

#### **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?**

No, we disagree. Contracts with customers are assets. Where such contracts are obtained in a business combination, it will be common for them to be recorded initially at fair value. Outside of a business combination, it seems appropriate for them to be recorded at cost, which would include any directly attributable costs of obtaining those contracts – for example, amounts paid to agents for obtaining the contract. In our view, such costs should be capitalised from the point at which it is virtually certain that a contract will be obtained.

**(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.**

See above.

#### **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?**

Yes, but it is important to allow sufficient room for judgement in how best to do this. In many cases, the unit price of an item is different depending on how many are purchased in a single transaction. It is important that any required methodology allows sufficient room for interpretation for an entity to arrive at an allocation that is economically meaningful, rather than arbitrary and misleading.

#### **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?**

Yes, we agree that the use of estimates should not be constrained. But it might be helpful for a standard to outline a hierarchy (similar to that used for the purposes of measuring fair value of financial instruments) so that, for example, estimates derived by adjusting selling prices for similar items would be superior to estimates based only on associated costs.

#### **Other comments**

##### *Royalties*

In practice, there are a number of issues associated with royalties receivable, but the DP does not address this subject. If a licensor has no further obligations to a licensee, the logic of the DP suggests that the amounts payable by the licensee will be recognised as revenue. Guidance will be needed, for example, on how to deal with uncertainties over the amounts that may be paid, particularly where these are within the control of the licensee (e.g. because they are linked to sales made by the licensee).

##### *Definition of revenue*

Paragraph 1.18 notes that there are different definitions of revenue in US GAAP and IFRSs. It would be desirable to have single converged definition of revenue as a result of this project.

The reference in the US GAAP definition to 'ongoing major or central operations' suggests that it is narrower than the IFRS definition, and might therefore lead to some income not being regarded as revenue. Under IFRSs, it is not uncommon for an entity to distinguish between revenue and other income. However, we see this as a presentation issue to be addressed in IAS 1 *Presentation of Financial Statements* rather than an issue for this project.

##### *Collectibility*

Paragraph 6.13 suggests that revenue might be recognised even where collectibility is not reasonably assured. We believe that more consideration should be given to this at the next stage of the project. It seems possible to us that such an approach might work where an entity has a reasonably large population of similar revenue transactions, such that it is possible to estimate overall expected outcomes reliably. However, we doubt that such an approach would provide meaningful information for an entity with a very small population of revenue transactions.