

DUTCH ACCOUNTING STANDARDS BOARD (DASB)



Secretariat:
Antonio Vivaldistraat 2-8
Postbox 7984
1008 AD Amsterdam
The Netherlands

T +31 (0)20 301 03 91
F +31 (0)20 301 02 79
rj@rjnet.nl
www.rjnet.nl

International Accounting
Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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Direct dial : Tel.: (+31) 20 301 0391 / Fax : (+31) 20 301 0302
Re : Comment on the Discussion Paper “Preliminary views on Revenue Recognition in Contracts with Customers”

Dear members of the International Accounting Standards Board,

The Dutch Accounting Standards Board (DASB) appreciates the opportunity to respond to the IASB Discussion Paper (DP) on revenue recognition.

Overall we support the comments of EFRAG raised in their draft comment letter which was published on May 5 2009 with the exception of a slightly different view on the issue of day-one-revenue.

General

Generally we have two main concerns regarding the principles of the Discussion Paper:

- We are in favour of a continuous approach from the perspective of the supplier instead of a critical event approach from the perspective of the customer; and
- Although with some hesitations we believe that in some cases a ‘day-one-revenue’ (revenue at contract inception) reflects the economic substance of transactions and therefore should be recognized.

Below we have summarized our main concerns with respect to the DP. In Appendix 1 to this letter we have included our specific answers to the questions of the Discussion Paper.

Continuous approach from the perspective of the supplier

We believe that the approach of the DP to recognize revenue not sooner than at the transfer of goods and services to the customer, will not lead to the desirable relevance of information in the financial statements. We are of the opinion that performance should be assessed from the perspective of the supplier, rather than from the perspective of the customer as in the DP. The supplier perspective leads to more relevant information about the performance relating to agreements with customers during a period. Therefore we are in favour of a model in which

revenue, pursuant to a contract with a customer, is recognised which reflects the progress of the entity pursuant to the contract, and not merely the transfer of assets between the entity and its customer(s)". In such a so-called continuous approach model revenue best reflects the activity towards completion of goods and services, although (we think) certain criteria should be met before revenue is recognised. For example these can be (besides (the existence of) an agreement with a third party), a transfer of risks and rewards, a reliable measurement of both revenue and costs associated with the transaction and the probability that economic benefits associated with the agreement will flow to the entity.

We are therefore in favour of the model proposed by EFRAG in their draft comment letter which was published on May 5 2009.

Day-one-revenue / revenue at contract inception

Concerning this issue in general we are not convinced that measurement of the performance obligations in contracts with customers at the initial transaction price will always lead to economic relevant information. Although with hesitation we nevertheless believe that in some situations at contract inception an asset is likely to exist and therefore revenue could be recognized. This is because there could be situations in which entering into a contract can lead to a revenue because concluding the contract can be considered an activity. Based on the assets / liability approach it can be argued that, when certain conditions are met, entering into a contract leads to a contract asset that is higher than the remaining performance obligations. Therefore in principle we support the exit price approach for the reasons set out in paragraphs 5.15 and 5.16 of the DP. This approach typically can be appropriate when concluding the contract is the most substantive part of the transaction(costs) and/or the costs of fulfillment of the performance obligations are rather insignificant. So day-one-revenue might be appropriate in cases where the transaction price is substantively higher than the fair value / exit price of the performance obligations.

The following examples illustrate such situations:

- The transaction price includes amounts to recover relative substantial costs associated with obtaining the contract. Like for example in obtaining a large construction contract where the supplier has to make an extensive proposal including a proposed design and/or plan for the realization of the project. Other examples are life insurance contracts or hotel / holiday time share contracts with relative large selling commissions;
- The costs of fulfillment of the performance obligation are rather insignificant compared to the transaction price like for example types of entrance fees or membership fees;
- Part of the transaction price does not relate to the performance obligations as a result of an imperfect market where the customer pays a price that actually is too high. For example as a result of an aggressive selling technique. Or as a result of some kind of monopoly-position of the supplier.

We believe that in those situations revenue could be recognized at contract inception and initial measurement of the performance obligations should not be at transaction price, but at fair value / exit price. This also could solve the mismatch that may occur when direct selling costs (such as commissions paid to a third party for obtaining a contract) are recognized as

expenses as incurred, which may not be in the same period as that in which the related revenue is recognized.

We understand the concerns of the board with an approach that allows recognition at contract inception as stated in DP 5.17 onward (uncomfortability with the pattern of revenue recognition, complexity and risk of error). Our hesitation for measurement at fair value / exit price mainly is because we are not sure whether this value can be measured reliably. For this reason we believe that before any revenue could be recognized at contract inception, an entity clearly should be able to demonstrate that:

- the fair value / exit price of the performance obligations is substantively lower than the transaction price; and
- the fair value / exit price can be measured reliable.

Therefore we propose to consider a rebuttable presumption of initial measurement at transaction price. A standard should contain sufficient and well described guidance on how to measure the fair value / exit price reliable.

Scope

The board has not considered yet whether any financial instrument contracts, insurance contracts and leasing contracts should be excluded from the proposed model, and has planned to do so after reviewing comments on the DP Revenue Recognition (DP S11-S13).

In addition, the board may consider a second measurement approach for revenue recognition for certain types of contracts with highly variable outcomes like some insurance contracts (DP 5.99). Because the insurance project will probably lead to an exposure draft during the next twelve months and the outcome of the discussions on revenue recognition could have a great impact for the insurance project, we have attached a separate Appendix 2 to this letter with our comments to the DP from a perspective of insurance contracts.

Context of our comments

Our comments should be read in the context of existing IFRSs. We thus believe that a general standard for revenue recognition in contracts with customers should be part of a comprehensive approach of future developments in standards, including the Framework.

Of course, we would be happy to discuss our reaction with you.

Yours sincerely,



Hans de Munnik
Chairman Dutch Accounting Standards Board

Appendix 1: Answers to the questions

Appendix 2: Comments to the discussion paper from a perspective of insurance contracts

Appendix 1: Answers to the questions

Chapter 2

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?

Answer DASB

Yes we agree. We believe revenue should be based on a contract or agreement with a customer and can be measured on the basis of changes in contract assets and contract liabilities. Contracts with customers are the lifeblood of entities that provide goods and services. Also a principle of revenue recognition based on an entity's contract position could solve the current problems in IFRS as described in DP 1.9 to 1.16.

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?

Answer DASB

We believe revenue should be recognized as obligations towards customers are met: a continuous approach. We do not agree with the principle that revenue can only be recognized when an entity has transferred the promised goods or services to the customer. We believe that the activity towards completion of the goods and services should measure the revenue, although certain criteria should be met before revenue is recognized. For example these can be (besides (the existence of) an agreement with a third party), a transfer of risks and rewards, a reliable measurement of both revenue and costs associated with the transaction and the probability that economic benefits associated with the agreement will flow to the entity. We believe that this approach leads to more relevant information about the economic activity undertaken pursuant to more complex customer contracts than critical event approaches (such as the transfer of an asset). We also believe that such a continuous approach is easier to apply to transactions involving multiple deliverables.

For more detailed reasoning on this subject we refer to the draft comment letter of EFRAG.

Also we believe that, in certain cases, entering into the contract itself could lead to the recognition of revenue, and that this should lead to recognition of revenue at contract inception. For more detailed reasoning on this subject we refer to our cover letter.

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.

Answer DASB

Yes we agree. (the board's definition is: A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract.)

Chapter 3

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.

Answer DASB

We do not think that the definition and supporting material in the discussion paper would be sufficient to enable entities to identify the deliverables in a contract on a consistent basis. For more detailed reasoning and comments on this subject we refer to the draft comment letter of EFRAG.

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?

Answer DASB

We agree.

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?

Answer DASB

In cases where the 'right to return' could be sold separately we think that right is a performance obligation, because it is a promise to transfer cash that is an enforceable term of the contract.

In many cases however customers will make no or only little use of the right to return the goods. In these cases the value of the 'right to return' can be insignificant compared to the value of the goods. Identifying a separate performance obligation is not practical in those situations and we believe is not necessary for economic relevant information.

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?

Answer DASB

Yes, we believe that sales incentives give rise to performance obligations in case the incentive could be sold separately.

Chapter 4

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.

Answer DASB

We do not agree that the satisfaction of a performance obligation should be assessed from the critical event of transferring an asset (the perspective of the customer). We believe the satisfaction of a performance obligation should be assessed from the perspective of the supplier and therefore a continuous approach of fulfilling a performance obligation is more appropriate. For detailed reasoning we refer to our answer to question 2.

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.

Answer DASB

We do not agree entirely. In our cover letter we explain that in some cases it should be possible to recognize revenue at contract inception, therefore before satisfaction of a performance obligation. Secondly we do not agree with the proposal to consider the performance obligation only as satisfied at the transfer to the customer.

Furthermore we think it is not clear on how to apply this principle of revenue at transfer in cases where the fulfillment of the promise to transfer an asset depends on whether or not a future event occurs, for example in insurance contracts or financial instruments. In that case the entity may not transfer any good or service at all (although there is a promise to do so in case the future event occurs).

Chapter 5

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?

Answer DASB

No, we do not agree entirely. In some situations we believe that at contract inception an asset is likely to exist and therefore revenue could be recognized. There could be situations in which entering into a contract can lead to a revenue because concluding the contract can be considered as an activity. Based on the assets / liability approach it can be argued that, when certain conditions are met, entering into a contract leads to a contract asset that is higher than the remaining performance obligations. In principle we support the exit price approach for the reasons set out in paragraphs 5.15 and 5.16 of the DP. This approach typically can be appropriate when concluding the contract is the most substantive part of the transaction (costs) and the costs of fulfillment of the performance obligations are rather insignificant. Day-one-revenue might also be appropriate in cases where the transaction price is substantively higher than the fair value / exit price of the performance obligations. Therefore we believe that in some situations initial measurement of the performance obligations should not be at transaction price, but at fair value / exit price.

(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?

Answer DASB

Yes, we agree (because of the principle of prudence);

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.

Answer DASB

We refer to our answer of question 10 (a).

(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.

Answer DASB

We refer to our answer of question 10 (a).

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 (e.g. 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?

Answer DASB

There should be a mechanism to solve the mismatch that may occur when direct selling costs (such as commissions paid to a third party for obtaining a contract) are recognized as expenses as incurred, which may not be in the same period as that in which the related revenue is recognized.

(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.

Answer DASB

We refer to our answer of question 10 (a).

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?

Answer DASB

We agree.

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?

Answer DASB

We agree.

Appendix 2: Comments to the discussion paper Preliminary views on revenue recognition in contracts with customers from a perspective of insurance contracts

1 General

The purpose of this annex is to highlight some potential implications of the DP revenue recognition for insurance contracts. On November 28, 2007 we issued our comments to the IASB's preliminary views on insurance contracts. In our opinion, the choices that eventually will be made with respect to revenue recognition will interact with the answer to the question as to whether insurance contracts should be partly or entirely scoped out from a revenue recognition standard.

2 Identification of the nature of an insurance contract

In our comment letter of November 28, 2007 we articulated the importance of properly identifying the nature of an insurance contract. Insurance contracts may have the nature of:

1. (Mainly) a service contract.
2. (Mainly) a financial instrument.
3. A set of contractual arrangements that may individually be identified as a service contract or a financial instrument respectively.
4. A different type of contract that neither meets the characteristics of a service contract or a financial instrument.

We believe that users of financial statements would be best served by generally applicable principles that apply to all types of contracts. If however, option 4 would be the case, the final and separate standard for insurance contracts might not necessarily mean that the principles set out in the future new standard on revenue recognition will contradict with the principles for insurance contracts. The IASB has already included considerations in the DP revenue recognition of having two measurement approaches (transaction price and explicit measurement) of which one of them might be applicable for insurance contracts¹. If on the other hand option 1 – 3 would be the case, at least the following subjects that are specific to insurance contracts, should be addressed:

- Unbundling.
- Building block approach (including dealing with risk margins and measurement).
- Day 1 profit (and acquisition cost).
- Beneficial policyholders' behaviour.

3 Unbundling

In our understanding, revenue recognition in accordance with the measurement of performance under the contract requires unbundling of contracts that embed various deliveries, taking place at different moments. The more complex such a contract is the more difficult is unbundling. Certain insurance contracts have great complexity and performance takes place over a long period. When commenting on the preliminary views on insurance contracts, the insurance industry raised great concern about unbundling. Specific concerns are:

¹ When current fulfilment value, based upon the 3 building blocks will be the measurement attribute for insurance liabilities, this may lead to a similar revenue recognition pattern as foreseen in the DP.

- Transaction prices for the individual components of the contracts are often not available. Hence, unbundling could require an approach that is related to the fulfilment costs of the separate components rather than the transaction prices.
- Most insurance enterprises have blocks of existing contracts (some originate from decades ago) for which information regarding the separate components may not be available. Without a practical approach, the cost of unbundling may exceed the benefits to the users of financial statements.

4 Building blocks and measurement

In our understanding, the building blocks approach still refers to the IASB's conceptual view, but the alignment to the transaction price is a "practical shortcut" that gives relevant and faithfully represented information for most of the contracts with customers.

In our opinion, insurance contracts are an exception where the more conceptual building blocks approach as explained in paragraph 5.9 is more appropriate, because current estimates of the fulfilment costs and changes therein are relevant to users. This is especially true for long-term contracts.

One of the building blocks mentioned in paragraph 5.9 is the margin. We assume that this margin includes the risk margin. This risk margin is of specific importance to the insurance industry, because the core activity of this industry is "handling risks". We did not make up our mind about the question whether or not the risk margin should be remeasured each period, but we cannot imagine that it would not play a role in the onerous contract test.

In addition, we would mention subsequent measurement. The best estimates of cash flows relating to an insurance contract change over time and the impact for long-duration contracts may be material. We believe that the impact of such changes is relevant to the user of financial statements; consequently, the impact of true-ups should always be recognised and not only (as the DP suggests) when they trigger the onerous contract test.

5 Day 1 profit

The IASB's preliminary view is that no profit should be recognised at inception of the contract. This is consistent with most comments to the preliminary views on insurance. However, we wish to point your attention to some consequences of such a position.

- Unrecognised profit at inception may be relevant information to the users of financial statements and is under circumstances part of the available solvency. Disclosure of reliably measurable unrecognised profits should be seriously considered (consistent with IFRS 7).
- For many insurance contracts significant upfront expenses are incurred. These expenses create an accounting mismatch unless it would be allowed bifurcating premium income into a pre contract and a contract fulfilment component or the delivery of the insurance cover to the customer would be considered performance.

6 Beneficial policyholders behaviour

In the discussion paper on revenue recognition, the IASB deliberately restricts to contractual obligations and not to contractual rights.

We are not sure as to whether insurance contract measurement would depict all relevant aspects without involving the contractual rights. The IASB should make a choice between generally involving the contractual rights in the discussion of measuring (net) performance obligations or looking for a solution that is specific for insurance contracts.

If this issue is not addressed, IFRS may become irreconcilable with other publicly available reporting (like MCEV or the intended Solvency and Financial Condition Report under Solvency II) and acquisition costs may create accounting mismatches because of the term of many insurance contracts and the upfront investment by insurance enterprises to obtain such contracts.