

Sir David Tweedie Chairman of the International Accounting Standards Board 30 Cannon Street London EC4M 6XH **United Kingdom**

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Dear Sir David

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

We appreciate the opportunity to comment on the Discussion Paper mentioned above and would like to submit our comments as follows:

General Remarks

The Boards propose a single, contract-based revenue recognition model that might have significant effects on present practice in some circumstances. Revenue is a crucial part of an entity's financial statements and has an important role for the assessment of an entity's performance. Therefore, a thorough discussion and definition of the terms "revenue" and "performance" should be carried out in the context of the Conceptual Framework-Project before a new approach on revenue recognition can be deliberated seriously. Especially, the question whether revenue should reflect the activities that an entity undertakes in fulfilling a contract with a customer (even if the customer does not yet control and have the risks and rewards of ownership) has to be tackled conceptually.

In our view, it is an indispensable prerequisite of a fundamental change in accounting requirements that the intended improvement of the financial statement information is substantiated. We believe that this is not the case with regard to the Discussion Paper, at least in respect of construction contracts. We would therefore prefer the Board concentrate on amendment and improvement of the current standards (IAS 11, IAS 18) to eliminate the identified deficiencies in-

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stead of rashly implementing a considerable change to the revenue recognition model. Although the Discussion Paper refers to the lack of guidance for transactions involving the delivery of more than one good or service (i.e., multiple-element arrangements) and other issues as a main reason for the proposals (cp. DP 1.12 et seqq.), in our view, the paper does not result in a substantial improvement in this area. It might have been sufficient to integrate the respective interpretations of the IFRIC into IAS 18. All in all, we believe that there is a stronger need for a change in the revenue recognition standards in US GAAP as compared with IFRSs.

The Discussion Paper draws solely on the principle of "transfer of control" in order to determine the point in time when an entity satisfies a performance obligation, i.e., when it recognises revenue. In contrast, extant IAS 18 refers to the concept of "risks and rewards" and "control". We are concerned that attaching less importance to the "risks and rewards" approach may result in a legalistic approach. This might be the case, for example, when assessing whether an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation. We refer to our answer to question 6. We believe that the economic aspects always need to be considered appropriately, as we have previously noted in our comment letter on ED 10 "Consolidated Financial Statements" dated 19 March 2009.

The Discussion Paper was published despite the fact that the Boards have not yet discussed certain important matters relating to the proposed model, in particular, the measurement of the contractual rights, including time value of money, uncertain consideration and non-cash consideration (cp. DP S8, S24, 5.5). Therefore, this constitutes yet another example of a piecemeal approach rather than proposing comprehensive solutions in one step, as we had previously mentioned in our comment letter to the IASCF on the Constitution Review, Part II, dated 19 March 2009.

In this context, we would like to mention that we do not support the IASB accelerating projects on account of the pending changes in the composition of the Board, because there is a danger that this may result in overly hasty decisions, as well as an artificial fragmentation of projects that are actually intrinsically related to oneanother.

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



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why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

In general, we agree that a single revenue recognition principle is preferable to having two or more different principles. However, if a thorough analysis were to suggest that this is not feasible, at least at this point in time, it might be preferable to improve the current standards instead of implementing a new model prematurely. We refer to our General Remarks.

Given the definitions of an asset (Framework, para. 53 et seqq.), liability (Framework, para. 60 et seqq.), income (Framework, para. 92) and revenue (Framework, para. 74), we believe that the Boards' proposal is appropriate because it enhances the verifiability of financial statements. However, those terms would first of all need to be substantiated in the context of the project on the Conceptual Framework. Until this has been achieved, it is not possible to assess whether the identified inconsistencies between the revenue recognition standards and the Framework would be resolved, not only in the short term but also in the medium and long term.

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?

According to the Discussion Paper, revenue is recognised when the promised asset is transferred to the customer. Consequently, in case of (specifically negotiated) construction contracts, revenue will be recognised on a continuous basis only when there is a continuous transfer of assets and a continuous transfer of control over the assets so that the asset becomes the customer's asset continously. In the proposed model, revenue would reflect the transfer of promised goods and services to customers, and not the activities of the entity in producing those goods and services. Activities that an entity undertakes in fulfilling a contract result in revenue recognition at the time of those activities only if they simultaneously transfer assets to the customer and, hence, satisfy a performance obligation. Under this revenue recognition model, for construction contracts as defined in IAS 11 revenue would usually not be recognised during the construction phase by reference to the stage of completion of the contract activity, because, at least in Germany, the legal environment often hinders a successive transfer of both "control" and "risks and rewards" (we refer to our comment letter on IFRIC D21, dated 2 October 2007). We appreciate that the



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proposals of the Boards are internally consistent. However, in our view, the proposed model seems to be overly legalistic and to neglect the economic substance, at least for construction-type contracts.

The Boards are considering excluding financial instruments and insurance contracts from the scope of the revenue recognition standard. We share the Boards' doubts as to whether the proposed revenue recognition model would appropriately depict those types of contracts.

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 Boards believe that the definition of a contract as proposed in DP 2.11 ("A contract is an agreement between two or more parties that creates enforceable obligations.") is consistent with the IASB's definition of a contract in IAS 32.13 ("In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing."), despite their different wording.

However, in our opinion, the IFRS should include only one definition of a contract, even if the two definitions are believed to be consistent with oneanother. Otherwise there is a danger that these different definitions might be subject to different interpretation.

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.

The Discussion Paper defines the term performance obligation as follows: "An entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer". A promise in a contract may also arise from the operation of law or an entity may, by its customary business practice, have implicitly or constructively created an obligation



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that would be enforceable. At a conceptual level, we agree with the proposed definition. However, we are not convinced that the Discussion Paper sets out how to identify separate performance obligations sufficiently clearly. In Example 1 and Example 3, whether the service could be sold separately appears to be decisive. Para. 3.37 of the Discussion Paper draws on whether customers would pay an additional consideration. However, in the case of access fees for membership (Example 7), the Discussion Paper comes to the conclusion that such an entrance fee does not transfer a promised asset to the customer. We would appreciate the Boards clarifying how performance obligations should be identified in a principles-based manner.

According to the Discussion Paper, a warranty would be accounted for as a separate performance obligation, resulting in the recognition of revenue only when the promised warranty is provided to the customer, i.e., over time as the warranty services are transferred to the customer. Accordingly, accounting for the expected cost of a normal (statutory) warranty in accordance with IAS 37 at the time the related procuct is sold, as is current practice under IAS 18.16(a) in conjunction with IAS 18.19, would no longer be allowed.

In our view, this is neither convincing from a conceptual point of view nor practicable, for the following reasons:

- From a conceptual point of view, it could be argued that the costs an entity incurs to meet normal (statutory) warranty claims are further costs directly related to items already delivered (see IFRIC 13.BC9(a)). These costs result from features of the delivered good as promised in the contract. Accordingly, such warranty services are, in our view, not separate performance obligations.
- Measuring the stand-alone selling price of such warranty services is burdensome because usually they are not directly observable and therefore have to be estimated.
- Services pertaining to normal (statutory) warranty provisions will usually be immaterial when compared with the product to which they belong.

Admittedly, this might be different in the case of voluntary (additional) warranties. The latter are indeed separate performance obligations, since the entity can decide whether it wants to offer the product in conjunction with the voluntary warranty or not. Consequently, the customer will have to pay an additional consideration in order to obtain the voluntary warranty.

Furthermore, the distinction between goods and services is a crucial feature within the proposed revenue recognition model as it determines the pattern of



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revenue recognition, for the following reason: Typically, a good is an asset that is transferred to a customer at a point in time, whereas a service typically results in a continuous transfer of assets to a customer over a period of time. Accordingly, in case of goods, revenue usually is recognised at a single point in time whereas there is a continuous flow of revenues from services because of the continuous transfer of control to the customer over a period of time. However, the distinction is not sufficiently clear in the Discussion Paper. The chapter pertaining to this topic (cp. DP 4.38 et seqq.) draws on examples rather than establishing a clear principle. For instance, according to DP 4.48 customisation of a good is an indicator that the contract may be for services, but the incidence of customisation does not, per se, lead to that conclusion. An ambiguous distinction might result in problems, for example if an entity promises to develop specific software for a customer, it might be difficult to decide whether the performance obligation is the development of the program, i.e., a service, or the transfer of a good, i.e., of the finished program.

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?

According to DP 3.24, if an entity promises to transfer a bundle of goods and services to the customer at the same time, then the entity can account for those promised assets as a single performance obligation. In other words, an entity needs to separate a contract's promises into separate performance obligations only when the customer receives the promised assets at different times. The principle underlying this notion is on aggregation of identified performance obligations. In our view, the main problem in this context is not aggregation or separation of performance obligations, but identification and definition of a performance obligation. We refer to our answer to question 4.

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?

Based on the Boards' assumption that it is appropriate to draw solely on the principle of "transfer of control" in order to determine the point in time when an



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entity satisfies a performance obligation, an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation. The promised right of return is an enforceable term of the contract. Some of the revenue is attributed to the return service and the transferred good can no longer be recognised as an inventory. However, in order to reflect the economic substance of the transaction, we believe that it is necessary to consider "risks and rewards" in addition to "transfer of control" (we refer to our General Remarks).

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?

In our view, it is appropriate to classify sales incentives included in a contract with a customer as performance obligations provided that they relate to the existing contract, and not only to a future contract. For example, if the customer receives the sales incentive without having to enter into a new contract, i.e., without an additional obligation to pay, this gives rise to a performance obligation within the existing contract. In contrast, if the customer has to enter into a new contract in order to receive the sales incentive, it is not a part of the existing contract, but of the new contract.

However, we would like to point out that the distinction between existing and future contracts is not as straightforward as it may seem at the first glance. For example, where a framework agreement exists between the entity and its customer, it is not clear whether each individual contract should be treated separately. We would appreciate the Boards clarifying the relevant unit of account in this context.

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.

The Boards believe that a focus on "control" results in more consistent decisions about when assets are transferred and reduces the room for judgement.



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Accordingly, the linked revenue recognition concept of extant IAS 18.14 ("risks and rewards" <u>and</u> (transfer of) "control") would be replaced by "transfer of control" as the only revenue recognition criterion. In our view, because the concept of "control" is related to the legal structure of the transactions, there is a danger that economic aspects might be neglected.

Furthermore, we doubt whether the concept of "control" as set out in this Discussion Paper is consistent with the "control" notion in the Exposure Draft "Derecognition – Proposed amendments to IAS 39 and IFRS 7" published in March 2009. According to the Exposure Draft, an entity (transferor) still has control over an asset if the entity transfers the asset to another entity (transferee) but the transferee does not have the practical ability to transfer the asset for the transferee's own benefit (cp. ED IAS 39.17A). This implies that the transferee must be free and able to transfer forward the asset that is subject to the (first) transfer in order to assume control. Such a "control" notion is different from the "control" concept proposed in the Discussion Paper "Preliminary Views on Revenue Recognition in Contracts with Customers".

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.

We refer to our answer to question 2, in which we explained our concerns pertaining to the effects of the proposed revenue recognition model on construction 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?

We agree with an initial measurement of performance obligations at the original transaction price.



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(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?

We 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.

DP 5.69 states: "The IASB is discussing the existing measurement requirements of IAS 37. One interpretation of that standard is that it would require entities to measure a performance obligation at the lower of (a) the amount to transfer the obligation to a third party at the financial statement date and (b) the amount to settle with the customer at that date." This interpretation assumes a current settlement notion. As already set out in our joint letter with the GASB, dated 22 May 2007, in our opinion, this view is neither compelling nor appropriate, provided the entity intends to fulfil the obligation itself. Frequently no market prices are available for these kinds of obligations. In general, it might be appropriate to draw on best estimates of the future costs. However, there are differing views as to whether to include only incremental costs or all costs that can be reasonably allocated to the settlement of the obligation ("incremental costs approach" versus "full costs approach"). Such an ultimate settlement notion is, amongst others, supported by IAS 37.68, which refers to costs of fulfilling the contract as the relevant measurement basis. In contrast to the statements set out in DP 5.68 and DP 5.77, measurement in accordance with current IAS 37 is therefore not always based on a current price trigger, i.e., including a margin, but a cost trigger, i.e., without a margin, at least when the incremental costs approach is applied.

In our opinion, a cost trigger should be used to determine whether a performance obligation is onerous because remeasurement should only be necessary if the entity expects that the satisfaction of a performance obligation will result in a loss. Using a current price trigger and thus reflecting every adverse change in circumstances would increase both the frequency of remesurement and the complexity of the future standard.

Another topic which still has to be considered in the context of remeasurement of performance obligations when deemed onerous is the appropriate unit of account. The following alternatives might be considered:

• level of the individual performance obligation



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- level of aggregated, similar performance obligations
- level of the contract as a whole.

The higher the level on which the onerous test is carried out, the higher the probability that there is an offset of gains and losses. In our opinion, the relevant remarks in the Discussion Paper are not sufficiently clear on this topic (cp. DP 2.27, 3.24, 5.55 et seqq.). We would appreciate the Board clarifying this issue in its Exposure Draft.

- (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.

DP 5.90 lists examples for which the proposed measurement approach might not provide decision-useful information (beyond financial instruments and insurance contracts). These are long-term, fixed price contracts for goods and services with volatile prices, contracts in which the outcome depends on specified uncertain future events and long-term contracts involving "big ticket" items, such as large construction projects. We do not share the concerns with an approach that remeasures such performance obligations only when they are deemed onerous. As mentioned above, remeasurement of performance obligations should not reflect every adverse or favourable change in circumstances. Instead, the approach should be similiar to that of an asset impairment test, resulting in a remeasurement only if the performance results in a loss (one-way test). Furthermore, the remeasuring of performance obligations only when deemed onerous is consistent with IAS 37.66 et seqq.

We do not support any exemptions for the respective contracts, because we suspect that a clear definition and distinction, respectively would not be possible.



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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?

In our view, it is appropriate to include amounts that an entity charges customers to recover any costs of obtaining the contract in the initial measurement of the performance obligations while recognising those costs as expenses, unless they qualify for recogition as an asset. We concede that this leads to a measurement of performance obligations that includes components that do not relate to the remaining performance obligations, thus distorting the pattern of revenue recognition. Nevertheless, mainly for reasons of practicality and verifiability, we prefer this treatment to the recognition of revenue or income at contract inception, i.e., before the entity transfers any of the goods and services that are promised in the contract to the customer.

(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.

We are not aware of any circumstances where recognising contract origination costs as expenses as they are incurred would not provide decision-useful information about an entity's financial position and financial performance. In our view, an asset should be recognised if, and only if, it fulfils the requirements of the definition of an asset and the prerequisites for the recogition of an asset.

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



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services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

We 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.

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?

We also agree, in principle, to this position of both Boards. However, in practice it might be very difficult to carry out such allocations, for example in the software industry where programming and maintenance or support often are closly related. In such circumstances, estimates will inevitably include substantial spreads.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

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