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C E R T I F I E D   P U B L I C   A C C O U N T A N T

Steve Ong
Director Standard Setting Department
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

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Dear Steve!

It has been my pleasure to attend the Financial Reporting Forum on 31 March 2009 on

IASB Discussion Paper on *Preliminary Views on Revenue Recognition in Contracts with Customers*

Please find attached some answers to the Questions for Comment.

Kind regards,

Joachim Klein

Enclosures

25 F/B • IVY ON BELCHER'S • 26, BELCHER'S STREET • KENNEDYTOWN • HONG KONG
PHONE: (852) 614 58711(M) • (852) 2986 3477(H)

Responses to the IASB Discussion Paper on

Preliminary Views on Revenue Recognition in Contracts with Customers

By Joachim Klein
25 Floor, Flat B, Ivy on Belcher's
26, Belcher's Street, Kennedytown
Hong Kong, SAR China
+852 2986 3477 (H)
+852 614 58711 (M)
joachimklein@netvigator.com

Chapter 2

Question 1

Do you agree with the boards proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

No.
There are inconsistencies in the accounting frameworks of both standard setters. The inconsistencies in US-GAAP stem partly from inconsistencies in the the FASB's conceptual framework, in particular CON-5 and CON-6 on revenue recognition (‚Asset/Liability Approach' versus ‚Earnings Approach'). These conceptual inconsistencies could be removed separately. Also, as regards IFRS, the inconsistencies mentioned in section 1.11 of the DP (i.e. transaction involves both goods and services) could be addressed by keeping the risks and rewards approach: Although certain transactions are considered as a whole and all of the revenue is recognised on delivery of a good, the standard could be amended by adding criteria for the determination of the ancillary service component of a contract and main service component of a contract, such as already outlined in IAS 18.16(c) (‚significant part of a contract').
As regards the warranty problem discussed in section 1.11 of the DP, while it is correct that an entity might recognise *all* of *the profit* in the contract before the entity has fulfilled *all* of its obligations, this is a measurement problem of the warranty provision and not necessarily a problem of revenue recognition, i.e. the warranty provision could include that part of the profit (gross margin) which relates to the unfulfilled obligations in the contract.

As regards the inconsistencies between IAS 11 and IAS 18 (see section 1.15 and 1.16 of the DP), it would be too risky to remove long-established accounting practices. Accounting for construction contracts is one of the few areas in which a comprehensive model for revenue recognition exists. Also, the disadvantages of a removal of a proportional performance revenue recognition model would outweigh the advantages of having no inconsistencies between conflicting standards.

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

As mentioned under question 1, if the boards propose a single contract-based model of revenue recognition, the accounting model of a proportional performance revenue recognition (i.e.. IAS 11) would be replaced by a model in which the satisfaction of a ‚performance obligation' by the entity triggers revenue recognition (see section 2.41). As specified in section 4.62, for long-term construction contracts, the satisfaction of

the performance obligation occurs only if assets are transferred to the customer and the customer controls the partially constructed asset.
The boards are surely aware of the fact that, for example. in the shipbuilding industry construction projects last over months and years. How could the customer control a partially constructed ship or a partially constructed airplane or pipeline? And if so, would the customer be able to use the partially constructed airplane or ship as collateral for its creditors? Even if there are ways to partially ‚transfer' the asset (e.g. by customer certification) there are open questions as regards the measurement of these partially transferred items. For example, as mentioned in section 5.103 of the DP, the boards propose that the initial measurement of the performance obligation should be at the transaction price (customer's promised consideration) and this transaction price is then allocated to the performance obligations on the basis of the relative stand-alone selling prices of the goods and services underlying those performance obligations. How could relative stand-alone selling prices be determined at an initial stage, if the long-term construction contract is for a specific construction project for which such selling prices do not exist? Examples 5 and 6 in the Appendix do not satisfactorily answer these questions either.

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

No.

For certain jurisdictions, the definition of a contract as per section 2.11 of the DP leaves uncertainty in applying this definition. This uncertainty is illustrated by using the example (cash sale) mentioned in section 2.15 of the DP.

In certain jurisdictions, a normal cash sale (i.e. the shopkeeper sells a product to a customer and receives cash as consideration) consists actually of two legal transactions and therefore, in applying the definition in section 2.11, there remains unclarity to which transaction the term ‚contract' actually refers to.

In Germany, according to the civil law (Bürgerliches Gesetzbuch, BGB), a normal cash sale is separated into two separate acts of legal significance:

1. The shopkeeper commits to deliver the product to the customer and the customer commits to pay the purchase price to the shopkeeper (disposition agreement).
2. The shopkeeper hands the product over to the customer and the customer hands over the cash to the shopkeeper (executory agreement).

The strict separation of disposition agreement and execution agreement (i.e. contractual right and right in rem) under German law allows the following contractual stipulation which is very common in normal business relationships:

A seller of a product stipulates in the contract with the customer that the transfer of title of a good actually is contingent on the full payment of the purchase price (Eigentumsvorbehalt – Reservation of title). That means, even if the goods are already handed over to the customer, the shopkeeper still has legal title on the goods sold to the customer as long as he has not received full payment.

By applying revenue recognition solely on the existence of *an entity's contract with a customer* (see section 2.8) and by using the definition in section 2.11 the question still needs to be answered to which legal transaction the term ‚contract' actually refers to – at least in some jurisdictions.

Thus, in some jurisdictions, enforceable obligations between two or more parties are created in several ways (see section 2.14) and could imply the existence of several contracts.

Chapter 3

Question 4

Do you think that the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

No, not necessarily.

According to the proposed definition by the boards, an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer.

The proposed definition omits circumstances in which an entity enters into a contract with a customer in which neither a service is provided nor an asset is transferred to the customer. For example, a company like Walt Disney Inc. markets its intellectual property rights in its characters (e.g. Mickey Mouse, etc.) by enabling the stationery industry to use these characters, i.e. by giving them the licencing rights to produce stationery with those characters on it. There is no doubt that a contract exists between Walt Disney and the stationery producer and that a licensing fee is paid depending on the output produced by the stationery company.

However, by using the definition mentioned in section 3.2 of the DP, it is difficult to see what service Walt Disney actually provides or what asset is actually transferred to the customer. There is no discernible service or asset in this case.

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?

Yes, but further clarification is needed. The crucial problem here is a measurement problem: How does the entity allocate the revenue to the multiple elements of the contract? According to the proposed definition by the boards, the *timing* of when the goods and/or services are delivered to the customer is determining *how many performance obligations* have to be accounted for (see section 3.24 of the DP, see also Example 1 in Appendix A). As outlined in Appendix A, Example 1, the entity allocates the revenue to the individual elements (performance obligations) as it expects that the assets are transferred to the customer at different times. The measurement, i.e. the allocation of revenue to the deliverables software and customer support, is based on estimates.

This could lead to different accounting treatments depending on what the entity *promised* to the customer as regards timing of the bundle of goods and services to be delivered in contrast to what the entity actually delivers.

Normally, the software license would be delivered first, then the customer support would be performed over the service term. If most of the revenue is allocated to the software license based on the entity's estimates, the entity would be able to recognise most of the revenue of the whole bundle immediately upon delivery of the software license. Thus, the proposed model gives the entity a significant leeway in allocating revenue to the deliverable for which auditable documents (proof of delivery) can be demonstrated.

By referring to the *timing* (i.e. when the entity transfers the assets), the proposed model does not take into account the interdependencies between the relevant elements. For example, a software vendor sells a software licence and implementation services to a customer. If substantial customisation work has to be performed, the functioning of the software element is highly dependent on the performance of the service (i.e. implementation). By allocating revenue only depending on the *timing* aspect without taking into account the interdependencies of the individual elements, the entity could realize revenue up front, i.e. once the software licence is delivered to the customer (and not once the whole software implementation project is completed and customer acceptance has been obtained). Under existing US-GAAP, the entire arrangement would have to be accounted for using contract accounting (SOP 81-1), but it seems that under the new model, contract accounting is not an option any more.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

No.

The Discussion Paper discusses the proponents view (return right is a performance obligation) and the opponents view (the return right represents a failed sale). In my opinion, the right of return is a failed sale. Also, the likelihood of goods to be returned can be estimated easily by the entity based on past experience. In contrast, the proponents view to attribute some of the revenue to a ‚return service' and to realise revenue for this return service only after the right of return period has lapsed would only imply more complexities in accounting for each indiviual good which would not necessarily lead to a higher decision usefulness. For example, a process (and controls) would have to be implemented to account for goods returned within the period of return and outside of the period of return.

Question 7

Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and ‚free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

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Chapter 4

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.

No.

In certain industries (e.g. in the semiconductor industry), some manufacturers hold consignment stock at so-called ‚fabs' (e.g. spare parts). The consignee (e.g. the fab) accepts the spare parts without any liability except to reasonably protect them from damage. The consignor (manufacturer) has legal title over the spare parts. However, the consignee (fab) *controls* these spare parts as it needs to have access to these parts at any time. Depending on the individual circumstances, one could argue that the entity has transferred the consignment stock to the fab. That would be a major change to the existing practice where revenue is not recognised up until the spare part has been used in the production of the fab.

Also, the definition in section 4.56 (satisfying another performance obligation) does not necessarily lead to a more practical result, as the manufacturer may not have other obligations in addition to the supply of spare parts.

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.

See answer under Question 8.

Chapter 5

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- **(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?**
- **(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?**
- **(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligation makes that approach unsuitable? Please provide examples.**
- **(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.**

Yes, however, the allocation of the transaction price to the identified performance obligations in proportion to the stand-alone selling prices or in proportion to estimated stand-alone selling prices (see section 5.47) may mean significant estimation by the entity for which observable evidence cannot be provided.

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- **(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?`**
- **(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.**

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?

Please refer to my answer in Question 5.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

No, if an entiy does not sell a good or service separately, the entity should not be able to allocate the transaction price based on stand-alone selling prices.
Instead, the proposed model should be amended and further restrictions should be added for allocating the transaction price. The accounting treatment should reflect the economic reality.