



COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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RE: CESR's response to IASB's *Discussion Paper* Preliminary Views on Revenue

Recognition in Contracts with Customers

The Committee of European Securities Regulators (CESR), through its standing committee on financial reporting (CESR-Fin), has considered EFRAG's draft comment letter on the IASB's Discussion Paper Preliminary Views on Revenue Recognition in Contracts with Customers.

We thank you for this opportunity to comment on your draft letter and we are therefore pleased to provide you with the following observations.

First, CESR would like to make the following comments regarding the environment in which this project is developed:

1. CESR notes that revenue is a key indicator for users of financial statements. To ensure comparability between companies operating in the same industry it is important that clear, consistent and comprehensive recognition and measurement principles are developed.
2. CESR appreciates the efforts of the IASB to address an area in which many stakeholders have, over the past years, identified a number of application problems. In CESR's experience, application issues related to revenue recognition mainly arise in the following areas:
 - a. Deciding whether to apply IAS 11 or IAS 18
 - b. In relation to complex transactions where IAS 18 provides little (if any) guidance as to how the revenue recognition and measurement principles should be applied. Complex transactions include sales which contain multiple elements (combining and segmenting criteria), the recognition of revenue from services when the supplier stands ready to provide a service or capacity, subscriber acquisition costs and renewal options in industries such as the telecommunications industry, exchanges of assets that do not involve the transfer of money, agency arrangements, contracts with extended payment terms and/or settlement discounts, etc.

As a result of the lack of guidance in existing standards, many entities use guidance provided by US GAAP to develop their own accounting methodologies. However, US GAAP sets out its guidance on revenue recognition in numerous narrowly-scoped pronouncements of varying authority issued by several different bodies. This situation is not satisfactory.

Before providing our comments on the details of EFRAG's draft comment letter, CESR wishes to express its views on the alternative model presented in Appendix 2 to EFRAG's draft letter:



3. CESR has strong reservations regarding the alternative model proposed by EFRAG in Appendix 2. Our understanding is that when a product is not developed to the specific requirements of a customer but is effectively made available “off the shelf”, the entire revenue from the sale of a product would be recognised at the order date in EFRAG’s activity based model. CESR cannot agree with this outcome because we believe that both control and risks and rewards remain with the seller unless delivery to the customer takes place on the same date.

These preliminary views being presented, CESR’s main comments regarding the project are the following:

4. On many issues CESR is supportive of the comment letter prepared by EFRAG. In particular, CESR supports the objective of providing a single principle for recognising revenue. However, as stated by EFRAG in its comment letter, whether the development of a set of principles capable of universal application is possible at the moment is another matter.

CESR notes that paragraph S11 implies that the IASB is seriously considering scope exemptions for financial instruments (and even non-financial instruments contracts), insurance contracts, and leasing contracts.

In addition, we note that many of the issues brought to IFRIC’s attention are not addressed in the current project (see par. 2.b. and 11 of this letter). CESR is concerned that the scope of the current project seems only to address a limited number of the application issues mentioned above (mainly eliminating the choice between IAS 11 and IAS 18, and providing new guidance on some multiple-element transactions).

Finally owing to a lack of detail in definitions on key elements such as control and revenue (which in our view should incorporate some concept based on the principle of activity, in particular in connection with IAS 11-type contracts), we believe that the current proposal is not refined enough to ensure its consistent application in areas such as long-term contracts.

Therefore our suggestion is twofold. In the short term, the IASB could improve the existing standards and provide additional guidance in the many areas where application problems have been identified. In order to develop a new unique principle that would take into account all those situations more time is needed, therefore CESR sees such a project as a much more long term project. Further, in this case, considering the various comments included in the present letter, CESR believes the issuance of a new discussion paper may be necessary.

CESR did not prepare detailed comments for all the questions submitted by the IASB. Because a certain number of application problems are not addressed in the discussion paper, it is very difficult to make comments when CESR has difficulties understanding the consequences of the new proposal on those situations.

5. In more detail, CESR believes that a number of concepts are key in determining when revenue should be recognised: a contract with a customer, control over a product or a service, a performance obligation, and the definition of revenue as an indicator of an entity’s activity which is key to assessing performance over a period of time.
6. CESR agrees that control is a key element in assessing revenue (see par. 4.5) and consequently we believe a detailed definition of control is needed.

An example that CESR has discussed with IASB staff concerns defence contracts. Where defence equipment is concerned, the customer (a State) will often benefit from various protective rights that ensure that technology, know-how, technical capabilities, etc. will be known only to a limited and controlled number of people. In certain cases, the equipment concerned will be developed or built on premises that belong to the customer (for security



reasons). This extreme example highlights that control may be understood in a variety of ways. Paragraphs 4.42-4.44 of the discussion paper also provide examples demonstrating that assessment of control is difficult.

It is our understanding that the IASB believes that for many construction-type contracts control of the asset passes to the customer on a continuous basis. Our experience however is that continuous transfer of control in such contracts is rare. Generally, even when the asset is built or developed at the customer's site, control is not transferred until the customer formally takes receipt of the asset (e.g. when all technical or quality requirements are met). According to the discussion paper, the supplier should not recognise any revenue in such situations until final delivery of the asset. CESR is concerned that such a revenue recognition principle does not necessarily provide useful information to users of financial statements (see construction-type contracts where control is formally transferred at the end of the contract but for which CESR believes it is useful to recognise revenue based on the percentage of completion of work).

Furthermore, although CESR agrees with the IASB that contracts may be very specific in their detail, and that those specifics should be taken into account when assessing how to recognise revenue, CESR also believes that risks and rewards are important to that assessment. CESR does not see how a customer can have access to "future economic benefits" (see discussion paper paragraph 1.18 where a reference is made to IAS 18.7) without also bearing the risks and rewards of ownership. CESR feels that relying only on a contract (a formal definition of control) may give rise to structuring opportunities (i.e. recognising revenue whilst the risks and rewards are still retained simply on the basis that "control" has passed to the customer).

7. On the other hand, CESR sees a potential contradiction between the weight that the IASB gives to the contract and the fact that where multiple elements are included in a sale transaction (for instance in the telecommunication industry when a transaction deals both with the handset and the monthly subscription fee), the current project disregards the contractual agreement. CESR believes a clarification is needed in this area.
8. CESR would encourage the IASB to discuss in more detail what revenue actually is. The discussion paper makes a reference (par. 1.18) to the current definition in IAS 18 (IAS 18.7). CESR believes a discussion paper is the appropriate document where such an important concept as revenue should be discussed. An alternative way of defining revenue would be that the satisfaction of performance obligations has been transformed into claims towards customers. This definition lends more weight to the "activity" criterion. CESR is not certain that the approach set out in the discussion paper represents an adequate response to a certain number of situations which CESR believes are better addressed by the activity based model (for instance in the case of construction-type contracts, or of contracts where the supplier stands ready to provide a service or a capacity).
9. CESR agrees with the IASB that performance obligations are key elements in assessing whether revenue can or cannot be recognised, however, as EFRAG points out, these elements should be supplemented as a minimum by further guidance.

As far as measurement of performance obligations is concerned, the DP does not express a preliminary view on how an entity should measure a contract right (asset), but the guidance is expected to be based on the transaction price. The time value of money and any uncertainties, such as contingent consideration, will also need to be taken into consideration. Measurement of a transaction price is straightforward when the consideration in the arrangement is a fixed amount of cash but becomes more complex when there is uncertainty as to the total amount to be paid, as is the case when a portion of the consideration is contingent on a future event.



10. As regards the definition of a contract, CESR fully concurs with the concerns expressed by EFRAG that there are two definitions of a contract with slightly different wordings (one in the discussion paper and the other in ED 10). Given the different economic phenomena underlying financial contracts and other contracts, a proper discussion on this issue is needed.
11. An indication that it might be difficult to identify a universally-applicable principle is provided by the discussion paper paragraph 4.56. This paragraph sets out the rebuttable presumption that when an asset is used in satisfying another performance obligation in the contract, it is not transferred to the customer until the asset is used in satisfying the performance obligation. It is worth stating that this rebuttable presumption might be very useful for dealing with service concession arrangements of the “build-operate transfer” type where transfer to the grantor occurs only at the end of the arrangement. However, CESR is of the view that this paragraph represents an exception to the general principle.
12. CESR would suggest the IASB performs an analysis of whether the principles as set out in the discussion paper provide answers to the issues submitted to the IFRIC. A quick review of these shows that about 20 submissions were related to IAS 11 or IAS 18 or both. Four submissions resulted in the publication of final interpretations (IFRIC 12, IFRIC 13, IFRIC 15, and IFRIC 18). CESR thinks that it would be helpful to understand the consequences of the current proposal for these existing interpretations (in particular it is not clear how IFRIC 12 would be affected as in build-operate arrangements, the underlying asset is not necessarily transferred to the grantor of the concession service arrangement, which, except for the rebuttable presumption mentioned in the discussion paper paragraph 4.56, would impede the builder and operator from recognising revenue on the construction element of the contract until the end of the concession arrangement). Similarly, CESR believes it would be helpful to understand how the current project addresses the issues which were rejected by IFRIC.
13. As a final point, CESR agrees with EFRAG’s assessment that the discussion paper would result in significant changes to existing practice, and that these changes would probably result in the recognition of revenue occurring much later than at present for long-term contracts. CESR is concerned that this change will result in less decision-useful information being provided to users of financial statements.

Our detailed comments are set out in the appendix to this letter. I should be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando Restoy
Chair of CESR-Fin



Appendix: Answers to some of the questions included in the DP

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

CESR would also raise the issue of subcontracts i.e. contracts for the production or delivery an asset (e.g. manufacturing equipment or a machine) which forms part of a larger contract which the sub-contracting customer has with another third party to deliver a more complex product (e.g. a product line or a ship tc). At what point can the performance obligation be said to transfer: when the equipment which is the subject of the subcontract is transferred to the sub-contracting customer or when the whole product line is transferred to the third party? The time period between the subcontract asset and final contract transfers could be very long, e.g. one year.

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

As stated in our cover letter, CESR believes the notion of control can be understood in a variety of ways. Therefore, CESR invites the IASB to propose a definition and formulate application guidance that might facilitate a proper assessment of the proposal in the discussion paper.

The need for clarification in this regard seems all the more important as CESR believes that if the legal control criterion were used as the sole methodology for assessing whether transfer has taken place, this would open the door to many structuring opportunities.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

As can be inferred from our previous comments, depending on how the notion of control is eventually clarified, CESR's view is that a strict criterion of legal transfer would result in practices significantly different from those observed currently. CESR's understanding is that for contracts where control does not formally transfer on a continuous basis to the customer, the current stage of completion method would be prohibited.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

The examples given in the paper show that in cases where there is no stand-alone selling price available because the good is customised, an entity should make an assessment of the individual prices the customer would have accepted for each of the components of the transaction. This practice would not seem to differ greatly from what some entities already do in construction-type industries. However, it is unclear, whether the method of allocating stand-alone prices to component elements is also to be used for construction which span more than one reporting period. In such contracts, there are often contingent considerations which make it difficult to assess and measure the contractual performance obligation.