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

June 17, 2009

Dear Sir or Madam,

We are writing to express our comments on the discussion paper “Preliminary Views on Revenue Recognition in Contracts with Customers” issued jointly by the IASB and FASB. The European Software Accounting Group (ESAG) is composed of leading companies in the European Software industry (Alcatel-Lucent, Dassault Systèmes, Nokia, Sage, SAP, Software AG). The ESAG was formed to facilitate sharing of IFRS accounting principles and best practices, particularly on software revenue recognition. Our group meets quarterly to work hand-in-hand to identify issues with applying IFRS, to compare rules and practices between IFRS and US GAAP, to share points of view and policies and to discuss practical implications of these accounting rules. In addition, we discuss the implications of IASB Board projects on our industry.

Section 1: Superiority of a single revenue recognition model?

The Discussion Paper (DP) proposes a single revenue recognition model under which revenue is recognized when the reporting entity satisfies a performance obligation that it has promised in a contract with a customer. The entity satisfies a performance obligation when the customer has obtained control of the promised good or has received the promised service. In contrast, current IAS 11 and IAS 18 (as well as SOP 97-2 and SOP 81-1 under US GAAP) follow a mixed model approach under which revenue for goods sold is recognized when the significant risks and rewards of ownership are transferred while revenue for construction contracts and services is recognized as the activity under the contract progresses.

We agree that it would be desirable to have a single revenue recognition model that is applied to all revenue generating transactions. However, we believe that a single revenue recognition model should only replace the current mixed model if it is superior to the current mixed model. For the following reasons we do not believe that the model proposed in the (DP) meets this superiority requirement.

- For construction contracts (that are currently used in the software industry for certain services such as custom development of software) stretching over multiple periods, the model proposed in the DP could result in not recognizing revenue in

the periods during which the construction progresses and is not completed, but instead in recognizing all revenue in the period of delivery. This approach results in financial information that indicates a zero margin (assuming the contract to be ultimately profitable) or a negative margin (if the contract is onerous) in the periods of construction. Measuring and reporting progress towards completion of such a contract is important from an economic viewpoint. Consider two firms with identical circumstances, except that one ('entity A') is at a zero stage of completion in a materially profitable long-term contract, while the second ('entity B') is on the verge of completion. The DP proposal would treat these two entities identically in each of their statements of income, when in fact entity B is clearly in an advantageous economic position to entity A. For these reasons, we believe that the current mixed model provides more decision useful information in the case of long-term contracts.

- We are aware that under the DP, revenue from construction contracts would not need to be deferred to the day of final delivery if control over the unfinished results of the construction is transferred to the customer as the construction progresses. However, we do not believe that such transfer of control over unfinished goods is an appropriate criterion to drive revenue recognition. The unfinished good is not what the customer has contracted and may be of no use to the customer. The transfer of control may thus be a mere formality (e.g. granting the customer a license to unfinished software under development) and recognizing revenue depending on it would follow a form-over-substance principle which we do not consider appropriate.
- Under paragraphs 4.38 et seq. of the DP, revenue recognition may depend on whether the deliverable is a good or a service. If a deliverable is a service, a continuous transfer of control is generally assumed and revenue is thus recognized as satisfaction of the performance obligation progresses rather than when the entire contracted service is completed. In contrast, revenue is generally recognized upon complete satisfaction of the performance obligation if the deliverable is a good. We believe that this dilutes the notion of a single revenue recognition model and creates issues very similar to the perceived weakness of the mixed revenue recognition model under current guidance - which is the need to identify the kind of deliverable to then identify the appropriate revenue recognition approach.

As the proposed model does not appear superior to the current mixed model, we do not favour replacing the current mixed model by the model proposed in the DP.

Section 2: Other potential problematic impacts of the DP for the software industry

Recognition threshold: collectability

The DP (paragraphs 6.13 and 6.14) propose that "*when collectability is not reasonably assured, the boards' proposed model, in the absence of any other criterion, could result in the recognition of revenue sooner than at present. This is because the proposed model would recognise revenue on the basis of the transfer of assets to the customer (and the resulting increase in the entity's net position in the contract), rather than on the basis of cash collection*". Furthermore, "*collectability also relates to the measurement of an entity's rights in a contract (i.e. how*

uncertainty of customer payment should be reflected in the measurement of rights). The boards have not yet discussed that issue and its potential effect on the amount of the contract's transaction price that is allocated to performance obligations".

Under current IFRS and US GAAP, collectability is considered one of the key criteria in the revenue recognition process. In some circumstances a sale may occur with the corresponding revenue being deferred under current GAAP if there are doubts on collectability, with revenue then being recognised when the conditions of doubt have been removed, which could be upon collection of cash. For the software industry, the relevance of this point is exacerbated since the marginal cost of "goods" sold is not significant and the "goods" are intangible and not transferrable onwards by the customer.

We understand that collectability and its potential impact on revenue recognition has not yet been addressed by the Board and that, as stated in section 6.14, collectability "also relates to the measurement of an entity's rights in the contract" rather than a criterion of recognition of revenue. However, we would strongly support considering collectability in recognition rather than only in measurement by maintaining the recognition thresholds which already exist in current guidance whereby revenue is recognised provided that collectability is probable (IAS 18) or reasonably assured (SAB 104).

Determining stand-alone selling prices

The DP (paragraph 5.46) proposes "*that the transaction price be allocated to each performance obligation in proportion to the stand-alone selling price of the promised good or service underlying that performance obligation*". In addition, it states that the "*best evidence of that price is the stand-alone selling price of a good or service when the entity actually sells that good or service separately. However, in some cases, neither the entity nor any other entity sells the good or service separately and stand-alone selling prices are not observable. In those cases, the entity would estimate them*".

We agree that allocation of value between the various components is necessary and we support the Boards' view that the transaction price should be allocated based on the selling price. Furthermore, we strongly support the fact that, in the absence of reliably observable selling prices, the entity could base the allocation on estimates.

However, we note that in certain limited circumstances estimating stand-alone prices may prove difficult, impracticable and/or unverifiable. This could lead to various approaches being taken by companies and reduce comparability.

We believe that specifically in the software industry there are occasions in which we may be unable to reliably estimate stand-alone selling prices. For example: It is not uncommon in our industry to include in a multi-element arrangement a commitment to deliver in the future a specified software product or upgrade that is not yet developed. In such a scenario the scope and future pricing for the future product or upgrade may not be established at the time of commitment and the development costs are not determinable. While this does not impact making the commitment (the direct incremental cost of the commitment is zero) it makes it impossible in certain cases to reliably estimate a stand-alone sales price for the product/upgrade.

In addition, we would like to point out that the requirement to estimate prices for all the elements in an arrangement creates an additional burden for preparers which could be eliminated by allowing a residual method.

Accordingly we would suggest that the Boards consider a model whereby the following method could be used in allocating the revenue to the different performance obligations associated with an arrangement:

- the allocation would be based on observable stand-alone selling prices in similar past transactions if such prices are reliably determinable,
- If no such stand-alone selling prices are observable the allocation should be based on estimated stand-alone selling prices if such estimates can be made in a reliable manner.
- If stand-alone selling prices can be observed for most but not all elements of an arrangement, then the residual method should be permitted, i.e. contract fees are allocated to the elements with determinable/estimable stand-alone sales prices based on these sales prices with the residual contract fee being allocated to the element for which no stand-alone sales price can be determined/estimated.
- Deliverables that cannot be separated per the above should not be unbundled and thus be accounted for as one single element. Indeed we believe that there are instances in the software industry where it would not be feasible to estimate a reasonable selling price for a performance obligation, for example for certain product roadmaps, commitments to deliver when-and-if available software or specified future software upgrades or products.

Multiple-elements

The DP does not provide clear guidance with respect to the level of granularity of the identification of separate performance obligations. Moreover, it requires that performance obligations should be separated whenever they are satisfied at different times.

In addition, The DP (paragraph 4.26) states that *"In the boards' view, in assessing whether an asset has been transferred, an entity should focus on whether the customer controls the asset, rather than on whether the customer can use that asset as intended."*

Lastly, the DP establishes a presumption that if the delivered asset will be used to satisfy another performance obligation, then control has not yet been transferred (example: delivery of paint to be used in a painting contract). However this presumption would be rebutted if contract terms or law indicate that legal ownership over the asset has been transferred.

We believe that the above concepts may result in the identification of too many separate elements, thus creating unnecessary complexity, and potentially resulting in the recognition of revenue for items that have in fact no stand-alone value for customers. For example a software contract may be structured to immediately transfer control over a core license, while customization services will be performed by the vendor at a later stage, and these customization services are in fact essential to

the functionality of the license, i.e. the license cannot be operated as a standalone product (by the customer or another third party).

We believe that the following US GAAP concepts should be considered when determining whether the satisfaction of a performance obligation should be recognised separately:

- EITF 00-21: delivered element must have stand-alone value to customer
- SOP 97-2: delivered elements cannot be recognised separately if undelivered elements are essential to the functionality of the delivered elements.

Definition of transfer of control / preference for risks and rewards / intangibles

Under the proposed model, transfer is identified based on the control of an asset as opposed to the current model which identifies transfer on the basis of risks and rewards of ownership.

The Boards believe that the notion of determining whether an asset has transferred based on risks and rewards is difficult to apply because risks and rewards of ownership could be shared by more than one party and determining which entity has a preponderance of these requires significant judgment. As a result, the Boards believe that because of the level of judgment required, a risks and rewards model could result in different accounting being applied to similar transactions.

The Boards believe that a focus on control will result in more consistent decisions about when assets are transferred.

We think that the proposed focus on transfer of control is a significant change from the current practice under which revenue is recognized when the risks and rewards of ownership have been transferred to the customer.

We agree with the Boards' view that the application of a risks and rewards model to determine when transfer occurs is difficult and requires significant judgment. We acknowledge that this difficulty may result in inconsistent application of judgment and different accounting treatments being applied to similar transactions.

However, we do not believe that the Boards' goal of achieving greater consistency regarding when assets are transferred (and revenue recognized) will be met by the proposed model. To the contrary, our view is that a focus on transfer of control is too legalistic in nature and will increase the risks that certain entities structure transactions in order to obtain a desired accounting treatment and revenue recognition pattern. We believe that two transactions with a similar economic substance can be legally structured in order for control to pass at different times and we do not share the Boards' view that this difference in legal form should, in and of itself, be considered to be substantive (in our view, this point is well illustrated by the ToolCo examples that are provided in paragraphs 4.11 and 4.14 of the Discussion Paper).

Finally, we would like to point out that the identification of transfer of an asset based on control is bound to create significant practical difficulties when applied to services or “goods” with little or no physical substance such as intellectual property in general and software products in particular.

Section 3: Matching of costs and revenues (Question 11 in DP)

Certain companies perform long term service contracts where significant costs may be incurred upfront in connection with these agreements that may have a 7 – 10 year performance period. Under these contracts, a vendor may take over the operation and maintenance of the customer’s network. The vendor is expected to rationalize the network by upgrading it with more efficient equipment and also rightsizing the staffing based on the new network efficiency.

To execute under the agreement, the vendor incurs upfront transition or start-up costs which generally relate to activities which enable the vendor to begin initial performance under the contract. These activities include costs such as costs to build software interfaces with the customer’s equipment, data conversion costs, relocation and training of personnel and redundancy payments for downsized individuals. We are aware that some companies attempt to capitalize these direct and incremental transition costs in situations where there is a dedicated payment stream which assures their recoverability or through analogy to certain US GAAP such as FTB 90-1 where it is probable that the costs will be recoverable through the future contractual revenue stream. This capitalization allows for costs to be matched with associated revenues.

Although the discussion paper has stated that the basic model will be for costs to be expensed as incurred unless they are eligible for capitalization in accordance with other standards (6.44), it is not clear exactly what this will mean. Is the reference to “other standards” IFRS or US GAAP? Sometimes there are differences. It is also not clear when a new revenue standard is issued how existing literature will change. For example, will standards such as FTB 90-1 which include both revenue and cost guidance be superseded in their entirety or will only the portion related to revenue guidance be superseded?

We also believe that matching costs and associated revenues provides the most decision-useful financial statement information. We do not believe that the increased volatility associated with the bifurcation of costs from associated revenue streams will provide financial statement users with information that will best help them analyze company performance. Based on this, we believe that the board should provide additional guidance related to when it is appropriate to capitalize costs and we would recommend reconsideration in the model of matching costs and revenues.

Section 4: Other matters of importance to the software industry not covered in the DP

Uncertain consideration (including contingent consideration) – preference for recognition threshold rather than probability weighted measurement

Contingent consideration is a common component of customer consideration in the software industry. The board has chosen not to address uncertain consideration in the discussion paper although we understand that this issue is currently being deliberated by the board.

Although there are some exceptions, uncertainty in the amount of customer consideration to be received is generally considered as a recognition issue under the current accounting model (that is, revenue is generally not recognized until the contingency is resolved).

We understand that one of the options being considered by the board would be to consider uncertainty in the amount of customer consideration to be received as a measurement issue (i.e., at contract inception the transaction price would be the probability weighted estimate of the amount the entity expects to receive). While we understand the theoretical merits of this view, we are concerned by its practical implications. Overall, it is our view, that contingent consideration should be excluded from the transaction price until the amount becomes certain.

The view that revenue, once recognized, will eventually be converted to a corresponding amount of cash intuitively prevails for most financial statement users and we think that any deviation from the current approach (which requires a very high level of certainty for recognition of revenue) will create confusion.

Overall it is our view that the benefits of a more faithful depiction of the economics of revenue transactions that could be brought by a “measurement” approach are out-weighted by the potential loss of confidence placed by investors in reported revenues. In addition, we believe that moving uncertain consideration from a recognition issue to a measurement issue would result in significant additional preparation costs for most software companies. We therefore recommend the use of a threshold for recognition instead of a probability assessment.

Symmetry between asset transferred by vendor and assets recognized by customer

We believe that the current proposed methodology based on changes in assets and liabilities as noted in the discussion paper would create symmetry in the accounting between a vendor and a customer. If a standard warranty is considered to be a performance obligation that is extinguished as a vendor transfers assets to a customer, it seems that the model would dictate that the customer should be recording those assets as they are transferred by the vendor.

Take an example where a vendor sells a product to the customer for CU50,000 and provides a one year standard warranty as required by local law. Under the current proposal, the vendor could recognize, say, CU49,500 of revenue when the product is delivered and CU500 of revenue over the one year period that the standard warranty is being provided.

It seems that there should be symmetry in the accounting performed by the vendor and the customer that should be addressed by the board. If the vendor has a continuing performance obligation which will be extinguished as an asset is transferred to the customer over the one year warranty period, the customer should be recording an asset during that same period as control of that asset is transferred by the vendor.

The same situation occurs in the case where a vendor continuously transfers control of an asset to the customer under a construction contract. Since the vendor is continuously transferring an asset, it seems logical that the customer is continuously receiving an asset that they would need to recognize. However, in this case it may be difficult if not impossible for the customer to know the extent of work performed by the vendor and estimate the value of the asset transferred and therefore determine a reasonable amount to record in their financial statements.

We do believe that this approach would result in the customer having to make very unreliable estimates in determining the value being transferred by the vendor in extinguishing their performance obligation. Therefore, we would suggest that the board revisit the approach for standard warranty and similar de minimus services and continuous transfers under construction contracts to avoid the complexities of this accounting which we do not believe will add any decision useful information to financial statements.

Scoping – lease of intangible assets: lease project vs. revenue recognition project

In the software industry it is a common practice to sell the rights to use intangible assets owned by the vendor to multiple customers. These transactions can either represent the right to use the underlying intellectual property for a stated period of time (e.g., a two year right to use) or on a perpetual basis. These transactions generally represent significant revenue streams for software vendors. Further complexities can arise when post contract customer support or when-and-if-available software upgrades are also provided in conjunction with the license arrangement. The advent of software as a service (SaaS) has also made it difficult at times to determine when a right to use intellectual property is not in substance a lease of an asset but is in reality the provision of a service.

Since the board is currently considering excluding leasing contracts from the scope of the proposed revenue recognition standard and since IAS 17 includes in its scope leases of some intangible assets, we believe that the board needs to clarify the scope to address whether licensing of some intangible assets (e.g., rights to use software, patents, trademarks, etc.) are leases covered by the guidance in the revenue recognition discussion paper or the leases discussion paper. Without such clarity, we believe that there would be confusion as to which guidance applies and therefore would create inconsistent accounting within industries that currently derive revenues from the sale of intangible assets.

In a simple example, one view (View A) of the transaction could be that selling the right to use intellectual property is similar to the vendor performing a service for the customer as it is in substance a continuous transfer of rights to use intellectual property for a period of time (e.g., a six month period). Under this view the vendor

would be continually extinguishing its performance obligation over the period for which the right to use has been granted and the vendor would recognize the associated revenue pro rata over the covered period.

An opposing view (View B) would be that once the vendor has provided the customer with access to the underlying intellectual property (e.g., access to a website to download computer code or delivery of a physical medium), the vendor has extinguished its performance obligation. At that point the customer can control the resource underlying that promised right to use. Under this view the vendor would be entitled to recognize the associated revenue at the point where access to the underlying intellectual property was granted to the customer.

We would like to point out that the current practice in the software industry is to analogize the grant of a license to use software as the sale of an asset (View B). This practice results (assuming all other necessary criteria are met) in upfront recognition of the corresponding revenue. We believe that any departure from this existing practice would have major impacts on software companies' financial statements and could potentially cause disruption in their business models.

We also believe that one of the key critical factors that is generally considered in determining whether transfer of a right to use intellectual property (notably software licenses), occurs overtime (view A) or upfront (view B) is the exclusive or non-exclusive nature of the right granted to the customer. For instance, software licenses are generally granted on a non-exclusive basis and can be used by many concurrent users. Therefore they are accounted for in a manner analogous to an asset sale. To the contrary, the grant of the right to use a brand name is generally exclusive and is typically accounted for as a service over time. It is appropriate to treat exclusive and non-exclusive licenses differently: In the case of an exclusive license the licensor for the time of the exclusive license loses the right to further license while in the case of a non-exclusive license the grant of one license does not reduce the licensors rights as the licensor can still grant an unlimited number of non-exclusive licenses.

We recommended that the board clarifies which standard should be applied to transactions relating to the sale of the right-to-use intangible assets.

Yours sincerely,