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# **Exposure Draft – Revenue from Contracts with Customers:**Comment Letter#

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<sup>&</sup>lt;sup>#</sup> This paper is processed as an output of a research project "Analysis of Accounting Standards for Income Reporting – New Approaches in the World and the Possibilities of Their Utilisation in the Czech Republic" (registration number GA402/09/P523).

Dear Sirs.

I would like to provide you with several comments on the Exposure draft ED/2010/06 "Revenues from Contracts with Customers".

First of all, I should mention that I have been pursuing the work of both Boards since very beginning of the Revenue Recognition Project. I really appreciated an economic approach taken for the recognition and measurement of revenue. I am supporter of measurement of performance obligations at their fair value even if the risk of recognising revenue already at the contract inception exists. I understand why the Boards' members changed their minds and shifted to the measurement of performance obligations with the reference to (relative) stand-alone selling prices. However, I do not agree with the winning approach in some extent.

I am fully aware of all difficulties connected with the issues raised during Revenue Recognition Project. Revenue recognition is a complex task with a lot of ambivalent solutions. The inherent problems contained in the process of revenue recognition are one of main reason why the Project took delays and the deadlines for Exposure Draft and final standard were postponed several times. In the end, the Boards had to make some compromises in order to finish the work on the Project. Unfortunately, I suspect that compromises taken will preclude reaching the initial aim of the Project, i.e. to create cohesive standard eliminating inconsistencies in existing accounting guidance and giving more robust framework for addressing future revenue recognition issues.

Despite above mentioned objections, the Boards' effort to develop new guidance on revenue recognition is important and the (draft of) new standard is a genuine step forward. I will not answer the questions raised in the Exposure Draft, as I believe you will receive huge number of answers from reputable researches, institutions and companies. I will provide you "only" with some comments and questions on certain parts of the Draft which (from my point of view) can cause inconsistencies in the practical application. My remarks that follow are based on economic theory behind revenue recognition and also on my practical experience with several companies in the Czech Republic dealing with financial reporting under the IFRS. I hope you will find some of my comments useful for your future work.

Yours faithfully

David Procházka

# **Comments and questions**

# 1 Section "Scope"

# 1.1 Paragraph 7

# Text of the Paragraph:

A contract with a customer may be partially within the scope of this IFRS and partially within the scope of other IFRSs. If the other IFRSs specify how to separate and/or initially measure any parts of the contract, an entity shall first apply those separation and/or measurement requirements...

## **Questions:**

Is it possible to provide an example of such existing IFRSs, to which the ED/standard may refer? Or is it just a general proclamation in order to be prepared for future development within IFRS?

#### **Remarks:**

I can see possible risk of inconsistency if another IFRS sets different guidance on separation and/or measurement of performance obligations. The mixture of bases used for measurement can mislead the users and worsen the usefulness of financial statements. I would recommend using the same pattern for identification, measurement and recognition of performance obligations, contracts and revenues in all situations.

# 2 Section "Recognition of revenue"

# 2.1 Paragraph 15

# Text of the Paragraph:

Conversely, an entity shall segment a single contract and account for it as two or more contracts if the price of some goods or services in the contract is independent of the price of other goods or services in the contact...

#### **Questions:**

What would happen if none of conditions on independent prices is met (e.g. if neither entity, nor its competitors regularly sell particular goods or services separately), but the contract comprises of performance obligations which are supposed to be satisfied in different period of time?

# 2.2 Paragraph 16

# Text of the Paragraph:

If entity segments a contract in accordance with paragraph 15, the entity shall allocate the total amount of consideration to each identified contract in proportion to the stand-alone selling prices of the goods or services in each identified contract (i.e. on a relative stand-alone selling price basis)...

#### **Questions:**

Is the stand-alone selling price another measurement basis used by the IFRS? Will it be incorporated into the Framework?

#### Remarks:

The allocation of transaction prices into separate performance obligations is one of biggest issues. The foundation of preferred solution is obvious; to eschew recognition of revenue at the

contract inception. However, this prudent approach to measurement of revenue can cause the inconsistency in measurement of contracts containing single performance obligation (measured at transaction price) compared to contracts consisting of two or more performance obligations (measured at relative stand-alone selling prices). The measurement of liabilities is then inconsistent and the confusion of users can further increase taking into account the provisions of Paragraph 7 on possible distinct approach to measurement of performance obligations required by other IFRSs. As a consequence, the evaluation of financial position can be difficult.

# 2.3 Paragraph 19

# Text of the Paragraph:

An entity shall account for a contract modification together with the existing contract if the prices of the modification and the existing contract are interdependent...

... If prices of the contract modification and the existing contract are not interdependent, the entity shall account for the contract modification as a separate contract.

#### Remarks:

Despite of the fact that guidance on distinguishing whether prices are or are not interdependent is included in the Draft, the presented solution might raise doubts on possible errors or even manipulation and breach of rules when assessing the substance of contract modification. I would suggest considering treatment, which will use the single approach to all modifications. However, I leave open the decision, which treatment to use.

# 2.4 Paragraph 23

# Text of the Paragraph:

A good or service, or bundle of goods or services, is distinct, if either:

- the entity, or another entity, sells an identical or similar good or service separately; or
- the entity could sell the good or service separately because the good or service meets both of the following conditions:
  - it has a distinct function ...
  - it has a distinct profit margin ...

#### **Remarks:**

In my opinion, the condition that similar good or service has to be sold separately (either directly, or indirectly) is very prohibitive and can cause that entities will recognise simultaneously revenue from parts of contract which has very different pattern for satisfaction of performance obligations and thus different pattern of revenue accretion. As an example I can mention the guarantees, which are more deeply analysed in Chapter 4.

# 3 Section "Measurement of revenue"

# 3.1 Paragraph 35

# Text of the Paragraph:

... The transaction price reflects the probability-weighted amount of consideration that entity expects to receive from the customer in exchange for transferring goods or services...

#### **Remarks:**

The requirement of revenue measurement with reference to customer consideration, which is probable to be collected, is well in the line with the economic logic. However, it opens space for

earning management extensively. In order to arrive at useful and consistent information in financial statements it is necessary the treatment of subsequent changes in probability of receivables collection is handled in the same manner as initial measurement of revenue (i.e. via adjustments of revenues and not through expenses).

### 3.2 Paragraph 37

# **Text of the Paragraph:**

If an entity receives consideration from a customer and expects to refund some or all of that consideration to the customer, the entity shall recognise a refund liability.

# **Questions:**

How should the refund liability be accounted for? As a reduction of revenue or as expense? Or should it be accounted for only in balance sheet without influencing income statement? Or is the treatment left on the decision and accounting politics of each entity?

#### **Remarks:**

In the Czech accounting practice there are always a lot of disputes how to report certain items, esp. when the possibility of offsetting comes into account. Entities usually prefer "gross amount approach" through profit and loss with no or little offsetting. It would be good to provide a deeper guidance on this issue in the Standard in order to reach the same application of the standards' provisions worldwide.<sup>1</sup>

# 3.3 Paragraph 43 – Issue No. 1

# Text of the Paragraph:

Collectability refers to the customer's credit risk – customer's ability to pay the amount of promised consideration...

# **Questions:**

Shall an entity make the evaluation of customer's ability to pay on the individual basis (for each customer separately)? Or could it be done on bulk basis (for all customers together)?

# **Remarks:**

The text of the Draft seems to suggest that the evaluation of ability to pay has to be made on individual basis for each customer separately. This approach could be faulty esp. when an entity contracts a new costumer. In reality, the estimates of bad debts are usually more precise when customers are taken as a whole or if they are segmented into groups according to common features regarding size of a customer, amount of its purchases, its historical payment discipline, etc.

# 3.4 Paragraph 43 – Issue No. 2

# **Text of the Paragraph:**

... Once an entity has an unconditional right to consideration, the effects of changes in the assessment of credit risk associated with the right to consideration shall be recognised as income or expense rather than as revenue.

#### **Remarks:**

I strongly disagree with this proposal. As I mentioned at Chapter 3.1, the measurement of

<sup>&</sup>lt;sup>1</sup> Some studies confirm that differences in implementing IFRS exist due to different cultural, economical and social backgrounds of each country/group of countries. More clear guidance on the topic could be helpful for removing this kind of inconsistencies, which can occur.

revenue at probability-weighted amount of consideration that entity expects to receive from the customer, can elicit errors – either unintentional or deliberate. If the subsequent changes in credit risk assessment of customer's ability to pay are recognised outside revenues, entities are granted an opportunity to manage revenues in a great extent. They could simply underestimate the risk of uncollectibility (and thus overstate revenues), and in next periods they can reverse the previous underestimation by adjustment to the "real value of consideration" recognised as expense. Even if we omit the motivation for earnings management and will consider "common mistakes", the recognition of subsequent changes in the assessment of credit risk associated with the right to consideration as expense (income) does correspond to economic substance of the situation. Suggested solution distorts amount of revenues in the period of initial recognition; moreover expenses subsequently recognised in next period(s) are contaminated by the change of condition in customer's financial health and ability to pay. Therefore, revenues, profit margins, profitability and other relative ratios misrepresent true economic situation of an entity.

All circumstances influencing the amount of revenue and the collectibility of consideration relating to the contact with a customer shall be recognised as revenue. To evaluate a customer's ability to settle its liabilities from purchased good or service, an entity has to estimate the future conditions and events influencing customer's financial health and solvency. **Any future change in customer's ability to pay is the change in accounting estimate** and in accordance with IAS 8 the impact of any change shall be included in the item to which the change relates, i.e. within revenues in this case. Treatment presented in the Draft violates economic reality, precludes the comparability of revenues and margins among periods and contradicts other IFRSs.

# 3.5 Paragraph 52

# Text of the Paragraph:

When estimating stand-alone selling prices... Suitable estimation methods include the following:

- expected cost plus a margin approach...
- adjustment market assessment approach...

#### **Remarks:**

The use of expected cost plus a margin approach can lead to revenue recognition at amounts specific for a given entity. With reference to different and changing relative margins, entity can assign varying amount of customer consideration to performance obligation to reach certain goal. The bottom-up approach to measurement of revenue denies creation of prices between market participants. The price is not determined as "a surplus" to expenses incurred, but the price is negotiated and seller then has to test whether its cost function enables him to conclude the contract at profit or not. The potential market advantage (e.g. due to lower average costs for unit) should appear in the total amount of net income (profit), but the costs demandingness and required profit margins should not influence the amount of revenue. Therefore, I would recommend allowing only market approach for estimation of stand-alone selling prices and certainly without possibility to adjust the competitors' prices to reflect the entity's costs and margins (as it is currently presented in the Draft).

# 4 Application guidance

# 4.1 Product warranties and product liabilities

# Text of the Paragraphs B14, B17 and B18:

Entity shall assess the objective of the product warranty. If its objective is to provide a customer with coverage for latent defects in the product (i.e. defects that exists when the product is transferred to the customer but are not yet apparent), that warranty does not give rise to a

performance obligation...

If the objective of a warranty is to provide a customer with coverage for faults that arise after the product is transferred to the customer, that warranty gives rise to a performance obligation for warranty service...

In assessing whether the objective of the product warranty is to provide a customer with coverage for latent defects in the product or to provide a customer with coverage for faults that arise after the product is transferred to the customer, an entity considers factors such as:

- (a) whether the warranty is required by law if the entity is required by law to provide a warranty, that indicates that the warranty is not a performance obligation, because such requirements typically exist to protect customers from the risk of purchasing defective products.
- (b) whether the product could have been sold without the warranty if the product could not be sold without a warranty, that indicates the warranty is not a performance obligation. Conversely, if a warranty is sold as an optional extra, it is a separate performance obligation in accordance with paragraph 23(a).
- (c) the length of the warranty coverage period the longer the coverage period, the more likely that warranty (or part of the warranty) is performance obligation because it is more likely to provide coverage for faults arising after the product is transferred to the customer.

#### Remarks:

The distinction between warranties for latent defects and warranties for faults after delivery is quite artificial and it may be impossible to differentiate between those two types of warranties both from technical and economic point of view. Warranty granted to a customer often contains both components (and this fact is assumed implicitly by the Draft). Examples of such goods whose warranties contain both elements are devices and machineries requiring regular maintenance and function inspections or software.<sup>2</sup>

The different accounting treatment of both type warranties despite the fact that the economic difference is not clear-cut is contra productive and in my opinion it does not bring any additional useful information. The converse is true. Nobody is perfect and nobody is able to produce flawless products. In this context, all warranties provide only for latent defects by their nature.

A practical and an economic problem of the approach stipulated in the Draft can be found. In the Czech Republic, a law requires a seller to provide a customer, which is a business entity, with at least one-year warranty and an ultimate customer with at least two-year warranty. Based on the conditions (a) and (b) in paragraph B18, the law warranty is a warranty for latent defects (and thus it is not a separate performance obligation). However, with reference to condition (c) the warranty or at least a part of seems to be a warranty for faults after the product transfer.

Should the entity detach both elements of a warranty and account for them separately using different accounting politics? Or should an entity denote such a warranty as a single (law) warranty for latent defects even if it provides coverage two or more years?

If the first solution is preferred, how can then an entity separate one single warranty in two parts unambiguously? Because of technical incapability to make such a distinction clearly, it would be better to handle the warranty as the law warranty for latent defects in its entirety. However,

<sup>&</sup>lt;sup>2</sup> It is difficult to distinguish whether the software developer removes the latent defects of the software (e.g. by reprogramming of complicated formulas, which causes slow performance of the software) or whether the software developer adjusting the performance of software after some period of full productive use, which enables reprogramming and simplification of the software and thus enhancement of its performance.

the way how such warranties shall be accounted for is somehow unacceptable from economic point of view. *Example 4* of the Draft suggests that an entity providing warranty could recognise revenue only for products without defects and in addition an entity should recognise an asset representing the products passed over to customer, but containing defects. Is it really reasonable to report on the face of balance sheet assets, which were delivered to a customer e.g. almost two years ago and which are under economic control of a customer?

Due to technical difficulties with distinguishing between those types of warranty and in order to follow economic logic, I would recommend to apply a single approach to all warranties. The warranty is given for a certain lapse of time; the control over a good for which the warranty is granted, is usually transferred at a certain moment of time. Therefore, the revenue pattern of both components of contract is economically distinct. Consequently, revenue from both components of a contract should not be recognised at the same time. Based on short analysis made above, I would prefer solution under which all warranties are treated as a separate performance obligation (i.e. I prefer the solution defined in paragraph B17).

# 4.2 Principal versus agent consideration

# Text of the Paragraphs B21 and B23:

If an entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity's performance obligation is to provide the goods or services itself. Hence, the entity is acting as a principal and shall recognise revenue in the gross amount receivable from the customer.

If an entity transfers a performance obligation to another party so that the entity is no longer obliged to provide the underlying good or service to the customer (i.e. the entity is no longer acting as the principal), the entity shall not recognise revenue for that performance obligation. Instead, the entity shall evaluate whether to recognise revenue for satisfying a performance obligation to obtain a customer for the other party (i.e. whether is acting as an agent).

### **Remarks:**

Similarly as in case of warranties, the distinction between acting as principal or agent may sometimes be arbitrary. The same measurement of revenues in both situations would lead to more comparable information among entities. Such a treatment resulting in the same manner and amount of revenue recognised was introduced during the process of preparing the Exposure Draft. The method was called as "asset-liability approach" to revenue measurement; the main advantage of this method is that it is neutral regarding the business model of an entity. I would recommend using of the AL approach for the measurement of revenue in principal versus agent considerations.