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Sir David Tweedie,  
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**Re: Comment Letter on Preliminary Views on Revenue Recognition**

Dear Sir David and Mr. Herz,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),<sup>1</sup> in consultation with its Corporate Disclosure Policy Council (CDPC)<sup>2</sup>, appreciates the opportunity to comment on the IASB and FASB's joint project-*Preliminary Views on Revenue Recognition- Discussion Paper (DP)*.

The CFA Institute Centre represents the views of its worldwide members, including portfolio managers, investment analysts, and advisors. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

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<sup>1</sup> The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, Brussels and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

<sup>2</sup> The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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## **BACKGROUND**

We strongly agree that revenue recognition accounting needs improvement, based on the following considerations:

- Revenues are a critical component of earnings forecasts, future cash flow estimates and valuation analysis performed for purposes of making investment decisions;
- Revenues are used in valuation models for some industries, usually for companies that are growing rapidly, but are not yet profitable;
- Revenue recognition is a primary source of restatements and earnings management;
- Existing literature is transaction or industry specific. There are 100+ standards or interpretations in US GAAP related literature. This contributes to the complexity, inconsistency and limited comparability of performance across industries;
- Conceptual inconsistencies and vagueness exist in IAS 18 and IAS 11;
- The accounting is inconsistent, often inadequate, and widely divergent with respect to software, leasing, intellectual property, insurance, and financial instrument transactions;
- Conceptually, revenue is defined in terms of changes in assets and liabilities that arise from activities with customers. However, a shortcoming of the conceptual framework is that it states that revenues must be earned and realised/realisable, but fails to define these criteria or link them to the definition;
- Current standards lack adequate disclosures about revenue information. Accounting policy disclosures are too general to be informative and revenue data tends to be highly aggregated;
- Little guidance exists for service activities; and last, but not least;
- A common standard in US GAAP and IFRS supports global accounting convergence.

### **Summary of DP proposals**

The DP focuses on revenue recognition in the context of contracts with customers only. In summary, it proposes that:

- If a contract comprises more than one performance obligation—in other words, more than one promise to transfer an asset to a customer—each performance obligation should be accounted for separately if the related assets are transferred to the customer at different times. This approach is different from the current approach in IAS 11 which focuses on whether the different parts of a contract have been negotiated separately. IAS 18 is largely silent on when and how to sub-divide contracts for revenue recognition purposes.
- Revenue should be recognised when an entity has satisfied a performance obligation arising under a contract with a customer. Such satisfaction will occur when control of the asset (a good or a service) involved is transferred to the customer. The current model is based on an analysis of risks and rewards as a basis of determining whether transfer has occurred.

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- At contract inception both the rights arising out of the contract for the entity and the performance obligations involved are measured at the transaction price (the promised consideration) and that measurement is not updated unless the performance obligation is deemed onerous. If a contract comprises more than one performance obligation and the obligations are required to be accounted for separately, the transaction price should be allocated based on the stand-alone selling prices of the goods and services underlying those performance obligations.

## EXECUTIVE SUMMARY

Below is a summary of our responses to the key issues raised in the DP:

- **Unresolved conceptual gaps:** Whereas we acknowledge the inconsistencies and the inadequate nature of the earnings process approach, the proposed switch to an asset/liability model must consider the lack of progress on the definition of assets and liabilities and the implications of the Boards' decisions (likely divergent) with regard to the definition of control in the de-recognition project. The DP does not adequately address these critical difficulties.
- **Single Model:** Although we realize the imperative of having a converged revenue recognition standard by 2011, the proposed model is significantly under-developed due to the pursuit of a limited scope approach. It does not adequately resolve the difficulties in relation to multiple element contracts nor does it propose any robust solution to deal with contracts with highly variable outcomes. Consequently the proposed approach could result in conceptual inconsistencies in revenue recognition between industries covered by the scope of the new standard and those excluded from its scope.
- **Proposed measurement and separation basis for multiple element arrangements:** Sufficiently resolving the revenue recognition challenge of multiple element arrangements will be the yardstick of success of any proposed model. Resolving this particular aspect will enable the convergence and overall improvement of global financial reporting. Regrettably, the proposed model is far from satisfactory. We have serious reservations about the proposal to ignore exit value and instead use the estimated selling price of standalone performance obligations. This approach will likely introduce measurement and timing error and result in increased management subjectivity and earnings management opportunities. In addition, the DP does not propose a sufficiently robust framework to identify and separate performance obligations. The current definition of separation criteria, will likely present implementation difficulties in various sectors including the service industries. The discussion of this critical component of the proposed model is rudimentary and needs substantial enhancement.
- **Contract based approach:** We support the approach of basing revenue recognition on changes in contract assets and liabilities. However, there is ambiguity in the definition and accounting

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requirements of enforceable contracts. In addition, there is need to address the impact on revenue recognition of modification, cancellation, combination and segmentation of contracts.

- **Performance obligation as an accounting unit:** We support the notion of revenue based on the transfer of performance obligations. We are comfortable with transfer obligations based on control as we would expect this, in most instances, to be consistent with a risk/reward based assessment of transfer. This is predicated on risks and rewards being an indicator of control. However, as is noted in the DP, there are instances where a control versus risk-reward assessment of transfer may not yield the same answer. Given that exposure to risks and rewards is not part of the definition of control, but just an indicator of control we believe it is necessary that the risks unique to various performance obligations be disclosed and measured clearly and as objectively as possible.
- **Re-measurement of performance obligation:** We concur with the restriction of subsequent re-measurement of onerous performance obligations. While, in general, we support the symmetrical treatment of gains and losses consistent with the fair value approach, due to concerns and wealth of historical evidence related to front loading of revenues, we would support the deferral of any resulting gain until specified criteria are met.
- **Cost capitalization:** We support the expensing of all costs related to revenue and believe that such an approach should be applied consistently across all standards. Similar to its approach of carving out the revenue recognition of contracts with highly variable outcomes, it is odd that the boards have avoided imposing a consistent approach across contract categories and simply left the determination of treatment of revenue related costs to individual standards.
- **Disclosure:** The DP does not address disclosure requirements. There is a need to develop disclosures to address the problems with the heightened variability and lack of transparency related to the amount and timing of revenue recognition. We reiterate that disclosure is a complement and not substitute for recognition and measurement. There is a need to address and significantly improve revenue related disclosures. In the detailed specific comments we propose key required disclosures

Overall, we conclude that the DP model in its current form, falls short of one of its key objectives, namely to improve financial reporting. We understand that this is only a discussion paper and that it acknowledges several limitations in its scope and disclosure exclusions. However, we believe that the proposed model in its current form will neither improve current revenue recognition practices nor will it facilitate global accounting convergence. Consequently it is unlikely to produce more decision useful information. Therefore, we recommend that it is only worthwhile to overhaul current revenue recognition practices if the boards can complete the development of models that cover the full range of contracts that fall under accounting standards and integrate a measurement basis that enhances the objectivity in timing and amounts of reported revenues.

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## **GENERAL COMMENTS ON PROPOSED MODEL**

Paragraph S3 articulates that the boards are developing a single, contract-based revenue recognition model to improve financial reporting by providing clearer guidance on when an entity should recognise revenue and by reducing the number of standards to which entities have to refer. We agree that in order to reduce complexity and enhance comparability, it is highly desirable to have a single revenue recognition model across different industries. However, a single model is only acceptable if it is sufficiently robust and capable of faithfully representing the economic reality of customer contracts of varying complexity. In our evaluation of the proposed model we have serious concerns about the model's:

- Limited scope
- Failure to address linkage of contracts
- Proposed measurement basis for multiple element arrangements
- Failure to address disclosure and presentation requirements

## **LIMITED SCOPE APPROACH OF MODEL**

We believe that a revenue recognition accounting standard should consider the full range of problems with the recognition, measurement, and disclosure of diverse and complex revenue contracts. However, the DP has a limited scope as it excludes software, financial guarantees, financial instruments, and insurance and lease contracts. The limited scope creates a significant likelihood that there will be conceptual inconsistencies between the transactions covered by the new standard and those in excluded scope. By excluding complex contracts with highly variable outcomes, the DP fails to resolve inconsistencies in the literature. It appears to have simply carved out the very inconsistencies that are critical to resolve in a high quality accounting standard.

We are also concerned with the failure to conclusively evaluate whether it is appropriate to have more than one model for different contract arrangements (e.g. software transactions, financial instrument and leases). The DP ought to answer the question of why we must have a different model for software, leasing, and certain other contracts

## **LINKAGE**

The focus on measurement and satisfaction of performance obligations as the sole basis of determining revenue recognition overrides the necessary and inextricable linkage between customer contract assets and the underlying performance obligation. This will likely contribute to the distorted portrayal of entity performance. The DP does not address linkage and does not properly define the unit of account (i.e., when should two or more contracts with the same customer be combined and how does the combination affect recognition and measurement).

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## **SPECIFIC COMMENTS**

Below are specific comments regarding our other two key concerns, namely a) the proposed measurement basis for multiple element arrangements and b) the failure to address disclosure and presentation requirements

### **CONTRACT BASED APPROACH TO REVENUE RECOGNITION**

We support the notion of customer contracts forming the basis of defining revenues based on changes in net contract asset/liability. This is conceptually consistent and factors the linkage between the balance sheet and income statement as a basis of measuring performance. However, there are several areas that need to be addressed further:

- Treatment of contract renewal/cancellation provisions or modifications
- Implication of segmentation and combination of contracts on revenue recognition
- Clarification of enforceability requirements. We would expect these requirements to include constructive obligations and economic compulsion rather than legal enforcement
- Ensure consistency in the notion of enforceability across different accounting standards (e.g. IAS 32). There is a difference<sup>3</sup> in wording in IAS 32

### **PERFORMANCE OBLIGATION AS AN ACCOUNTING UNIT AND SEPARATION OF PERFORMANCE OBLIGATIONS**

We support the proposed definition of satisfaction of performance obligation, based on whether an entity has transferred control. We would expect this to be consistent with a risk/reward based assessment of transfer. We also believe that performance obligation and contract assets are linked and should be treated as such. Hence, the failure to convey this inextricable linkage is a critical shortfall of the model.

We would support the notion of unbundling performance obligations. We believe that it is decision useful for reporting entities to convey the pattern of transfer of performance obligations.

However there is a need for a comprehensive framework to enable the meaningful separation and measurement of performance obligations. Unfortunately, the DP does not provide a sufficient framework. Paragraph 3.24 asserts that an entity needs to separate a contract's promises into separate performance

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<sup>3</sup> IAS 32- An agreement between two or more parties that has clear economic consequences that the parties have little, if any discretion to avoid, usually because the agreement is enforceable by law. DP proposes 'agreement between two or more parties that creates enforceable obligations'

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obligations only when the customer receives the promised asset at different times. However, there are difficulties in applying this principle to long term contracts. For example, all products could be delivered at one point in time, but the return/warranty rights/obligations may last for different periods. There could also be conceptual inconsistencies with the proposed de-recognition model that defines control based on whether or not there are restrictions in the transfer of an asset by the transferee. If the same principle was applied to sales returns, outcomes between the proposed revenue recognition and de-recognition models may differ.

In addition, the current separation criteria would likely present implementation difficulties in various sectors including the service industries. Consequently, we believe that the proposed separation approach must be substantially enhanced.

#### MEASUREMENT OF MULTIPLE ELEMENT ARRANGEMENTS

Sufficiently resolving the revenue recognition model for multiple element arrangements will be the yardstick of success of the new standard. This will likely be an important requirement for substantive convergence and improvement of US GAAP and IFRS. Regrettably, in our view, the proposed model does not satisfactorily address the measurement of unbundled components.

As stated, we support the principle of separation of performance obligations. However, the DP proposes to allocate the customer consideration/transaction price when recording the initial revenue recognition of multiple element contracts based on the estimated selling price of stand alone performance obligations. Given that revenue is a critical driver of the reported earnings, we believe that this subjective approach is likely to allow considerable earnings management opportunities for financial statement preparers. Our concern stems from the:

- Lack of reliability of estimated selling prices of new products, especially when there is little or no correlation between costs and sales prices and when such products are not sold separately.
- Subjectivity of reported profit margins given the arbitrary allocation of both revenues and costs for multiple element contracts.
- Inability to allocate margins in bundled transactions, and transactions in which one or more deliverables are offered for an unknown period at a loss.

Our reservations are compounded by the failure of the DP to address required disclosures and our concerns that preparers will argue that competitive considerations preclude meaningful disclosures in this area.

By ignoring the exit value of the unbundled components, the proposed approach is likely to introduce both measurement and timing error and to impose significant interpretation burdens to users of financial statements. Allowing preparers considerable accounting choice with minimal disclosures makes its likely

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that comparability among companies will be lost and investors will not have enough information to make even rough adjustments.

The discussion paper has put forward the following arguments against applying exit value as the measurement basis:

- a) Concerns about front loading revenues and recognising day 1 profits
- b) Measurement error
- c) Implementation complexity

However, these arguments ought to be overridden by the observation that meaningful unbundling that reflects the economic reality of components of the performance contract can only be achieved if the exit value of each component can be determined. In addition,

- Concerns about Day 1 profit can be mitigated by recognising the corresponding credit in a non revenue account. In other words recognition of gains should be deferred until specified criteria are met.
- Although conceptually different from the front loading and Day 1 profit scenarios referred to in this DP, the proposed use of estimated selling prices may result in front loading of revenues through measurement bias with respect to existing products and services as well as the lack of sufficient information about future products and services in bundled arrangements. This poses significant problems for investors when combined with the problems of developing adequate disclosures. The latter is a concern because preparers are reluctant to disclose confidential information used to model estimated selling prices.
- Implementation complexity would apply regardless of measurement basis.
- Measurement error exists under both an exit value and transaction price model. The risk of failing to identify (understate) a performance obligation at contract inception exists under either model.

Hence, there is no satisfactory basis for rejecting the more economically meaningful and objective exit value as the measurement basis for the unbundled elements and the proposed approach simply swings the pendulum against transparency for investors. Therefore, we recommend that the existence of exit values or the availability of objective evidence should be a necessary criterion for separating performance obligations. At a minimum, we recommend that the boards should only implement the proposed estimate selling price for standalone performance obligations if it has comprehensively defined a hierarchy of disclosure in a fashion similar to fair value disclosures. Such a hierarchy should require higher levels of disclosure for revenue amounts for any management estimates that are not based on objective evidence.

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## REMEASUREMENT OF PERFORMANCE OBLIGATIONS

We support the restriction of re-measurement of performance obligations to onerous contracts. Although we support the fair value approach that would suggest the symmetrical recognition of gains and losses, we would be comfortable if any resulting gain is delayed until specified criteria are met.

## COST CAPITALISATION

We support the proposed approach of expensing all costs related to revenue contracts unless dictated otherwise by existing accounting standards. This approach differs from the capitalization of acquisition costs that is allowed for insurance contracts. However, we believe that the cost of getting business is a sunk cost and in most cases ought to be expensed. Once you have acquired the business the cost of doing so has no impact on the operating result. We acknowledge that from an analytical and valuation perspective, an evaluation of the post-acquisition results would take consideration of the cost of acquiring the operations, and believe this aspect should be addressed in note disclosures. But it is difficult to defend recording acquisition costs as an asset despite the existing insurance accounting standards.

A case can be made on the need to differentiate between costs that can be linked to a specific transaction (e.g. the commission paid to a salesman) as opposed to general administration costs that cannot be similarly linked. The ability to attach costs to specific contracts/performance obligations should be limited to direct and incremental costs.

Similar to its approach of carving out the revenue recognition of contracts with highly variable outcomes, it is odd that the boards have avoided imposing a consistent approach across contract categories and simply left the determination of treatment of revenue related costs to individual standards.

## REQUIRED REVENUE DISCLOSURES

Disclosure cannot compensate for inadequate recognition and measurement requirements. Nevertheless, for full transparency, enhanced revenue disclosure is necessary regardless of the existing revenue recognition and measurement models. We would recommend the provision of the following disclosures:

- Roll forward of performance obligation by product category
- Roll forward of the balance sheet accounts in which the major revenues have been recorded as assets or liabilities
- Nature and details of all measured performance obligations
- Basis of identifying and unbundling separate performance obligations
- If estimated selling prices are adopted, the basis of determining the price
- When contract assets are transferred to customers for each kind of performance obligation

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- Risk exposure of each performance obligation
- Terms of all deferred revenue arrangements, such as why revenue has been deferred and how it will be recognized in the future. Whether revenue is deferred net of costs and if so what the gross amount of deferred revenue is and the amount of costs netted against it.

## **CLOSING REMARKS**

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at [vincent.papa@cfainstitute.org](mailto:vincent.papa@cfainstitute.org), or Patrick Finnegan, CFA, by phone at +1.212.754.8350, or by e-mail at [patrick.finnegan@cfainstitute.org](mailto:patrick.finnegan@cfainstitute.org).

Sincerely,

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