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IASB
International Accounting Standards
Board
30 Cannon Street
London, EC4M 6XH
United Kinddom

15 June 2009

BUSINESSEUROPE's response to the IASB/FASB Discussion Paper on "Preliminary Views on Revenue Recognition in Contracts with Customers"

Dear Sir/Madam,

BUSINESSEUROPE appreciates the opportunity to respond to the proposals set out in the discussion paper "Preliminary Views on Revenue Recognition in Contracts with Customers". As revenue recognition is closely interrelated with the question of an entity's performance and its performance potential, it is the key area in external but also management reporting and controlling.

We understand the boards' intention to address inconsistencies in existing standards dealing with revenue recognition and to reflect on a revenue recognition model aiming at providing clear guidance on how to recognize revenue more consistently for similar contracts. We also welcome the boards' explicit objective to consider the need for users of financial statements to receive decision-useful information which can be provided by preparers at a reasonable cost.

In the first part of this comment letter we would like to focus on general remarks and highlight key issues identified with regard to the proposed revenue recognition model. These remarks need to be read in connection with our detailed responses to the specific questions raised in the discussion paper that are outlined in the second chapter. As the discussion paper suggests a single revenue recognition principle that should be applied to all types of contracts and businesses we assessed every question separately and answered to every question raised by the boards comprehensively.

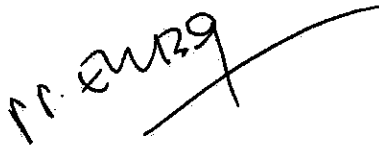
We note that many conceptual questions are not discussed yet so that the comments in this letter are primarily to be seen as comments to the proposed model in the discussion paper – but as the issue of revenue recognition is complex and highly interdependent it includes also aspects where decisions have not been taken yet. As the discussion paper is sometimes vague we want to emphasize that a definitive evaluation, at this project stage, is not always possible and that the implications of the proposed model on revenue recognition in practice depend significantly on the

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outstanding decisions, further definitions of the proposed model's elements (especially regarding the notion of control) as well as further specifications, above all to the continuous approach (e.g. postulated in DP 4.38 et seq., DP 6.34) and its measurement implications.

We remain at your disposal, should you wish to discuss these comments in more detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read "J.P. Chauvin", with a long horizontal stroke extending to the right.

Jérôme P. Chauvin
Director
Legal Affairs Department
Internal Market Department

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1. General evaluation

1.1. Summary of the proposed model

As we further base our comments on it, we want to share our understanding of the essentials of the boards' proposed model on revenue recognition in contracts with customers ("the proposed model"):

- A contract is to be seen as a series of rights and performance obligations.
- A performance obligation is defined as a promise in a contract with a customer to transfer an asset to that customer. The rights are basically constituted by the contractual entitlement for payments (i.e. customer obligation).
- The differences in value of the rights and obligations determine the net contract position. The net contract position at inception is nil.
- Satisfying a performance obligation increases the entity's net contract position and thereby generates revenue.
- The identification of the assets to be transferred is performed at contract inception. Performance obligations which are satisfied simultaneously may be bundled to one single performance obligation.
- A performance obligation is measured at the portion of the original transaction price allocated on the basis of the identified performance obligations' relative stand-alone selling prices that, for allocation purposes, may be estimated. The allocated amount is the amount of revenue to be ultimately recognized.
- Ultimate satisfaction of the performance obligation is deemed to have occurred when control of the underlying predefined asset has been transferred to the customer.
- Performance obligations are generally not updated unless the performance obligation is deemed onerous (no general remeasurement).
- In addition, in the March meeting the boards' tentative decisions are as follows: The entity's net contract position should reflect the time value of money. Furthermore, the contractual rights to be allocated at contract inception should include contingent amounts assessed on the basis of a probability-weighted estimate; after contract inception, this measurement of rights is updated and allocated to the performance obligations.

1.2. General remarks and key issues

BUSINESSEUROPE acknowledges that a single revenue recognition concept for all types of contracts within all industries may be desirable from a conceptual point of view. However, we believe that the practical implications on decision usefulness and the cost/benefit aspect should have priority when considering such significant changes

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to revenue recognition. It is our impression that the proposed model will in many cases not reflect the entity's performance and activity which, according to our understanding, is the user's main interest in revenue figures.

For means of providing decision-useful information to users of financial statements we believe that the starting point in developing a revenue recognition model should be the answer to the question about an entity's performance which may or may not coincide with the transfer of predefined assets. We regret that the discussion paper does not treat this fundamental question. In our opinion, in order to represent decision-useful information for users of financial statements, the basic principle of revenue recognition should be the measurement of activity carried out to fulfill a contract with a customer. This especially applies to customer-specific construction contracts, service contracts and also arrangements with multiple elements, e.g. with one activity being to deliver a product and other activities to render services subsequently. But, we think that this basic principle needs to be amended for short-cycle product business in a way that performance is based on the delivery of a completed good.

BUSINESSEUROPE believes that the general outlines in the boards' proposal regarding "traditional" arrangements with multiple elements (to be seen in contrast to customer-specific construction contracts), especially the need to estimate a stand-alone selling price when observable prices are not available, will improve financial reporting in contractual arrangements with a customer. A separation of, and thus, revenue recognition for delivered or provided elements seems to be generally possible, and an expected cost plus a reasonable margin approach is, in most cases, considered to more faithfully reflect the entity's performance and its business model with different margins for the different elements of a contract (e.g. delivery of a product and rendering services for a period of two years).

In contrast, in an overall assessment of the proposed model we have significant concerns. They particularly relate to the inclusion of customer-specific construction contracts into the proposed model:

Depending on the legal interpretation of acceptance clauses, contract and local law specifications (e.g. regarding formal transfer of title), the project time plan and further circumstances, the number of performance obligations to be identified may vary significantly from contract to contract resulting in the identification of several performance obligations to which, after their initial measurement, different margins are attributed. The internal management, controlling and reporting will continue to be based on the total project perspective with an overall margin which results in a disconnect between internal view and external reporting.

In contrast to today's practice for customer-specific construction contracts many of the contracts may require an extremely high degree of disaggregation as per the criteria proposed in the discussion paper. The bundling of performance obligations which are planned to be satisfied simultaneously will help to restrict the "atomisation" of contracts to some degree, however, experience shows that project time plans may change significantly over time and the exercise of defining performance obligations at contract inception will have to take into account that fact. In total, the identification of high numbers of pre-defined performance obligations may be costly and will imply a high degree of subjectivity. Moreover,

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the treatment of important elements of project execution is not clear. For example, it would be difficult to assess whether project management is a performance obligation and, if not, to which performance obligation the costs should be allocated to.

There may be other contracts for which only one performance obligation is identified. In such case, the proposed revenue recognition mechanism would ultimately result in "completed contract accounting". As the individual contract volumes may be very considerable, the entity's performance in the reporting periods may become significantly distorted. In practice, external users and management will demand adjusted revenue figures not including the one-time effects of such significant single contracts.

Especially within customer-specific construction contracts performance obligations identified at the beginning of the project may become obsolete and may be replaced by other obligations (e.g. when design is changed). The same applies to subsequent contract changes or changes in the total contract volume due to price escalation clauses. It is our view that the proposed model does not seem to be robust enough against such changes and that costs and complexity of remeasurement are unforeseeable. Any decision on a revenue recognition model should take such issues into consideration.

However, our concerns are not limited to the application of the proposed model to customer-specific construction contracts. The notion of control may introduce a legalistic view on revenue recognition that also influences product business. To review contracts worldwide as well as, for accounting purposes, to assess almost every local (steadily changing) legal framework in the world would be necessary, and contract terms that, in substance, are not important under a risk and rewards assessment may become unreasonably important for revenue recognition or do no longer have impact on the assessment (e.g. especially the legal transfer of title). Having evaluated these circumstances, we believe that a risk and rewards assessment is a more adequate approach to provide decision-useful information: a revenue recognition principle needs to be based on the contract's commercial substance, and should not primarily focus on certain specific contractual terms.

In addition, we believe that it is counter-intuitive to recognize loss provisions for separate performance obligations in an entity's financial statements when a contract with a customer in total is still profit-generating. We believe that this proposal will further disconnect the internal management perspective from external presentation.

Considering the expected impact on customer-specific construction contracts but also on all the other issues which are further addressed in chapter 2 (answers section) we do not share the boards' assessment that the proposed model is not expected to have much impact on revenue recognition in practice. We think that current practice will remain unchanged only for a restricted number of businesses and with regard to a limited number of types of contracts as it is probably the case in retail business.

We believe that such a model will impose excessive additional one-time and ongoing implementation efforts and costs on the preparers of financial statements as revenue recognition is the "heart" of every business IT-system that is linked to logistics,

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controlling, tax, other accounting as well as administrative processes of an entity. The customizing of existing IT-systems in order to automatically process business transactions is complex and very costly which can be substantiated by the experience of European Union preparers that recently introduced IFRS. In addition, we think that, particularly for internationally operating entities, the proposed model would also impose high follow-up costs if the control-based concept required a legal assessment of revenue recognition. These costs may even be higher after disclosure requirements of the proposed model have been assessed. Our concerns about introducing a very costly and complex model of revenue recognition have been reaffirmed by the boards' tentative decisions taken in the March meeting (the boards' May decisions, in contrast, have not yet been reflected in this comment letter).

In contrast to these costs, we do not see the proposed model's improvement on decision usefulness and, in addition, that such an improvement has already been sufficiently demonstrated by the boards for justifying such immense costs. This has also been seen in the context of the discussion about scope exclusions that, even by now, seem to impair the conceptual approach of introducing a single contract-based revenue recognition model applicable to all types of contracts within all industries. In case users ask for more detailed information on certain contracts (especially regarding PoC), this is a matter of disclosure requirements rather than a starting point for a new revenue recognition principle.

After our evaluation of the proposed model, we recommend the boards to rethink the proposals in the discussion paper starting with a reasoning about what the revenue figure in an entity's income statement should represent in order to provide decision-useful information to users of financial statements – which in our opinion is a measure of activity carried out to fulfill a contract with a customer and not a measure of transferred assets to a customer. Such an activity-based principle is deemed to provide a more appropriate and more reliable measure of an entity's performance than the presented concept of changes in control of pre-defined assets. Furthermore, we think that a revenue recognition principle which is solely based on contract terms and the respective legal conditions without an assessment of the contract's commercial substance will not lead to decision-useful information for the users of financial statements. We are therefore of the opinion that the proposed model is not the adequate approach for increasing decision usefulness of financial reporting.

Based on these points, we think that a single revenue recognition principle for all types of contracts and all businesses that universally leads to a decision-useful revenue-figure is difficult to achieve on the basis of the proposals in the discussion paper. A final standard, in our opinion, further needs to encompass more than one approach in order to provide decision-useful information about an entity's revenue figure – approaches that are based on the particularities and characteristics of different kinds of contracts which have to be specified solidly. As outlined above, an activity-based revenue recognition principle seems to be a good basic revenue recognition principle for many contracts and contractual arrangements with a customer, but we see that this principle needs to be amended for some kinds of businesses, especially short-cycle product business.

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2. Comments on the specific questions raised by the boards

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?

As indicated and discussed in the first chapter of this comment letter, BUSINESSEUROPE doubts that the proposed model will provide (more) decision-useful information for users of financial statements as, in our opinion, revenue is a measure of activity carried out to fulfill a contract with a customer rather than a measure of transferred predefined assets to a customer. Therefore we do not agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability. Our concerns are largely based, but not limited to, the application of the proposed model to customer-specific construction contracts.

With regard to customer-specific construction contracts we note that in the case only one performance obligation is identified, the proposed model does not provide decision-useful information about an entity's performance in the case the transfer of the underlying asset occurs upon completion; this would ultimately reintroduce "completed contract accounting". On the other hand, when unbundling a contract, it would not only introduce a highly complex and costly model of revenue recognition with initial in-depth analysis of the contract so as to appropriately identify its performance obligations – an assessment that depends on legal interpretation of acceptance clauses, contract and local law specifications (e.g. regarding formal transfer of title), the project time plan and further circumstances – as well as with on-going remeasurement questions. It is therefore essential to have accounting principles in place which are robust against such changes and where costs and complexity of remeasurement are limited.

In this regard, we encourage the boards to further specify what is meant by DP 6.34 that states that "a contract that continuously transfers assets to a customer comprises, in effect, a continuous series of performance obligations." This notion seems to imply a high disaggregation level of a customer-specific construction contract with many assets/performance obligations and respective consequences on their measurement as well as revenue recognition that follows the transfer of control of the performance obligations' underlying assets. In our opinion, such specification of a continuous approach with regard to customer-specific construction contracts needs to take the complex contractual (e.g. transfer of title for some shipments and overall acceptance clauses, termination clauses etc.), law-related and risk-reducing issues (like collateral security, retention of title) into account. In addition, more clarification is required with regard to the measurement implications of such a continuous approach (e.g. overall margin or individual margins for every asset to be transferred to the customer).

In the case a continuous approach implied not one performance obligation, i.e. one unit of accounting, within which the items/assets to be continuously transferred to the customer are accounted for on the basis of one overall margin applied to all transferred items, it would, in effect, introduce the same complexity as described above and in our

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other answers to the boards' questions. Since, on the basis of our first assessment, the proposed model does not seem to represent the economic view and management approach of such contracts we want to give an impression about this issue and would like to outline some characteristics as well as circumstances regarding customer-specific construction contracts:

- Many contracts that are currently accounted for under IAS 11 are managed and controlled as projects. Percentage-of-completion (PoC) accounting allows getting in line the internal management perspective with the external reporting by looking at the project as a whole as well as its progress, i.e. performance. Within one construction contract, the separation of single performance obligations with individual margins to be realized will lead to a disconnect between controlling (project perspective) and accounting (perspective of separated performance obligations).
- Furthermore, customer-specific construction contracts are characterized by not being comparable one to another. In many cases products, components or services are used which are not offered on a mass market. Evidence of stand-alone selling prices of such products, components or services may be scarce as they vary from transaction to transaction. Moreover, in order to adequately unbundle a contract into performance obligations, the proposed model seems to require a decentral and legal in-depth analysis for every single contract – activities to be undertaken in order to allocate the original transaction price to identified performance obligations whose allocation basis, as outlined above, is highly subjective.
- As the notion of "control" seems to trigger the unbundling of a contract, additional complexity in a contract's assessment would be introduced (see further question 8).
- For customer-specific construction contracts it is not uncommon that performance obligations can only be exactly identified during project implementation. Many contracts include clauses like "fit for its intended purpose" or "state of the art" clauses. Performance obligations identified at the beginning of the project may become obsolete and may be replaced by other obligations (e.g. due to a revised design). Impact on the project's costs may be limited but the assets transferred may be significantly different from those identified at contract inception. In addition, there are contingent obligations within a contract (e.g. the necessity to build an anti-noise barrier depending on a subsequent noise-level measurement performed) which can only be assessed when the project progresses (see further the answers to question 10c).

However, our concerns are not limited to the application of the proposed model to customer-specific construction contracts. In general, compared to an assessment based on the transfer of risks and rewards, the notion of control may introduce a legalistic view on revenue recognition and would therefore require accounting for similar contracts differently. This takes an internationally acting entity to review contracts worldwide and, for accounting purposes, to assess and continuously trace almost every legal framework in the world. Contract terms that, in substance, are not important under a risk and rewards assessment may become outstandingly important for revenue recognition or do no longer have impact on the assessment (e.g. regarding

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shipment conditions or details of contractual termination clauses). This would, in consequence, require entities to juristically analyze every single, even less complex contract in detail (for questions arising from such a view on the point in time of revenue recognition see also question 8).

A further issue we discussed is the application of the proposed control-based revenue recognition model to the variety of service contracts that exist in practice, especially when not a uniform service is provided. This issue, after our assessment, is not yet clear.

The discussion paper also postulates additional elements like a legal warranty or rights of return to be revenue-attracting elements within a contract rather than issues to be accounted for by a provision. This modification requires not only permanently presenting and tracing the net contract position, but may also imply to separately account for risks that are currently assessed and accounted for collectively. Due to many remeasurement issues that arise in practice and that seem to be assessed in a different manner on the basis of the proposed model (see also explanations to question 6 as well as question 10c), this change will, in our opinion, not necessarily lead to decision-useful information, but will introduce a complex and costly model of revenue recognition and accounting for risks.

With regard to the second part of this question please refer to our comments in the general remarks section of this letter.

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 already stated in chapter 1, we doubt that the proposed model would provide decision-useful information for users of financial statements as it does not in all cases and for all types of contracts appropriately represent an entity's performance which, in our opinion, is a measure of activity carried out to fulfill a contract with a customer rather than a measure of transferred assets to a customer which may or may not coincide with an entity's performance.

In particular, the boards' proposed model would not provide decision-useful information for customer-specific construction contracts. Even there are many, turnkey contracts as for power plants, refineries, sub-marines, war ships, or manufacturing sites with a typical duration of one to ten years are selected examples for the boards' proposed model not providing decision-useful information.

Specifically for such long-term customer-specific construction contracts a continuous recognition of revenue as per the activities carried out in order to fulfill the contract with the customer with having only one single unit of accounting with one single overall margin provides, in our opinion, a more adequate model to account for such contracts.

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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.

Basically, we agree with the boards' definition of a contract as an agreement between two or more parties that creates enforceable rights. We note, however, that IAS 32 already provides a definition of a contract which, at least, is based on another wording. In order to avoid confusion, we think that a difference, if any, between the two definitions should be clarified or only one definition of a contract in IFRSs should be used.

We further notice that the term "enforceable" is not assessed in the discussion paper yet. In order to establish a common understanding of this term we encourage the boards to specify that notion.

Question 4:

Do you think 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.

After having assessed the proposed definition as well as other statements that can be found in the discussion paper and that are closely interrelated with this question, we think that the boards' proposed definition of a performance obligation would generate difficulties for entities to identify consistently the deliverables in (or components of) a contract. This definition requires further clarification to serve as a useful basis to consistently identify performance obligations in a contract. Our statement is based on the following points:

- Even if the boards consider the definition of a performance obligation to be similar to the current notion of a deliverable, component or element, an overall assessment of the discussion paper seems to indicate that the definition's scope might be "broader" (e.g. discussion about legal warranties, rights to return, etc.) – but the discussion paper does not define any limit to the notion of a performance obligation.
- We do not find a clear definitional distinction between (a) a performance obligation according to the discussion paper and (b) a liability according to the Framework and IAS 37/ED IAS 37 that is defined as a present obligation as a result of a past event resulting in an outflow of economic resources. However, for accounting purposes, a precise differentiation and definition of both, a performance obligation as well as a liability, is crucial as they involve different consequences: The discussion paper states to account for a performance obligation of a contract that is not yet satisfied at the balance sheet date by deferring allocated revenue – without immediate recognition and presentation of that item in the balance sheet but future revenue recognition for it. In contrast, the Framework and IAS 37/ED IAS 37 classify some issues as a present

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- obligation that requires an immediate recognition of a liability in the balance sheet, but without recognizing future revenue. Obligations like e.g. warranties or guarantees seem to meet both definitions.
- A legal warranty is, in our opinion, not an asset to be transferred to the customer which could therefore not represent a performance obligation with the consequence of deferring revenue; it is a basic condition for every entity in the market. In addition, a legal warranty covers defects and, thus, does not represent a benefit for the customer. Therefore the margin is seen to be realized and an entity should account for the remaining risk. Furthermore, a legal warranty could not be sold separately.
- In addition, the discussion paper does not provide clear guidance on how to substantiate "a promise in a contract" and whether a contract – at contract inception – (a) has to be atomized infinitely into a big number of performance obligations or (b) finally includes only one performance obligation. The first conclusion may be based on the example on customer intent (DP 4.25 et seq.) indicating that a contracted functional ensemble is separated into a variety of performance obligations without considering its economic coherence. Instead, unbundling of a contract and recognition of revenue is based on the fact that the underlying assets will be transferred to the customer at different times. The discussion on how to account for a transferred asset if that asset is subsequently used in satisfying another performance obligation (DP 4.49 et seq.) may lead to the second conclusion. This ambiguity, in our opinion, is associated with the fact that the discussion paper, except presenting the definition of a performance obligation and stating the aspect of transferring asset(s) at different times, does not provide further separation criteria (see also remarks on question 5).
- Moreover, substantiated by the boards' example on services in DP 3.13 et seq., the term "transferred asset" in the performance obligation's definition seems to imply that an assessment whether a performance obligation exists or not is to be based on the customer's point of view, which may contradict the explanations on customer intent in DP 4.49 et seq. In order to clarify this issue also the meaning of the discussion paper's notion "whether that asset could be sold separately" needs to be outlined more precisely.
- We also think that the definition of a performance obligation, and thus subsequent accounting, seems to be difficult and complex to apply to services. We asked ourselves how a service component within a contract that includes a certain amount of service hours would be segmented so as to correctly represent the entity's net position in a contract, and, thus, to recognize revenue appropriately, if, above all, there are different types of hourly rates for engineers, technicians, assistants etc. Moreover, which performance obligations would long-term maintenance contracts with preventive elements (e.g. big inspections in certain intervals with – possible but not necessary – change of some parts of a power plant or a production line) as well as corrective elements (e.g. service and change of parts in case of a defect) contain?
- Another question arises as to how contingent obligations are assessed by that definition and then, how they are accounted for in the proposed model. Examples may be a delivery of unspecified future upgrades/updates or future additional products on a when-and-if-available basis during the contract term or the

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construction of an anti-noise barrier within a customer-specific construction contract depending on the noise-level measurement performed during project implementation.

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?

We agree that the timing of the transfer of assets to the customer could, for reasons of simplification, represent a preliminary assessment on whether an entity should separate the performance obligations in a contract.

However, as the future point in time, i.e. the reporting period of transferring the promised asset(s) to the customer in many types of, even not too complex contracts and businesses is vague at contract inception (e.g. delivery of a product and installation work), the need for separation may remain in many cases.

We therefore think that there is a need for separate and robust separation criteria which can clearly define the separation requirements and limit the granularity of separation (see also the answers in question 4). Such separation criteria should decrease the risk of revenue recognition for pre-defined "assets", which (a) do not have a stand-alone value for the customer and (b) may be returned by the customer if, e.g., the vendor is not able to deliver/render outstanding assets (i.e. performance obligations).

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?

We do not think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation. Revenue recognition should rather be deferred until the right of return expires, unless the proportion of transactions that the entity expects not to fail (i.e. customer accepts control of the goods) can be estimated reliably. For these transactions revenue should be recognized in proportion to the transactions the entity does not expect to fail.

To account for the proportion of transactions that the entity expects to fail, a provision should be recognized since the sale of goods with a customer's right of return is a stand ready obligation according to ED IAS 37.22 et seq. Therefore, a provision should be recognized for the unconditional obligation to stand ready to accept returns. The conditional obligation, i.e. the uncertain occurrence of future returns, determines the amount of the provision. Please see also our answer to question 4 for more details regarding this issue.

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Moreover, if the entity's obligation to accept a returned good and refund the customer's consideration was a performance obligation, revenue would also be recognized for a large portion of transactions that the entity expects to fail, as the performance obligation "right of return service" is, as we understand the proposed model, assessed on the basis of a probability evaluation of returned goods. The deferral of revenue for such performance obligations – instead of reducing revenue and recognizing that amount as a liability – may lead to the recognition of revenue for the performance obligation "right of return service" in all cases the customer does not return the purchased goods. Only in the case of an individual return, no/less revenue would be recognized for that performance obligation and a loss provision for the individual contract's onerous performance obligation "right of return service" may have to be recognized.

We furthermore want to underline that sales with a right of return would be one example for the proposed revenue recognition principle not to provide decision-useful information as no sustainable revenue would be recognized if the proposed model was based on the notion of transferring an asset's control to the customer.

Question 7:

Do you think that sales incentives (eg 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?

This issue is complex and, therefore, a differentiated assessment is required which depends on the relevant circumstances of the respective sales incentive. In all cases discussed below, this question may become clearer if robust separation criteria have been formulated (see also the answer to question 5).

In contrast to noncash sales incentives that are treated in detail in the following paragraphs, future cash sales incentives like list price deals with customers depending on their volume of purchases (quantity rebates) could, in our opinion, never give rise to a performance obligation. This is based on the reasoning that in case a future cash sales incentive was a performance obligation, a part of the original transaction price would be deferred and, in consequence, amounts would be recognized in revenue that effectively reduce the consideration received by the customer. Instead, such cash sales incentives should be deducted from the respective revenue amounts.

We think that individual future sales incentives related to goods or services (e.g. free products/services) should give rise to performance obligations if they are provided in a contract with a customer because they represent fix and discrete promises in the current contract. A part of the original transaction price should be allocated to them.

With regard to discounts on future sales of goods and services, in our opinion, only significant and incremental/additional discounts should give rise to a performance obligation being part of the current contract with the customer as this results in a promise to transfer goods or services at a reduced price depending on the customer's future demand and seems to be a significant additional and beneficial option for the customer. Furthermore, at inception of the future contract with the customer,

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recognizing a loss provision can be avoided in the case the cost of providing the goods and services exceed the agreed, but probably highly discounted consideration in the future contract with the customer. This issue may also be seen to be closely interrelated to the question of combining contracts which is not discussed yet in the discussion paper.

By contrast, mainly consumer goods companies have several complex deals subject to negotiation with trade chains that are not individually attributable to a contract with the customer and should, therefore, not give rise to performance obligations in the current contract. Such deals are characterized by taking place annually, quarterly, monthly, or on a case by case basis. Some agreements may be worldwide if the trade chain is a global one and their conditions may vary greatly from one agreement to another. Moreover, certain chains negotiate specific deals against a specific promotional action whereas others just take a commitment to perform certain promotional actions against a deal that is generally granted for a period of one year. At inception of the promotion the number of free products that would be delivered is not yet known, and they cannot be individually attributed to a specific contract. In case there are no individual future sales incentives related to goods or services in the current contract, such non-cash sales incentives should be deducted from the respective revenue amounts.

This also applies to granting customer loyalty points which, in contrast, neither create a fix promise of the entity in the current contract with the customer nor do they represent a significant additional and beneficial option for the customer in the current contract. They should, therefore, not give rise to a performance obligation. However, we acknowledge that revenue in the current contract should be reduced, and in analogy to the discussion in question 6, a provision should be recognized for the stand ready obligation to provide the entity's goods or services – or those of a third party – when certain conditions have been met.

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.

From a conceptual view, the proposed model seems to be inseparably linked to the notion of transferring an asset's control to the customer and therefore consistent and probably without alternative regarding a model that is based on predefined assets to be transferred to the customer. Based on the arguments with regard to the proposed model in general (see question 1), but also based on the points outlined below, we consequently do not agree with such a control-based concept.

Such an assessment, as stated in DP 4.11 et seq., results in the renunciation of the risks and rewards approach and may introduce a legalistic approach. If the notion of control introduced a legalistic view, revenue recognition both in terms of unbundling a contract and timing would change (even for assumedly "easy" contracts) as the applicable local legal framework would have a fundamental influence on revenue recognition. This change, in our opinion, would not only introduce a highly complex and

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extremely expensive way of revenue recognition, but it would also reduce comparability of accounting information as an internationally operating entity would recognize revenue for economically similar transactions differently as some (minor) contract terms may become outstandingly important. Applying the notion of control is not always easy and, in practice, many questions arise regarding the point in time of revenue recognition. We discussed some of them and would like to address them to the boards to reflect on:

- Does the customer, in the case of delivery with retention of title, have control of the purchased good before he pays it (note: the customer generally cannot dispose of the good ad libitum before he pays it)? If yes, when, and why?
- In construction-type business, the securities for the customer may comprise a combination of bank guarantees (e.g. advance payment guarantees) and transfer of title of delivered goods. Would there be a different treatment regarding revenue recognition, if, in one case, the transfer of title only occurs upon acceptance and the customer gets higher bank guarantees instead and, in another case (*ceteris paribus*), the title of the different components is transferred upon delivery and the level of bank guarantees is reduced instead?
- Does a local legal framework have an effect on control and, thus, on revenue recognition in the case it stipulates that e.g. fixtures and fittings on the customer's site are constituents of the land and are, as per the legal framework, owned by the land's owner who, above all, in customer-specific construction contracts is generally the customer? Which implications are to be expected from the assessment of control if, in addition, the entity installed fixtures and fittings on the customer's site that are received from sub-suppliers, but the sub-supplier delivered them with retention of title and the entity has not paid these fixtures and fittings yet?
- What is the effect of the local legal framework on control and, thus, on revenue recognition in the case it stipulates that e.g. the legal title of a car passes to the customer when that car has been registered formally?
- Furthermore, in the case of an item delivered to the construction site, for example, we discussed the question if the transfer of this delivered item's control to the customer depended on whether the construction site is fenced and/or the guard service is organized by the customer or by the entity.
- What is the influence of international trade terms (Incoterms) or local trade custom on control? Does control e.g. differ for the common Incoterms clauses "free on board" (FOB) or "cost, insurance, freight" (CIF)?
- What is the effect of acceptance clauses in customer-specific construction contracts on control and, thus, on revenue recognition, but also on unbundling a contract when, besides the agreement that title of shipped items for a construction is transferred to the customer upon shipment as per Incoterm or customer payment, and there is a contractually agreed overall acceptance clause by which the customer accepts the works and confirms that it has been executed in accordance with the contract's specifications?

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- Which effect do termination clauses and, above all, their contractual specifications in customer-specific construction contracts have on control and, thus, on revenue recognition? Should the details of such termination clauses have impact on revenue recognition, even if, in substance, the intention of a contract with a customer is the contract's fulfillment?

Taking this selection of questions into consideration that arise from a legal interpretation of the concept of "control", we encourage the boards to further specify this notion as many aspects of the proposed model depend significantly on its interpretation and, thus, the model's implications could not be evaluated with certainty yet. In order to provide decision-useful information, we believe that an economic interpretation of "control" is necessary.

Question 9:

The boards propose that an entity should recognize 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.

On the basis of the proposed model and our current knowledge about the model, we think that an entity should recognize revenue only when a performance obligation is satisfied.

However, this question is only the final point of the revenue recognition process traced by the proposed model which, as outlined in chapter 1, we assume not to start from the correct point as well as the appropriate questions in order to provide decision-useful information. Furthermore, revenue recognition on the basis of satisfying performance obligations is, in the proposed model, a matter of the definition, identification and separation of such performance obligations (= predefined assets to transfer) as well as aspects of allocation at contract inception, but also subsequent measurement – issues we addressed in our answers to the other questions of this discussion paper. Above all, the answers to questions 1, 4, 5, 8 and 10 are also considered answers to this question.

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:

Introductory remark: As outlined in our answers to question 1, any accounting approach for customer-specific construction contracts needs to provide a robust and manageable remeasurement system as there are often changes as construction progresses.

Question 10(a):

Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

BUSINESSEUROPE

We agree that performance obligations should be measured initially at the transaction price based on the arguments outlined in DP 5.28 et seq. as well as DP 5.18 et seq.

However, we note a conceptual interdependence of contractual rights as well as the measurement of the performance obligations of the contract: The original transaction price that is allocated to the identified performance obligations (i.e. the predefined assets of the contract to be transferred to the customer) subsequently triggers the amount of revenue to be recognized when the respective performance obligation is satisfied. As we understand the current tentative decisions revenue should also be recognized for uncertain amounts. The question of subsequent changes in contractual rights is not decided yet, but we want to point out that DP 2.36/5.12 do not provide clear guidance whether and how to account for such issues as revenue or gains/losses. With regard to that question, please consider the answers to question 10c and our answers to the boards' tentative decisions in the March meeting which can be found in the last paragraphs of this comment letter.

Question 10(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?

As this question contains two aspects we want to answer to them separately.

Regarding the level of the onerous test (DP 5.58 et seq.) the discussion paper postulates that it has to be carried out on the level of the performance obligations identified initially. This might result in recognizing loss provisions for parts of a contract (i.e. on the level of the single performance obligation) even if the whole contract is not onerous – in our opinion, a counterintuitive, but also misleading result. This outcome is not consistent with the Framework as a liability would be recognized even if an outflow of resources embodying economic benefits is not expected. This does not lead to a true and fair presentation of the financial position, performance and changes in the financial position of an entity as such losses are fictitious, and it is also not consistent with IAS 37/ED IAS 37 which require an onerous contract provision to be determined from a total contract's perspective (exception: segmented single "contracts" within an IAS 11-arrangement that are presumed to be independent "contracts").

The other aspect we would like to answer refers to the nature of the onerous test. We agree with the boards' preference of a cost trigger-based test to be the appropriate onerous test as it results in an approach which is compliant with IAS 37.68/ED IAS 37.58 that define an onerous contract as a contract in which the unavoidable costs of meeting its obligations exceed the contractually expected economic benefits. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it. This definition only permits a cost-based approach in order to identify an onerous contract and to measure the loss provision. Therefore, a current price trigger seems not to be in accordance with IAS 37/ED IAS 37.

BUSINESSEUROPE

Moreover, the implementation of a test based on a current price trigger and, thus, additional accounting rules for non-financial onerous contracts beyond IAS 37/ED IAS 37, would be a significant set-back into a rule-based approach as such a treatment would be inconsistent with IAS 37/ED IAS 37 that already set principles regarding accounting for onerous contracts.

Question 10(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 obligations makes that approach unsuitable? Please provide examples.

We identified three main categories of performance obligations for which we think the proposed measurement approach, above all regarding the issue of remeasurement and in consequence revenue recognition would not provide decision-useful information at each financial statement date. These comprise

- "performance obligations" in customer-specific construction contracts (see also answers to question 1 and 10a),
- performance obligations that, in substance, encompass accounting for risks assessed collectively, but that are accounted for separately under the proposed model (see also answers to question 1 and 6), as well as
- "performance obligations" in contracts based on activities to be effected or not to be effected depending on future facts and circumstances which is often the case in contracts, amongst others, including services, e.g. long-term maintenance contracts or postcontract customer support (PCS) with upgrades to be delivered on a when-and-if-available basis (see also question 4).

Particularly regarding customer-specific construction contracts, often neither all performance obligations finally to be fulfilled nor the overall transaction price that ultimately will flow to the entity can be determined definitely at contract inception, e.g. due to contractually agreed performance-based or (inflation) index-linked price alternations, further contingent payments, contractual changes becoming necessary or contingent obligations possibly to be fulfilled when the project progresses, etc. Initially identifying performance obligations and measuring them at the proportion of the contract's transaction price impairs the flexibility that is necessary to recognize revenue appropriately for such contracts as either the identified performance obligations during project implementation and/or the overall transaction price change.

Furthermore, customer-specific construction contracts may contain a significant number of performance obligations, many of which are related to components to be procured from sub-suppliers which may become onerous only due to the fact that escalating prices are agreed with the sub-supplier. Please also note, in this context, the details discussed in question 10b.

The second category refers to (revenue-attracting) performance obligations that, in substance, represent risks (e.g. legal warranty, right of return, etc.). They are assessed collectively, but accounted for separately – as part of the net contract position. As we

BUSINESSEUROPE

understand the proposals, revenue, e.g. for the performance obligation "legal warranty service", would generally be recognized in all contracts which include a non-defective good. In contrast a loss provision for the onerous performance obligation "legal warranty service" would be recognized in the contracts including a defective good – on the basis of the full amount of the returned defective good. This accounting treatment would, in our opinion, not lead to decision-useful information as revenue is also recognized for defective goods.

An example for the third category is a long-term maintenance contract with preventive elements (e.g. big inspections in certain intervals with – possible but not necessary – change of some parts of a power plant or a production line) as well as corrective elements (e.g. service and change of parts in case of damage). Having to change parts extraordinarily may impair an identified performance obligation with the need to recognize a loss provision even if that part may be included in another initially identified performance obligation to be satisfied later.

Question 10(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.

As outlined in question 1 as well as question 10c, and supported by the boards' March decisions, the proposed model either impairs the flexibility necessary in accounting for contracts that change in scope and value or if performance depends on future necessities, or it would set up a complex and costly model to account for such contracts. Therefore, in the context of the proposed model we do not see a reasonable and robust measurement concept for such performance obligations in such contracts.

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.

Question 11(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?

We do not 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. Such costs should not additionally increase the original transaction price negotiated with the customer which would be allocated to the contract's performance obligations. They should rather be expensed as incurred unless they give rise to an asset in accordance with an IFRS.

BUSINESSEUROPE

However, provided that those costs are part of the finally agreed (original) transaction price with the customer and therefore represent contractual rights that effectively flow to the entity, this answer should not force an entity to single such costs out of the original transaction price in order to initially measure the entity's performance obligations in a contract.

Question 11(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.

There are, in our opinion, probably only few cases in which recognising contract origination costs as expenses as they are incurred do not provide decision-useful information about an entity's financial position and financial performance. Examples may be contracts, e.g. when offering complex solutions to customers (especially turnkey contracts), in which it is necessary to considerably invest into pre-design in order to make a solid price calculation and to give performance guarantees usually required by customers.

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?

We agree that the transaction price should be allocated to the performance obligations on the basis of the entity's observable or – if not available – estimated stand-alone selling prices of the goods or services underlying those performance obligations.

However, as reasoned e.g. in our answers to question 1 or 10c, it should be underlined that we do not see a reasonable basis for applying the proposed model, including these allocation considerations, to customer-specific construction contracts.

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?

We agree that if an entity does not sell a good or service separately the allocation should be based on estimated stand-alone selling prices. This will, in our opinion, improve financial reporting regarding "traditional" arrangements with multiple elements (to be seen in contrast to customer-specific construction contracts) as a faithful representation of an entity's performance within a contractual arrangement with the customer seems to be achievable, i.e. the activities carried out to fulfill a contract. A separation of, and thus, revenue recognition for delivered or provided elements may

BUSINESSEUROPE

generally be possible, and, above all, an expected cost plus a margin approach is considered to faithfully reflect the entity's business model with different margins for the different elements within a contractual arrangement with the customer.

However, in order to prevent an arbitrary allocation of revenues, subjectivity of estimations should be limited by requiring a reasonable and consistent assessment of estimations of stand-alone selling prices that reflect the entity's business model and, if necessary, the respective circumstances of the industry.

Response to the boards' tentative decisions in the March meeting:

After having assessed the boards' tentative decisions in the March meeting regarding the reflection of the time value of money and accounting for uncertain amounts of the customer consideration, BUSINESSEUROPE's concern about the proposed model to introduce a highly complex and costly model of revenue recognition is reaffirmed.

As we doubt that the proposed model will provide decision-useful information about an entity's performance for all types of contracts and businesses (please refer to our remarks in the first chapter as well as to question 1 and 10c), we consequently expect that the current proposals regarding the reflection of the time value of money will draw a disrupted picture for such timing effects. This is based on the fact that the reflection of the time value of money is based on an entity's net contract position that, in turn, is largely a measure of customer payment(s) and "performance" defined by the boards' proposed model. We further want to point out that this question may become a predominant one as an entity's net contract position permanently changes and may be nil only at contract inception.

We acknowledge that amounts received by the customer beyond the original (certain) customer consideration, i.e. uncertain elements like contingent consideration, variable pricing, performance bonuses/penalties, and milestone payments, should become revenue as such amounts represent rights in a contract with a customer and they are directly associated with an entity's ordinary activities. But we assume that such an approach would, for many contracts, introduce a general remeasurement requirement based on a periodic assessment of the probability-weighted estimate of the uncertain customer consideration. Such an approach also adds subjectivity, above all, if revenue recognition is not limited to the certain amount. Complexity introduced may additionally increase in contracts where performance obligations vary over time (see also our answers to question 10c).