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

The Danish Accounting Standards Committee set up by The Institute of State Authorized Public Accountants in Denmark is pleased to comment on the discussion paper on Preliminary Views on Revenue Recognition in Contracts with Customers (in the following referred to as 'the DP'). Please find our comments on the questions in the order suggested by you in the appendix to this letter.

In summary, we support the proposal in the DP to develop a single contract-based revenue recognition model if this is an achievable goal. At the same time, we find it important that all types of contracts with customers are accounted for in a way that provides useful information for the users of financial statements and is also reliable. These objectives might not be possible to achieve within a single standard, but this must of course be the overall objective of the project.

In general, we support the proposed contract-based model which recognises revenue based on the transfer of control. However, we do have some reservations about the proposal for certain types of contracts (e.g. certain types of service contracts and many construction contracts), and we question whether transfer of control model as set defined in the DP is an appropriate definition.

In many situations, transfer of control as set out in the DP could be interpreted as a change of legal ownership. In our view, the transfer of control should be understood in a broader sense, i.e. transfer of economic control, which in transactions with certain goods and services might take place at an earlier point in time than the transfer of legal ownership. In the appendix, our view is supported by some examples.

We would furthermore like to draw to your attention that the principles presented in the proposed revenue recognition model in the DP are relatively broad, and the examples presented in the DP to illustrate the principles presented are relatively simple. Furthermore, the boards have not yet determined how to apply various aspects of the proposed model.

For those reasons, we find it difficult to fully evaluate the proposed model, including how the model would be applied for more complex transactions.

Therefore, we find that the boards need to draw up a well-developed framework for applying the broad principles to achieve a consistent application of the principles. Furthermore, we find that an implementation guidance is needed, e.g. to cover more complex transactions and industry-specific transactions.

Please do not hesitate to contact us if you would like to further discuss any specific issues addressed in our response.

Yours sincerely

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## **Appendix – Responses to the questions asked in the DP**

### **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?*

We agree with the proposed single-based revenue recognition principle, which is, in fact, a concept that could reduce some of the inconsistency in the existing standards. On the other hand, we believe that the proposed model in most transactions will provide the users with decision-useful information, but in some transactions, the model might not provide the most useful information. We refer to the examples in question 8.

Furthermore, we believe that the boards should analyse several more complex revenue transactions to develop a view on whether the single-based model will provide the most decision-useful information for the users.

### **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?*

In some situations, we find that there are some types of contracts for which the proposed principles would not provide decision-useful information. Those contracts relate to the recognition of some construction contracts and some service contracts. If those contracts only include one performance obligation (as defined under the proposed model - i.e. the transfer of control), the recognition of revenue will take place at a much later point in time than under the current revenue recognition principle. We question whether this change in the timing of recognition of the revenue will improve the understandability of financial statements and the decision-usefulness of financial statements.

Some have argued that the proposed contract-based transfer of control model should be changed to a more activity-based model to reflect the economic reality in an entity as the activity progresses. This would solve the problems addressed with certain construction contracts and service contracts. On the other hand, some other issues would arise - e.g. a reliable measurement of the activity based on, for example, progress of the production, or the discussion of whether an activity in an entity should only be based on production or also on sales and distribution.

We also believe that a model based on changes in an entity's assets and liabilities is a conceptual improvement of the current model. The asset-liability definition of revenue can probably solve many of the inconsistencies that exist in the current revenue recognition.

In our opinion, the proposed model - with some minor changes - does meet a lot of the goals set out for a revenue recognition model, but the boards certainly need to investigate some specific weaknesses in the proposed model on certain revenue transactions. Mostly, the weaknesses are due to the concept that a performance obligation is satisfied when the transfer of control of a certain asset passes from the entity to the customer. We believe that the definition of transfer of control might be interpreted as a transfer of legal ownership of the asset. In our opinion, the transfer of control should be understood more widely and be based on the substance of the transaction and a transfer on the economic control of the asset.

See to our answer to question 8.

### **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.*

We agree with the boards' definition of a contract. Some have argued that there are differences between the definition in the DP and the IAS 32 definition of a contract. As it is important that standards only include one definition of a contract, the boards should consider whether it should be the one in IAS 32 or the one in the DP.

### **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.*

In our opinion, the proposed definition of a performance obligation is acceptable, but before the principle is finalised, the boards need to implement more guidance on how to identify different performance obligations in a contract.

Furthermore, we would like to direct attention to our answer to question 8, in which we discuss how the transfer of control, in our opinion, should be more widely defined.

### **Question 5**

*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?*

In our opinion, there is no doubt that this is a performance obligation. The fact that the customer has a right of return does not imply that there has been no sale of goods. The asset is transferred to the customer, and the customer has control of the asset, i.e. a performance obligation is satisfied. The contract includes another performance obligation which is the right of return, and it makes sense to recognise revenue on this obligation as the right of return expires. Otherwise, more or less all sales in the retail business would not be recognised until the right of return expires, which would not be useful information to the users, as a sale in most of the transactions has taken place, and the goods will not be returned.

### **Question 6**

*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 on the basis of when the single performance obligation is satisfied, i.e. the transfer of the asset promised to the customer. But we are also of the opinion that the separation of performance obligations is essential to the proposed model, and we therefore encourage the boards to include several examples of and guidelines on how to split a contract into separate performance obligations.

Regarding separation, we would like to draw the boards' attention to the definition of onerous contracts as it could be difficult to identify such onerous contracts if the performance obligations delivered to the customer at the same time are not separated. On the other hand, we acknowledge that it is impossible, in practice, to separate all performance obligations into separate obligations only to secure the recognition of onerous contracts. Therefore, we accept the presented principle for separating performance obligations.

#### **Question 7**

*Do you think that sales incentives (eg discounts on future sales, customer loyalty points, 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?*

We agree that sales incentives should be treated as separate performance obligations if they are in a contract with customers. It is of no consequence whether the sales incentive is discounts on future sales, customer loyalty points or free goods.

#### **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 agree that the transfer of control takes place at the time when the performance obligation is satisfied. On the other hand, we would like to see a more widely defined concept of control based on economic control rather than on transfer of legal title. Our thinking is to some extent similar to the control concept under the current and proposed derecognition of financial assets rule's. It is best illustrated by a couple of examples.

The first is an example of a buyer and a seller entering into an agreement of the construction and the sale of a vessel. The contract only contains one performance obligation, which is the delivery of the vessel, but the vessel is produced based on specifications from the buyer and is produced in a way so that it can only be used by the buyer. Under current IFRS, such a transaction would probably be considered a construction contract, and revenue would be recognised along with progress of production. Under the DP, revenue on such a contract would probably only be recognised at the time of the transfer of the vessel to the customer. In such a situation where there is no doubt that the vessel will be delivered to the customer when the production has been finished, it could be argued that the new recognition principle would lead to a too narrow definition of the transfer of control. This is due to the fact that because the shipyard has no realistic alternative but to deliver to the customer with whom it has the contract, the shipyard does in fact loose control along with progress of production. This is due to the fact that no other customer would ask for exactly the vessel under construction and the fact that the shipyard would have to pay a significant compensation to the buyer if it failed to deliver under the contract.

Another example is a transport service where the transporter enters into an agreement with a customer to transport some of the customer's products from A to B. In this situation, the present recognition principle would lead to recognition of revenue continuously as a service contract under IAS 18. Under the new principle, the performance obligation is only satisfied when the goods are delivered at the destination, and revenue can therefore only be recognised

at this point of time. This also applies even though there is no doubt that the transporter will deliver the service (transport) to the customer and the customer has no possibility to replace the transporter.

One could also discuss a transaction involving the statutory audit of the financial statements of a company where the audit is performed over a long period of time. The performance obligation will, in this example, be the expression of an audit opinion which is only satisfied once the auditor signs the audit opinion. In such a situation, the only performance obligation is the expression of the audit opinion, and revenue under the new principle will only be recognised at this point in time, even though there is no doubt that the auditor will get paid for the hours spent on the engagement (this will be the case even if the auditor is replaced during the audit).

In our opinion, the boards should consider a more widely defined concept of the transfer of control as there is a risk that financial statements containing transactions such as the above-mentioned would not present the most useful information. The economic substance in a transaction should therefore also have an impact on when the transfer of control takes place. In the above-mentioned examples there is no doubt that the goods or service will be delivered by the seller, and they cannot be exchanged by other goods or services. One could therefore argue that the transfer of economic control takes place through the production of the good or performance of the service, and revenue should be recognised as this transfer takes place even though only one performance obligation is satisfied at the time of delivery of the service or the good.

### **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.*

As we have discussed in earlier questions, one could argue that some construction contracts and some service contracts, where there does not appear to be a continuous transfer of control (control as defined in the DP) - i.e. there is no transfer of control until the final delivery of goods or services is made - might not present useful information to users of financial statements. One could argue that the proposed model will not provide decision-useful information for those construction contracts and service contracts where there is no doubt that the transfer of the asset/the service, due to the contract with the customer and due to the customised good or service, but where there is no performance obligations satisfied until the actual transfer of legal ownership.. Therefore we propose that:

- The definition of transfer of control is broadened
- Application guidance is provided to help entities identify performance obligations and to help entities assess when performance obligations are satisfied.

We further refer to our comments on question 8 above.

### **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 the boards' proposal. Measurement of a transaction initially at the transaction price is a well-known and understandable concept, which is also used today. It represents the consideration agreed upon in a transaction between two independent parties. The transaction price also represents a reliable measurement of the transaction between buyer and seller, which in many transactions could lead to problems if the current exit price approach was used.

- (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 initial measurement of the performance obligation? Why or why not?*

We agree that a performance obligation, which is deemed onerous, should be remeasured. We also agree that a cost trigger is the most consistent way of measuring an onerous contract. Having said that, a discussion whether a contract is onerous normally takes place under IAS 37, and the principles for recognition and measurement of onerous contracts are subject to that standard. It is therefore our opinion that the discussion concerning onerous contracts should take place together with that liability project as it does not directly involve revenue recognition. Furthermore, we do not believe that there can be two measurement principles for onerous contracts; one in the new revenue recognition standard and one in the new liability standard. The principles have to be the same.

- (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 boards have, so far, excluded financial instruments, leases and insurance contracts from this revenue recognition discussion. Furthermore, they have, to some degree, scoped out biological assets. Doing so, they have excluded some of the contracts where measurement at fair value is relevant. Therefore, we find that the measurement principles for performance obligations in the DP provide useful information for users of financial statements.

- (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.*

It could be argued that all performance obligations should be measured based on the same method, e.g. no changes in measurement at each reporting date, or based on the current exit price approach. We have not considered whether another principle might be relevant for a specific type of contract.

### **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 an expense, unless they qualify for recognition as an asset in accordance with other standards.*

- (a) *Do you agree that any amounts that 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?*

We agree with the proposal. Any consideration the customer pays should be included in the measurement of the performance obligation as part of the total consideration. This also includes any amount that the entity charges the customer to recover the cost of obtaining the contract.

- (b) *In what cases would recognising contract origination costs as an expense as incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.*

In our opinion, contract origination costs should be expenses as incurred. But one could argue that this does not present useful information as the costs in many transactions are linked directly to the sale and therefore is part of that sale. On the other hand, is it difficult under the current definition of an asset to argue that such a cost can qualify as assets that should be capitalised. The situation is therefore difficult to address in a reliable and consistent way, and our view would therefore be based on the asset definition, under which contract origination costs do not qualify for capitalisation.

### **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?*

We agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices.

### **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 agree with the proposed estimation model. In our view, estimates should only be constrained by reliability. If an estimate is not reliable, revenue should only be recognised at the same level as costs have been recognised, and no profit should therefore be recognised. The same principle is applied today in IAS 11.