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Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers – Comment Letter"

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Introduction

I really appreciate the job you have done within the Revenue Recognition Project. I consider the tentative conclusions so far reached as a huge step forward. However, I feel some aspects need more attention from your side. In this Comment Letter, I do not aim at answering all questions raised in the Discussion Paper. I would like to present my point of view on some issues, which the Discussion Paper opens either explicitly or implicitly, and which – in my opinion – should be resolved before the Exposure Draft and the final standard are published.

1 Crucial features and changes proposed by the Discussion Paper

1.1 Definition of revenue

I strongly agree with the "preservation" of current definition of revenue in terms of an increase in an entity's net assets.

1.2 Revenue recognition principle – Question 1-2 of the Discussion Paper

Your approach postulating that "for a contract with a customer, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two)" (DP 2.35) seems to be a very useful and clear-cut principle for revenue recognition. Based on definition of an asset and a liability, the focus on changes in the net assets provides more operational tool for determining whether revenue exits and when revenue shall be recognised than current earnings approach which refers to the conditions of realised (or realisable) and earned revenue. Proper identification of all contractual assets and contractual liabilities is essential to consistent application of proposed revenue recognition principle across entities. I believe the Discussion Paper offers a sufficient guidance for this identification.

The question is whether the suggested recognition principle shall be also applied for recognition of revenues not from a contract with a customer (e.g. in agriculture industry).

1.3 Measurement of performance obligations — Question 8-13 of the Discussion Paper

I have followed your deliberations from the very beginning. I regard the measurement of revenue (or the measurement of performance obligations) as the crucial problem to be solved. I do strongly agree with your initial support to the fair value model (further refined to the current exit price approach). I also understand the reasons that have caused change of your opinion, rejection of this model and its replacement by the original transaction price approach. Firstly, I would like to summarise main features of proposed models. Then, I will evaluate both models and outline some my objections to model preferred by the Discussion Paper.

1.3.1 Current exit price approach – main features

Current exit price is the amount that the entity would be required to pay to transfer the

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performance obligations to an independent third party at the financial statement date. Exit price is a useful measure of the market's perception of measurement of the performance obligations in a contract. The Discussion Paper is mentioning this approach. However, the current exit price approach¹ is rejected for three reasons.

1. Pattern of revenue recognition:

Ignoring the transaction price for initial measurement of performance obligations may lead to recognition of a contract asset or a contract liability and corresponding revenue or expense at contract inception. The transaction price includes usually expected costs, time value of money and profit margin that "may not relate to the remaining performance obligations that exist once the contract is formed" (DP 5.18). The Boards "are uncomfortable with an approach that allows an entity to recognise revenue before the entity transfers to the customer any of the goods and services that are promised in the contract" (DP 5.20).

2. Complexity:

As the current exit price of the remaining performance obligations would rarely be observable, measurement of the performance obligations needs to use the estimates. This could be complex and subject to objections as far as verifiability and reliability concern.

3. Risk of error:

The cardinal weakness of this approach is the possibility of erroneous identification and/or measurement of performance obligations at contract inception. A not identified performance obligation results in the situation that an entity recognises too much revenue at contract inception. Moreover, the net position of an entity in a contract with a customer will remain misstated until the omitted performance obligation is satisfied. The consequence of incorrectly measured performance obligations is also inadmissible – error in measurement would be included in profit and loss already in contract inception.

1.3.2 Original transaction price approach

An entity usually sets up the transaction price so that it covers all costs and profit margin, including amounts that the entity charges the customer to recover costs in connection with obtaining and concluding the contract. An original transaction price is (according to the Discussion Paper) the favourite attribute at which an entity shall measure performance obligations arising out of a contract at its inception.

1. Pattern of revenue recognition:

Measurement of performance obligations at the original transaction price precludes recognition

¹ This approach is explicitly listed in the Discussion Paper as the Boards probably leave the doors open for the case they will be persuaded by clear evidence in comments to the DP to follow this approach instead of the second one.

of a contract asset and revenue at contract inception. Thus, "revenue is recognised only when an entity transfers an asset to the customer" (DP 5.28). This provides a better depiction of an entity's performance at the contract. Moreover, the statement of comprehensive income should not reflect any performance of an entity in the contract until the promised assets are transferred to the customer.

2. Simplicity of measurement:

In most cases, the transaction price is observable at contract inception. That reduces complexity and costs of searching for and/or estimating another price. Using this attribute prevents the entity from recognising revenue as a result of either omitting or understating of performance obligation at the time of contact conclusion.

1.4 The first objections to favoured model for initial measuring performance obligations

The original transaction price approach is preferred despite two strong disadvantages. As the transaction price contains a part that should recover an entity's costs for obtaining the customer, the performance obligations measured at the transaction price are overstated at contract inception. However, "this disadvantage is preferable to the disadvantages of the current exit price approach" (DP 5.36).

My question: "Is any objective evidence confirming this assertion available?"²

The second shortage consists in the splitting of the transaction price into the particular performance obligations. DP 5.46 suggests that "the transaction price should be allocated to each performance obligation in proportion to the stand-alone selling price of the promised good or service underlying that performance obligation. The stand-alone selling price of the promised good or service is the price at which the entity would sell that good or service if it was sold separately at contract inception (i.e. not as part of a bundle of goods and services)".

My question: "Can you explain the substance of difference between measuring each performance obligation at its fair value and allocating customer consideration based on relative stand-alone selling prices which seems to be the reason for your preference of the original transaction price approach?"

2 Assessment of models proposed in the Discussion Paper

2.1 Advantages and disadvantages

As described above, there are two competing models of measurement of performance obligations which satisfaction by an entity gives rise for recognition of revenue. The fair value model (or current exit price approach) calls for measuring of performance obligation at contract

² I suspect that text of DP 5.36 breaches the qualitative characteristic "neutrality", as this attitude is not free of bias.

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inception at their fair value (or current exit price).³ This approach assures that an entity's performance in the contract with a customer is measured with reference to the market perception of its business model. Moreover, fair value model enables the separated evaluation of activities preceding the contract inception from subsequent activities and performance of the entity aiming at satisfaction of contractual performance obligations. The users of financial statements can acquire information to evaluate:

- performance in the process of obtaining a customer by comparing revenues from the selling effort and costs incurred to contract such a customer;
- performance in the "own" revenue-generating process by comparing revenues from satisfying the performance obligations and costs incurred to satisfy those obligations.

As a result, statement of comprehensive income may enable users to assess not only the development of revenues across industries and entities, but also to compare relative performance of entities in each segment of business activity. This could be reached even if the entities are different as far as the volume of marketing, advertising and other activities aiming at promoting products and contracting the customers concerns.

On the other hand, the proposed model increases the risk of error cause by:

- wrong identification of performance obligations (omission of performance obligation would result in premature recognition of revenue at contract inception);
- improper measurement of performance obligations (overstatement or understatement would result in incorrect recognition of revenue or expense at contract inception).

The alternative approach, which prefers the allocation of the original transaction price to performance obligations, eliminates disadvantages of the first model - esp. the risk of premature revenue recognition. The Discussion Paper tries to outline some arguments in favour of original transaction price approach. In my opinion, the arguments are not economically valid. Moreover, I do not understand what is meant by the expression that Boards "are uncomfortable with an approach that allows an entity to recognise revenue before the entity transfers to the customer any of the goods and services that are promised in the contract"

I am uncomfortable with many things, but I do never dare arguing like that, i.e. without any logical support. I guess that the notion of "uncomfortable Boards' member" has its roots in the traditional prudence principle. However, the subjectively prudence presented like in this case

³ The Discussion Paper is operating with the term "current exit price". As the Revenue Recognition Project used to work with fair value for the major part of its duration, I prefer to denote this competing model as "fair value approach" rather than "current exit price approach". Moreover, I believe that fair value should be apply as an attribute for measuring of performance obligations instead of proposed current exit price. I will outline the reasons for this assertion further in the Comment Letter. However, the economical logic and inferences are the same in case of both fair value and current exit price.

seems to me to be too little support for such an importing issue as revenue recognition principle surely is.

My point of view is as follows. The "normal" business model of a going-concern entity is to settle its obligations by delivering a product or service according to the contract. In connection with the contracting of a customer entity has to incur some costs, e.g. for marketing, advertising, legal fees, etc. The customer consideration usually contains charges to recover those costs. The economic logic asks for the comparison (or let us say matching) of revenues and costs at the same time. Revenue from the selling effort is therefore an inherent part of a business model of all entities. The constitution of revenue already in contract inception cannot be viewed as something unusual. Entity should be allowed to recognise revenue at "Day 1" because it has performed the selling services. Its customer has proved the usefulness of those services by entering into the contract. Moreover, it could be reasonable expected that **revenue from the selling effort would create only a fraction⁴ of the customer consideration** received or receivable.

The second important argument supporting original transaction price approach is the complexity of measurement. The Discussion Paper asserts that the initial measurement of performance obligations at the current exit price (or fair value), which is not always observable and must be sometimes estimated, would be complex, would impose unnecessary burden on an entity and would be difficult to verify. In contrast, the transaction price is observable, avoids costs and complexity. This is a true assertion only for the simple transactions that consists of one performance obligation.

If the contract includes two or more performance obligations, the entity has to allocate consideration received or receivable onto the separately identifiable components. This requires using of estimates, too. Thus, the allocation of transaction price is not of less complexity than current exit price approach. The complexity in measurement of revenue is present not because of the complicated requirements in guidance on revenue recognition and measurement. The main reason lies in the fact that business per se has becoming more complex and true and fair presentation of the course of an entity's economic activity is subject to legitimate reservations and ambiguity. The second reason causing the problems with measurement of revenues is the pressure on the preparing information as soon as possible (preferably immediately).

2.2 What remains unsolved?

In my opinion, several issues should be resolved before publishing the final standard for revenue

⁴ It could be significant amount, but not substantial part of consideration. I recommend the Boards to conduct the research aiming at the estimation of the average share of selling revenue on the customer consideration. It would provide a more robust foundation for rejection of the fair value model rather than vague notion of discomfort.

recognition. Based on previous reasoning, you should:

1. Reassess "pattern of revenue recognition" as the argument for original transaction price approach and as argument against current exit price approach:

There is a substantial economical difference between a trading company selling the unified goods as its competitors and a manufacturer of specialised machines (e.g. producing digging machines for mining industry). The success of trading company critically depends on the attractiveness of marketing campaign and other activities aiming at persuading the customer to buy the entity's goods. The marketing costs and other costs incurred to contract a customer are quite significant. In contrast, the manufacturer of digging machines is not impelled to concentrate big resources for gaining customers, as it is a rather unique way of business with lesser competition. The original transaction price approach enables to evaluate source, nature, amount and timing of revenue (if applied consistently by both companies). Nevertheless, the assessment of relative performance (based on profit margin) is incomparable as the cost to contract a customer and not matched with corresponding revenue from the selling effort. Therefore, different relative profit margins between industries do not refer only to the different pattern of satisfaction of performance obligations. Time lag between recognition of revenue and expenses can distort relative margins.

2. Clarify the difference between current exit price (which can be a representative of fair value if certain conditions are met) and stand-alone selling price:

Except from contracts with only one performance obligation, both models needs to ascertain or estimate an attribute for measuring performance obligations. There is no substantial distinction between those measuring attributes and the time, costs and other effort to estimate them. The reliability of measurement is also of the same questionableness.

3. Depict the nature of allocated customer consideration:

Balancing pros and cons of both approaches, original transaction price approach may result in useful and less costly information in simple selling transactions. In multiple-element arrangements, however, the need to allocate the original transaction price to performance obligations raises a question how the part of allocated customer consideration can be interpreted from the economic point of view. This could lead to confusion of users. The interpretation of measurement of performance obligation at its fair value is clear-cut.

4. Specify a clear and cohesive definition of revenue:

Revenue is defined as an increase in entity's net assets excluding the contributions from owner under both IFRS and US GAAP. The IASB's definition of revenue refers only to the gross inflow of economic benefits; the FASB's definition regards as revenue not only inflows, but

also other enhancements in the net assets. Principally, revenue can arise even in other cases than from contracts with customers according to the definition of FASB. In my opinion, the IASB's definition excludes this possibility. It would be useful to unify definitions and to choose one view of revenue to be followed. The broader concept of revenue (in terms of any increase and/or enhancement in an entity's net assets) should be supported. This would be helpful in recognition revenue in transactions where a contract with a customer is not concluded (for further discussion see next point).

5. Introduce revenue recognition principle broadly applicable for all type of transactions:

The Discussion Paper offers the alternatives for revenue recognition in contracts with customers. For some industries, revenue recognition could be contemplated even without a contract with a customer. Regardless having concluded a contract with a customer or not, revenue recognition principle applied should be the same for all revenue transactions.

6. Explore the possibility whether it can happen a situation resulting in recognition of performance obligation even without the contract with a customer (in a non-selling transaction, i.e. in a transaction which is not revenue generating):

If such a situation occurs, the consistency in measurement of the non-contractual performance obligation in comparison with its contractual counterpart is of a crucial importance. The measurement of the performance obligation in a contract should be consistent with the measurement of the performance obligation arising out of a contract. Original transaction price approach (esp. when the consideration is allocated) excludes this requirement.

3 Conclusion

All crucial remarks to the tentative conclusions of the Discussion Paper are presented in the previous chapters. To summarise my regards on revenue recognition topic, I would like to emphasis that:

- In my point of view, pattern of revenue recognition is an argument rather for than against the fair value model. Entity shall recognise a contract asset and corresponding revenue at contract inception if the sum of fair value of all contractual performance obligations exceeds the consideration received or receivable. Therefore, an entity can recognise revenue even without satisfaction of any performance obligation.
- Financial reporting frameworks stress the superiority of fair value measuring attribute over other measurement basis. The Statement of Financial Accounting Concepts no. 7 alleges the following: "For measurements at initial recognition or fresh-start measurements, fair value provides the most complete and representationally faithful measurement of the economic characteristics of an asset or a liability" (SFAC 7.36).

The transaction price is not presumably fair value. Therefore, the difference between fair value and transaction price shall be immediately recognised in profit and loss in the case of assets or liabilities, which are subject of measurement by their fair value at initial recognition. The Discussion Paper refuses this procedure as far as revenue generating transactions and contractual assets and liabilities concern. However, recognition of element of comprehensive income on "Day 1" in revenue generating transactions has more logical foundation than recognition of profit or loss on "Day 1" regarding e.g. financial assets and liabilities (classified as "FVPL").

- The recent development in financial reporting indicates that the way to (almost) full fair value accounting has been established. If the tendency is abandoned or weakened, it could threaten the users' view on credibility of financial reporting. Therefore, I recommend application of fair value model for measurement of performance obligation at initial recognition. The proposed current exit price approach needs to be changed to the fair value model for the reasons mentioned in the previous remark.
- The main concern about the fair value model is the possibility of premature revenue recognition. Stressing again, I presume the amount of revenue from the selling effort to be marginal in comparison with total amount of revenue generated by the particular selling transaction.
- The measurement of revenue is about the simplicity and consistency. The introduction of principle respecting the "simplicity of measurement" does not imply that the process of preparing information on revenues will become easier. The complexity of business transactions causes the complications in that process, not the lack in guidance (as in IFRS) or much detailed guidance (as in US GAAP). The simplicity of measurement is thus an argument with low relevance. Therefore, the consistency remains the decisive determinant of the useful and relevant measurement attribute. I believe that the proposed original transaction price approach introduces more inconsistency by launching a new measurement technique (or basis?⁶) "allocated consideration amount referring to standalone selling price". I hope that allocation should not be utilised for measurement of performance obligation. However, if any allocation technique is approved, it should utilise a measurement basis that is currently used.

At the end of this Comment Letter, I would like to suggest that you should pay attention to two additional topics that are slightly pushed aside by the Discussion Paper. Firstly, the new

⁵ This holds esp. in the area of financial instruments.

⁶ Is the stand-alone selling price a new measuring attribute not defined by the Frameworks? If it is, what is the reason to introduce a new measurement basis? Will it be used in any other standards?

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standard on revenue recognition should follow up the recent development – e.g. there should not be a huge discrepancy between the new standard and IFRIC 13.⁷ The possible significant departure can elicit the concerns on the conception of the standard-setting process and on consistency and predictability of its development in the future. Secondly, the issue of measurement of consideration receivable should be solved together with the Revenue Recognition Project. Discounting of future cash inflows and outflows is a general weak point of the financial reporting standards. Lack in guidance on ascertaining time value of money multiplies the problems in the sphere of revenue measurement.

⁷ The allocation method shall refer to fair value or as IFRIC 13.6 states, "the consideration allocated to the award credits shall be measured by reference to their fair value, i.e. the amount for which the award credits could be sold separately." This procedure is not the pure fair value model. However, it furnishes some potential for extension the logic behind this requirement into the fair value model as discussed in this Comment Letter. The possible extension of guidance of IFRIC 13 can serve as solid reasoning for the defence of the pure fair value model as I suggest in this Comment Letter.

Appendix

In connection with tentative conclusions reached within the Revenue Recognition Project, I performed an empirical experiment regarding the perception of revenue-generating process by the "common" users of accounting.

During the winter semester of academic year 2008/2009 (i.e. before a publication of the Discussion Paper), I conducted an empirical experiment on students of the course "Introduction to Accounting". Students enrol in this course in the 2nd year of their bachelor study programme. Students are recommended to enrol in the course after successful passing the courses of "Economics" and "Business Economics". Therefore, they have basic economical and business knowledge, but they are not biased by accounting perception of business world. I guess we can assume those students to be representatives of "common" users of financial statements.

In the seminar,⁸ which goal is to explain the differences between cash and accrual basis of accounting and to learn to detect the moment at which revenue arises and should be recognised, the students were called upon to determine the date when the entity may recognise revenue from selling the machine. The illustrative example was as simple as follows:

Example 1: Revenue recognition – an illustrative example

The Manufacturer seeks the supplier for a new machine:

- On 1 November 20X0, the Manufacturer sends its demand to thee domestic and one foreign suppliers. All suppliers send back their offers with technical, delivery and payment terms.
- On 20 November 20X0, the Manufacturer chooses the foreign supplier to produce and deliver the machine.
- The contract between the Manufacturer and the Supplier to deliver machine is concluded on 25 November 20X0.
- The Supplier starts the production of the machine on 1 December 20X0.
- The machine is finished on 20 December 20X0
- A deputy of the Manufacturer accepts the condition of produced machine after technical tests made by the Supplier on the next day.
- The machine is shipped on 28 December 20X0.
- On 30 December 20X0, the Supplier sends an electronic invoice to the Manufacturer.
- The Manufacturer receives the delivery on 6 January 20X1.
- On 31 January 20X1, the Supplier receives the payment for the machine.

⁸ The fourth seminar of the course (out of 13 seminars).

The students' task was to determine the moment at which revenue arises. *Table 1* summarises the results.

Tab. 1: Empirical Experiment - Students of "Introduction to Accounting"

Date	Event	Occurrence (Number of students)	Occurrence (In %)
01.11.20X0	demand	0	0,0%
20.11.20X0	decision	0	0,0%
25.11.20X0	contract inception	97	63,8%
01.12.20X0	start of production	1	0,7%
20.12.20X0	finish of production	2	1,3%
21.12.20X0	technical approval	5	3,3%
28.12.20X0	shipping	9	5,9%
30.12.20X0	invoicing	24	15,8%
06.01.20X1	delivery	11	7,2%
30.01.20X1	payment	3	2,0%
Total	XXX	152	100,0%

In my opinion, the experiment has demonstrated very interesting inferences. When discussing with students the results of the example and accounting and economic aspects of the revenue-generating process, I arrived to the following conclusions regarding students' point of view:

- concluding the contract is an important business act and under normal circumstances both seller and buyer are willing and doing the best to fulfil their contractual obligations,
- sales representatives, marketing employees and other employees are often remunerated with reference to the volume of concluded contracts (sales),
- the crucial point in the entrepreneurship process is gaining the customer, because under current economic development there is not a problem to produce goods or to provide service, but to find the customer,
- risk and reward approach or realisation approach that were explained afterwards were understandable to students, but they still insist on the superiority of economic concept of revenue and therefore revenue should be recognised at contract inception.

If we disregard the users with "good knowledge" of accounting (e.g. financial analysts, creditors) we have to conclude that "common" users with only basic knowledge do not always view revenue recognition under risks and rewards and/or earning process approach. The common user perceives the revenue-generating process as a "function" of gaining (or contracting) customer. If an entity succeeds in concluding the contract with a customer it should recognise some revenue; at least as a counterpart to costs sacrificed in the process of contracting customers.

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Despite some positive steps, the development of *Revenue Recognition Project* so far is perplexed. There are more open issues than solved, it is not clear the goal of the project, it is omitted the influence of suggested new rules on existing and proposing standards and unambiguous measurement of contractual rights is missing. In my opinion, before issuing the final standard for revenue recognition standard-setters should:

- define the economic nature of revenue (definition of revenue is satisfactory, but the economic interpretation of the definition in plain English is insufficient),
- determine what the amount of revenue should represent,
- clarify when the revenue arises with regard to different informational potential of each revenue recognition model,
- explore the behavioural model describing the users perception of revenue-generating process.

I expect that the new standard for revenue recognition would be predetermined to failure without sound support in all of above-mentioned issues. The scrutiny should respect inferences of both accounting and economic theory regarding the concept of income and nature of revenue. However, the important questions remain open. Are we able to describe and define exactly the users of financial statements, their needs and their point of view on business process and the way accounting is representing these business transactions in the financial statements? In addition, are entities able to prepare needed information?