EFRAG
European Financial Reporting Advisory Group

22 October 2010

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

Dear Sir/Madam,

Re: Revenue from Contracts with Customers

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, *Revenue from Contracts with Customers* ('the ED'). This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRSs in the European Union and European Economic Area.

Under current IFRSs, there are two main standards on revenue recognition – IAS 11 *Construction Contracts* and IAS 18 *Revenue*. EFRAG acknowledges that the standards are based on inconsistent principles, and experience shows that some practical application questions remain unanswered.

The IASB and FASB have jointly decided to develop a fully converged revenue standard, based on a single set of principles for recognition and measurement that would be exclusively applied to revenue-generating activities in contracts with customers.

EFRAG welcomes the work being carried out on this subject. In our opinion, revenue recognition is the cause of some practical problems and a fully converged and simplified standard will be beneficial to financial reporting. Furthermore, EFRAG recognises that revenue recognition involves significant conceptual issues, including performance reporting, and therefore believes that a fundamental overhaul of the existing standards is appropriate.

In EFRAG's view, the driving factor for preparing standards on financial reporting should be information usefulness. EFRAG is concerned that the ED has been issued without thorough conceptual debate on why revenue is an important figure, what it should represent and why it provides useful information.

The ED proposes that revenue should be recognised only when control of goods and services is transferred to the customer. EFRAG does not support that model and considers that the IASB has not explained why the proposals would result in useful information. Without awaiting the finalisation of the conceptual framework, but prior to completing this project, we encourage the IASB to examine how the revenue figure could be most useful.

EFRAG believes that financial statements would be most decision-useful if revenue is considered a measure of the establishment of an irrevocable right to consideration, subject to continued performance, that arises as the entity fulfils a contract with the customer. In Appendix 3 to this letter, EFRAG presents an alternative model for revenue recognition based on this approach. In EFRAG's view, the model presented in Appendix 3 would trigger fewer changes to existing revenue recognition patterns than the IASB's proposals.

In the Basis for Conclusions to the ED, the IASB infers that the proposed model will bring discipline to the earnings process approach. While EFRAG may agree that the proposals have such potential, this improvement does not justify in itself the fundamental change made to the revenue recognition model. A change in the revenue recognition model may prove costly for both preparers and users of financial statements. EFRAG believes that these costs should be justified. We note that a proper assessment, including field-testing, should be carried out to conclude whether the benefits of a new standard on revenue recognition would outweigh its costs.

Putting aside EFRAG's fundamental concern regarding the model for revenue recognition and focusing on the model proposed, we have set out our detailed comments on the ED in Appendix 1 and 2 to this letter. Our main comments can be summarised as follows:

- EFRAG supports overall the proposed guidance on combining and segmenting contracts and contract modifications. However, we think the guidance should be clarified.

- Generally, EFRAG supports the proposed guidance for separating performance obligations. However, in considering whether a promised good or service is distinct, EFRAG believes that only an entity's own customary business practices should be considered, rather than the business practices of other entities.

- EFRAG considers that the definition of control should be developed at the conceptual framework level to ensure consistency across the standards. Accordingly, revenue recognition should be based on how the term 'control' is used in other standards or the term 'control' should not be used when addressing revenue recognition.

- EFRAG has concerns in relation to how the 'control' notion should be applied in the context of revenue recognition for long-term and service contracts. Additionally, EFRAG is concerned about the usefulness of the indicators included in the ED for determining whether control of a promised good or service has been transferred to a customer.

- EFRAG does not think that a customer's credit risk should be reflected in revenue.

- EFRAG believes that the transaction price should be allocated to separate performance obligations, based on the margin of the separate performance obligations, rather than the stand-alone selling prices. In addition, subsequent changes in the estimated transaction price should be allocated to different performance obligations based on facts and circumstances, rather than automatically in proportion to the stand-alone selling prices or margins.

- EFRAG does not consider that an entity should recognise a liability if a performance obligation included in an overall profitable contract is onerous.

We acknowledge that our recommendations may not be compatible with the June 2011 deadline that the IASB has set for itself in this project. However, we believe that supplementary time required to make the final standard robust and worthwhile is a matter of months and not years.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

APPENDIX 1

EFRAG's responses to the questions asked in the exposure draft

General comments

1 EFRAG holds a fundamentally different view as to what revenue is, and when it should be recognised, compared to the model proposed in the ED. However, rather than repeating this point throughout our responses to individual questions, EFRAG has chosen to answer the questions asked in the ED on the basis that the 'control model' for revenue recognition – that revenue is recognised only when the customer obtains control over the good or service transferred by the entity – would be applied. The approach that EFRAG favours, and the main differences and similarities between this approach and the model proposed in the ED are discussed in Appendix 3.

2 Appendix 2 includes EFRAG's comments on some issues of the ED not directly addressed by the questions of the ED.

3 As a general comment, we urge the IASB to consider the costs and benefits of the proposals in more detail. During our outreach we noted that the costs of application seem to be lower when one of the following conditions is present: (1) there are relatively few high value contracts, (2) all performance obligations are delivered within a relatively short time frame (3) a limited number of types of sales contracts exists, and/or (4) contract modifications are infrequent. However, in industries where these mitigating conditions are not present, the cost of application of the proposals remains a concern to be addressed. We also note that the costs and benefits of the proposed disclosure requirements vary greatly between industries. We believe the disclosure requirements should be targeted to ensure that benefits outweigh costs.

Recognition

Question 1 — Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether:

(a) **to combine two or more contracts and account for them as a single contract;**

(b) **to segment a single contract and account for it as two or more contracts; and**

(c) **to account for a contract modification as a separate contract or as part of the original contract.**

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

EFRAG supports overall the proposed guidance on combining and segmenting contracts and contract modifications. However, we think that the guidance on price interdependence should be clarified.

4 EFRAG is supportive overall of the proposed guidance for combining and segmenting contracts and contract modifications. However, we are unsure how to

interpret 'price interdependence', as the term is applied in the ED and explained in the application guidance.

5 We understand that contracts are priced interdependently when a customer receives a discount in one contract, in exchange for paying a premium in another contract. From the ED, it also appears that the price of one contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in a contract because of an existing customer relationship arising from previous contracts. Between these two situations, however, we think that a 'grey' area may exist.

6 We consider that 'price interdependence' in this 'grey' area may be addressed in the application guidance of the ED. Example 2 in the application guidance illustrates how to account for an extension of a service contract. It illustrates that if a customer (in relation to the extension of an existing contract) receives a discount reflecting that the current stand-alone selling price of the remaining part of the original contract has decreased, the extension should be considered a separate contract. However, if the discount is more substantial, the extension should be accounted for as a contract modification. Unfortunately, we do not understand how the IASB has reached this conclusion, and the example is therefore unhelpful. We also note that the conclusion in this example does not seem to be consistent with the guidance included in paragraph 14 of the ED, which proposes that the price of one contract is not interdependent with the price of another contract solely because the customer receives a discount, due to an existing customer relationship. If the reasoning behind the conclusion is also unclear to other parties, it could result in divergent accounting practices, reducing the general comparability and usefulness of financial statements. Therefore, we consider that the principle of 'price interdependence' requires further clarification.

Question 2 — The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

EFRAG generally supports the proposed guidance for separating performance obligations, but believes that in considering whether goods or services are distinct, the entity's own customary business practice should be considered, rather than the business practice of any other entity.

7 In response to the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (the 'DP'), EFRAG noted that it could be very costly for some entities to account separately for every performance obligation. The ED has removed this concern to some extent by requiring that an entity should only account for a performance obligation separately if the promised good or service is distinct from other goods or services promised in the contract.

8 Paragraph 20 of the ED states that an entity should evaluate the terms of the contract and its customary business practice to identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation. We approve of requiring an entity to consider its *own* business practice in determining how to unbundle performance obligations. However, the wording of paragraph 23 (a) of the ED suggests that an entity should

also consider what *other* entities do. We disagree with this and believe that unbundling should be based on an entity's own business practice alone.

9 If a painting contractor does not sell paint separately then we do not believe that paint should be identified as a separate performance obligation by that contractor. However, the guidance in paragraph 23 (a) suggests that if *some* entities sell paint separately, then *every* entity should treat delivery of paint as a separate performance obligation (assuming, of course, that it is not transferred to the customer at the same time, or the contract involves an overall contract management). We do not think that an entity (or an operating segment in an entity), which performs painting services and does not sell paint separately, should consider delivery of the paint as a separate performance obligation. In considering whether goods or services are distinct, EFRAG considers that the reporting entity's *own* customary business practice should be considered, rather than the business practice of any other entity. EFRAG's second preference would be to refer to the customary business practice of entities that apply the same business model as the reporting entity (i.e. the reporting entity's peer group).

10 As mentioned below in our response to question 9, EFRAG does not believe an entity should determine whether its obligations are onerous at the level of individual performance obligations, as required in the ED. In our view, the definition of a contract boundary based on price interdependence would be contrary to considering any performance obligation being onerous in isolation of an overall profitable contract. However, in case the IASB proceeds with this proposal, EFRAG has discussed how the recognition of a provision for onerous performance obligations would interact with the option not to account separately for distinct performance obligations that are satisfied at the same time (see paragraph 24 of the ED). In our opinion, it is not clear from the ED if an entity would be permitted or required to test whether or not its obligations are onerous at a bundle level, considering all distinct performance obligations within a contract that are satisfied at the same time as the bundle, or at a level where distinct performance obligations are considered separately. If an entity were to carry out the test on a bundle, then it might avoid recognition of losses by satisfying performance obligations at the same time. EFRAG does not think that there are good reasons for accounting differently for performance obligations that are satisfied at the same time when it comes to testing onerous performance obligations. Accordingly, if the onerous test is to be performed at the performance obligation level (and we disagree with this), it should be performed for each of the distinct performance obligations.

Question 3 — Do you think that the proposed guidance in paragraphs 25–30 and related application guidance is sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

EFRAG does not support the proposed control model for revenue recognition, as it believes that an approach focusing on the establishment of an irrevocable right to consideration, subject to future performance (as explained in paragraphs 5-9 in Appendix 3), would result in more decision-useful information.

EFRAG has concerns about the application of the proposed guidance to services and long-term contracts.

If the IASB proceeds with a proposed control model, EFRAG believes that the transfer of control should be considered from the seller's rather than from the customer's perspective.

EFRAG is concerned about the indicators included in paragraph 30 of the ED for determining whether control of a promised good or service has been transferred to a customer.

Furthermore, from a standard-setting perspective, EFRAG believes that the IASB should either (a) apply the notion of 'control' in relation to revenue recognition consistently with how the term should be applied in relation to other standards; or (b) base revenue recognition on something other than transfer of 'control'.

11 EFRAG does not agree with the revenue recognition model based on the transfer of control over goods or services. EFRAG supports a model where revenue is a measure of the establishment of an irrevocable right to consideration that takes place as the entity fulfils the contract with the customer. The model proposed by EFRAG is further explained in Appendix 3.

12 Having said that, our comments below address the proposed control model should, the IASB decide to proceed with it. EFRAG does not believe that the ED proposes appropriate guidance in paragraphs 25–31 and in the related application guidance for determining when control of a promised good or service has been transferred to a customer. Our two main concerns relate to the application of the proposed control model to services and long-term contracts and the indicators included in paragraph 30 of the ED.

General concerns

13 Firstly, we note that revenue is recognised under the ED upon transfer of control. We note that the notion of 'control' is included in different standards and has a different meaning, depending on whether it relates to control of an asset or control of an entity. From a standard-setting perspective, we suggest that the IASB should either:

(a) apply the notion of 'control' in relation to revenue recognition, but ensure that the term 'control' is consistently defined and applied across all standards. We appreciate that the IASB attempts to define control in relation to revenue recognition and control of a good or a service at an individual standard level in the ED. However, we urge the IASB to consider this cross-cutting issue at a higher level to achieve greater consistency. We think that by addressing control on a piecemeal basis, consistency could easily be lost. As indicated in our comment letter on the ED *Conceptual Framework for Financial Reporting: The Reporting Entity*, we believe that, as a first step, the general definition of control should be developed in the *Conceptual Framework,* as 'control' is a pervasive notion used in many standards. The application and the implementation of the control notion should then be set out at a standard level to deal with specific issues. We acknowledge that a consistent application of 'control' following this approach could result in a different pattern of revenue recognition than what is currently suggested in the ED.

(b) base revenue recognition on a criterion other than transfer of 'control', which would be our preferred approach.

14 Secondly, we wonder whether the control model applied in the ED reflects what the IASB thinks revenue should be. As already mentioned, we do not think the IASB has clearly explained what revenue is – and why this is an important figure. However, from our discussions with IASB members and IASB staff, we think the IASB considers revenue as something that arises in an exchange with a customer. That is, revenue arises when the entity delivers something to a customer in

exchange for a right to consideration. If this is the case, we are not sure whether transfer of control as described in the ED fully reflects this approach. For example, we note that in relation to some construction contracts, control is transferred continuously according to the ED. However, an entity clearly does not have a right to receive any kind of consideration before the entire project is completed. We therefore do not think that an exchange has taken place when revenue is recognised in these circumstances.

15 This being said, we do not think the IASB should attempt to limit the use of the percentage-of-completion method, as we think it provides useful information under the circumstances described in Appendix 3. Rather, the IASB should consider whether the exchange approach is the right starting point when considering revenue recognition.

Control in relation to services

16 EFRAG is concerned that it is frequently difficult to determine when control in relation to services is transferred to a customer. Therefore, the resulting information may not be decision-useful. For example, if a customer orders a container to be shipped from Rotterdam to New York within 60 days, should the shipping company recognise half of the profit when the ship is in the middle of the Atlantic Ocean?

17 According to the ED, a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. The ED explains that control includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service. Additionally, it explains that the ability to direct the use of an asset refers to the customer's present right to use the asset for substantially all of its remaining economic life or to the asset in the customer's business activities. For example, if an entity is cleaning a customer's offices, the control of the cleaning service may be transferred to the customer as the cleaning takes place, not least because other customers would not be able to benefit from the cleaning service. However, in the above shipping example, it not clear to us how one would decide whether control of the shipping service had been transferred to a customer, particularly because the customer may have no control over how the service is being performed (how the container is transported to New York). Indeed, the customer may not receive any benefit from a half-way transported container (certainly not if the container is first shipped to places further away from New York in order to be pooled with other containers).

18 We do not think our shipping example above is particularly complex. We therefore think that if the revenue recognition principles suggested in the ED are difficult to apply in this example, they will be difficult to apply in many situations.

Control from the customer's perspective

19 In addition to the fact that, the control model seems to be difficult to apply to service contracts overall, we think it adds to the complexity that control should be assessed from the customer's, rather than from the seller's, perspective. We believe that it would be more complicated for an entity to evaluate the customer's situation, rather than its own.

20 EFRAG also considers that the requirement to focus on the customer may be difficult to follow when the party receiving the good or service from the entity is

different to the party entering into the contract with the entity and being liable for payment.

21 We appreciate that the IASB has chosen to consider control from the customer's perspective, as the IASB focuses on the assets that the customer receives. We understand that the IASB's concern is that if control was assessed from the entity's perspective, some activities, such as assembling a workforce, could result in recognition of revenue, although the customer would not receive anything from this activity. However, we do not share this concern as we think that the focus should be on the performance of the entity that, subject to continued performance, results in a right to consideration. We refer to our alternative model described in Appendix 3, under which the assembling of a workforce should result in revenue recognition if certain conditions are met including the close association with the relevant contract.

Indicators that the customer has obtained control

22 Paragraph 30 of the ED includes four indicators that control of a good or service has been transferred to the customer. We have two concerns in relation to these indicators:

(a) it is unclear whether the indicators should be applied in interpreting and assessing when control has been transferred; and

(b) in particular, the fourth indicator (paragraph 30(d) of the ED) does not adequately reflect what the ED considers to be 'control.'

23 EFRAG is concerned that the purpose of the indicators is not clearly articulated in the ED. It is our understanding that the indicators are only included in the standard in order to provide examples of circumstances under which control often would be considered to have been transferred to the customer.

24 EFRAG thinks that the unauthorised use or possession of an asset does not constitute control under the ED. If a customer, for example, could use or even sell an asset, but is prohibited from doing so by the terms of the contract or by law, the customer does not control the asset according to EFRAG's interpretation of the ED. This assumption seems to be supported by the fact that, under the ED, a customer does not control an asset if the seller has an option to require the asset to be returned. Accordingly, it is our understanding that a customer's ability to direct the use of, and receive the benefit from, the good or services transferred should be (legally) enforceable. Whether a customer has an enforceable right to direct the use of an asset seems to us to be a matter of contractual rights and relevant legislation.

25 It is therefore our understanding that an entity would always have to assess whether the contract and the relevant legislation provide the customer with control (that is, the ability to direct the use of, and receive the benefit from the good or service). We believe that there may be cases, in which control may not have been transferred even when all (or none) of the indicators stated in paragraph 30 are met. For example, control has not been transferred, even though all of the indicators have been met, when the seller has an unconditional repurchase option.

26 Accordingly, it is our understanding that the indicators are nothing more than the impairment indicators in IAS 36, which do not offer conclusive evidence about the existence or absence of an impairment loss.

27 However, when reading the ED and the Basis for Conclusions, the role of the indicators could be understood differently. Paragraph 31 of the ED, for example, states that not one of the preceding indicators determines by itself whether the customer has obtained control. This paragraph could be read in line with our interpretation of the role of the indicators. However, it could also be read as requiring that if two or more indicators have been met, then control is considered to have been transferred.

28 EFRAG also considers paragraph BC 66 of the Basis for Conclusions to be unclear. It states "[t]he Boards think that applying the proposed definition of control and the proposed indicators of control to a construction contract would be consistent with the requirements currently contained in IFRIC 15 [...]". This statement could be interpreted to mean that the indicators listed in paragraph 30 should be considered when interpreting the control notion of the standard.

29 In order to avoid the indicators being used as a kind of checklist for when control exists, we think the role of the indicators needs to be clarified. This seems particularly important when the indicators do not always reflect what control is considered to be, according to the ED, as the use of the indicators could result in revenue being recognised at different points in time, compared with the results that would be obtained from following paragraphs 25 to 29 of the ED.

30 EFRAG has also considered whether the list of indicators is helpful and would result in decision-useful information by improving consistency.

31 In particularly, the indicator in paragraph 30(d) of the ED does not seem to reflect the model proposed in the ED for revenue recognition. Paragraph 30(d) of the ED states that, because an entity cannot sell a customer-specific asset to another customer, it is likely that the entity would *require* the customer to take control of the asset as it is created. While this might be the case, we think that in many instances it would be more important for the entity to secure the payment from the customer for the work performed, rather than to ensure that the customer takes control of the asset. We acknowledge that in some cases the customer will pay only if it receives the asset. However, we would like to emphasise that in these cases the entity would not necessarily *require* the customer to take control of the asset as it is created, but would have an *option to require* the customer to take control of the asset being created. It is our understanding that such an option of the seller to require the customer to take control of an asset (a put option) does not result in the customer controlling the asset. EFRAG therefore considers the indicator unhelpful. We believe that it is more relevant to consider whether a customer should take delivery if the contract is terminated by either party. If that were to be the case, we would consider the customer to have obtained control.

Cash-cap on revenue

32 Paragraph BC95 of the ED states that 'uncertainty in the amount of consideration should be reflected in the measurement of the contract asset rather than through recognition.' We note that some of our constituents believe revenue should be limited to cash received from customers. As a result, we recommend that the IASB clarify in the Basis for Conclusions how it reached its conclusion, especially in terms of benefits to users.

Suggested amendments to the model proposed by the IASB

33 While EFRAG thinks that revenue should be recognised in accordance with the suggested, alternative model presented in Appendix 3, it also thinks that some

modifications could be made to the model proposed by the IASB, to ensure that reported revenue will be useful for all industries. In case the IASB would not base revenue recognition on our preferred model as presented in Appendix 3, we would suggest the following:

(a) It should be considered when an asset is appropriated to a contract, instead of when a customer obtains control. EFRAG believes that, in some cases, an entity loses some ability to benefit from an asset when the asset is appropriated to a contract. For example, we think Entity A in paragraph 23 of Appendix 3, loses its ability to use the bricks that are included in the construction of a specific building, as these bricks are used for the construction. By considering the appropriation to a contract instead of the transfer of control to the customer, we think that percentage-of-completion accounting would be applied in more circumstances (for example, the circumstances described for Entity A in paragraph 23 of Appendix 3).

(b) 'Control' should be considered from the entity's (the seller's) perspective (see paragraphs 19-21 of Appendix 1).

(c) The indicators of when an element of control has been transferred from the supplier should be improved and turned into criteria. We think that the indicator, "the customer has an unconditional obligation to pay", is too restrictive. In many construction and service contracts, the customer would only have an unconditional obligation to pay when the service or construction has been finalised.

(d) The transfer of control could be defined as taking place when the entity has an irrevocable right to consideration, subject to continued performance; there is reasonable assurance that the entity will perform; and the good(s) or service(s) are designated to a particular customer. This would result in an outcome similar to that of the alternative model.

Measurement

Question 4 — The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

EFRAG generally agrees with the proposal, as it limits the use of estimates in the measurement of revenue. However, as we have noted in the context of other projects, we do not believe that the use of expected values is appropriate in the case of individual items or small populations.

34 EFRAG agrees that when the transaction price (or part of the transaction price) is variable, revenue should only be recognised if the transaction price can be measured reliably (or for the part for which it can be measured reliably). However, EFRAG disagrees that the use of the expected value method would be appropriate in all circumstances.

35 In response to other discussion papers and exposure drafts from the IASB, we have often been opposed to the use of probability-weighted amounts, especially in respect of single items. In EFRAG's view, the use of the expected value method is only appropriate when applied to a large population of items (please refer more particularly to our comment letter on IAS 37 amendments).

36 We welcome paragraph 38 criteria and agree that these criteria should be met if an expected value approach is to be applicable to variable revenue measurement. However, we believe that variable revenue should be recognised only if and when, in addition to conditions set in paragraph 38, variable revenue is measured for a large population of contracts.

Question 5 — Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognises when it satisfies a performance obligation rather than whether the entity recognises revenue? If not, why?

EFRAG does not agree that the customer's credit risk should be reflected in revenue. EFRAG believes that credit losses should not affect the revenue line.

37 EFRAG does not agree that a customer's credit risk should be reflected in revenue for two reasons:

(a) Firstly, we understand that users of financial statements usually find it useful if the revenue amount represents quantity of goods or services sold, multiplied by prices of these goods or services, and they usually consider a credit loss on a receivable separately. We understand that the main reason for this is that amounts related to credit losses have a different predictive value as they represent an estimate and require more judgement than the quantity of goods multiplied by their prices. In addition, we understand that under the proposed model, there may be cases when revenue recognition criteria for some goods or services are met before the definition and the recognition criteria are met for a receivable. In these cases, an entity would recognise revenue and a contract asset. If changes in the estimated credit risk occur prior to recognition of a receivable, then the contract asset would be adjusted in correspondence with the revenue line. We believe that this could create unnecessary volatility of the revenue amount (not at least because improvements in customer's credit ratings could also affect revenue), that would reduce the ability of the users to forecast future cash flows.

(b) Secondly, we believe that credit risk should be presented consistently across different standards. Therefore, we do not find arguments for a different treatment of credit risk in the revenue recognition standard compelling. Particularly this is because the IASB proposes in the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* that credit risk be presented separately from interest income.

38 In relation to credit risk, some may argue that the requirements included in paragraph 43 of the ED are not sufficiently clear about the option to estimate a credit risk on a portfolio basis, although the application guidance seems to allow such an approach. We suggest that this point be clarified in paragraph 43.

Question 6 — Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the

contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

EFRAG agrees with the proposal although we think it should be clarified how an entity should account for the time value of money when payments are received in advance.

39 EFRAG agrees with the proposal. In cases where a customer pays in advance, we notice that the liability recognised by the entity (the performance obligation) is generally not a monetary item; therefore, one can argue that the 'time value of money' notion should not be applied to advances received, since no cash flows occur in the future.

40 Nevertheless, EFRAG considers that if a customer pays in advance of the goods being delivered or services being provided, then the transaction contains a financing arrangement, i.e., customer financing of the supplier. Therefore, revenue should be measured at the fair value of the consideration at the date the revenue is recognised and not when the payment is received. The underlying assumption is that receiving consideration before the service is rendered is like entering into a finance arrangement and a service arrangement simultaneously, i.e. receiving a loan, paying interest, repaying the loan and then providing the services and receiving the customer's consideration. The customer would not pay the consideration in advance without getting a discount to compensate for the lost interest, i.e., the customer would be required to pay a higher amount if the payment was made at a later date. For example, an entity sells goods to a customer in one year, and the customer can choose either to:

(a) pay 90 cu now and receive the goods after one year;

(b) pay 94 cu when the goods are received in one year's time; or

(c) pay 100 cu one year after the goods are received.

41 We think that the revenue amount should be the same in all three scenarios (provided the differences reflect the time value of money) and that the financing component should be recognised separately from revenue.

42 Furthermore, we believe the IASB should clarify the manner in which an entity should take account of the time value of money when payments are received in advance, and payments in advance should be defined as in IAS 11.

Question 7 — Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate and how should the transaction price be allocated in such cases?

In EFRAG's view, the transaction price should be allocated to separate performance obligations in a contract, in proportion to the actual margins of these performance obligations. After the initial allocation changes in the estimated transaction price should be allocated to different performance obligations based on the relevant facts and circumstances.

43 As mentioned below in the response to question 9, EFRAG is concerned that the proposed model could lead to the recognition of a liability for onerous performance obligations that are part of an overall profitable contract. EFRAG does not support a model with this result. Although our solution would be to test whether a contract is onerous at contract level, the issue has led us to consider that it would be more appropriate to allocate the transaction price to the separate performance obligations, based on the margin of each performance obligation.

44 For example, consider that an entity enters into a contract containing the following performance obligations:

	Total	*Performance obligation 1*	*Performance obligation 2*	*Performance obligation 3*
Stand-alone selling price	300	100	100	100
Costs	210	92	48	70
Margin	90	8	52	30

If the entity agrees a contract price of 276 cu with the customer, an allocation based on the stand-alone selling prices would lead to the following allocation:

	Total	*Performance obligation 1*	*Performance obligation 2*	*Performance obligation 3*
Allocated transaction price	276	92	92	92
Costs	210	92	48	70
Margin	66	0	44	22

This means that performance obligation 1 will have no margin. However, if the discount of 24 cu were to be allocated, based on the relative profit margin of the individual performance obligations, the allocated transaction price and margins would be as follows:

	Total	*Performance obligation 1*	*Performance obligation 2*	*Performance obligation 3*
Allocated transaction price	276	98	86	92
Costs	210	92	48	70
Margin	66	6	38	22

In our view, the approach proposed in the ED would over-allocate trade discounts to the low-margin items sold as part of a bundle. In addition, it could easily result in individual performance obligations being onerous on day 1 of a contract, this despite the overall contract being profitable. For these reasons, we believe that an allocation based on the relative profit margin would be more relevant and useful.

45 We also disagree that changes in the estimated transaction price should be allocated in all cases to different performance obligations based on the initial stand-alone selling prices (or margins) without considering the relevant facts and circumstances. Consider the following example:

An entity enters into a contract to sell two fire engines: one vehicle containing the water tank (V1) and the other being a ladder truck (V2). V1 is to be delivered in year 1 and V2 in year 2. The two vehicles are regularly sold separately at the stand-alone selling prices of 100 cu for V1 and 150 cu for V2. For budgeting reasons, the contract states that the price of V1 is 125 cu and the price of V2 is 125 cu. V1 is delivered in year 1. However, in year 2 it is clear that V2 can only be delivered in year 3. Parties agree that, because of the delay, the overall contract price will be reduced by 20 cu.

46 In this example, the contract is not separated into two separate contracts as the goods are priced interdependently (V1 is 'overpriced' and V2 is 'underpriced'), but

under the proposals in the ED the delivery of the two fire engines should be accounted for as two separate performance obligations and the transaction price of 250 cu is allocated to each performance obligation based on their stand-alone selling prices: V1 – 100 cu and V2 – 150 cu.

47 Under the proposals in the ED, when the entity delivers V1 in year 1, revenue of 100 cu is recognised. In year 2, when the price reduction of 20 cu is agreed, the entity should allocate the price reduction to both performance obligations on the same basis as at the contract inception. The entity should therefore recognise negative revenue of 8 cu (100 cu / 250 cu * 20 cu) in year 2, reflecting that the transaction price for V1 was only 92 cu (100 cu – 8 cu). In year 3, revenue of 138 cu (150 cu / 250 cu * (250 cu – 20 cu)) should be recognised when V2 is delivered to the customer.

48 EFRAG does not believe that the proposed treatment fairly reflects the economic substance of the transaction. EFRAG thinks that in the example above, the entire price reduction of 20 cu should be allocated to V2, as it relates entirely to that performance obligation.

49 Therefore, EFRAG thinks that changes in a transaction price should be allocated to the performance obligations based on the relevant facts and circumstances. We acknowledge that such an allocation would require more judgement by management, compared to the mechanical model proposed by the ED. However, we think that in most cases, it should be relatively clear whether a change in the transaction price relates to completed or uncompleted performance obligations.

Question 8 — Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 *Intangible Assets* or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

EFRAG does not agree that the costs of securing a contract should always be expensed as incurred.

EFRAG thinks that requirements regarding capitalisation of contract costs should be included in IAS 2.

50 Overall, EFRAG supports the IASB's effort to specify which costs are eligible for capitalisation as contract costs. However, we do not agree with the placement of the proposed guidance.

51 Also, we do not agree with the proposal to exclude from the list of eligible costs *any* costs incurred before contract inception, unless they are used in the process of satisfying performance obligations related to the good or service to be delivered to the customer. We understand that the ED will thereby prohibit the cost of securing a contract to be capitalised.

52 While we agree that costs before the contract is secured should not be capitalised unless they are used in the process of satisfying the performance obligations, we do not agree that the cost of securing a contract could never be capitalised. In our view, if commissions and similar costs are incremental, necessary, directly related to a contract and will be recovered through the contract, they should be capitalised

and not recognised as expenses when incurred. We are aware that, generally, an entity expects all costs incurred to be recovered somehow, and the fact that the entity expects the costs of securing a contract to be recovered is therefore not a valid argument on its own. On the other hand, we believe that capitalising costs related to securing a contract is linked to a specific contract and is consistent with the current requirements in paragraph 21 of IAS 11, and we are not convinced that the proposal would result in more decision-useful information than the current requirements. EFRAG also considers that capitalisation of costs of securing a contract is consistent with the accounting for loan origination fees, which are included in the calculation of the effective interest rate. In principle, we also think it is consistent with the proposed requirements for insurance contracts, although we note that the issues may not be completely comparable.

53 Except for the requirements on the costs of securing a contract, EFRAG does not think that a revenue recognition standard should include requirements about costs incurred in fulfilling a contract. We acknowledge that the replacement of IAS 11 *Construction Contracts* means that some guidance regarding contract costs will have to be included in another standard. However, instead of incorporating requirements regarding these costs in a revenue recognition standard, we think that the requirements should be included in IAS 2 *Inventories*. In addition, the requirements regarding inventories of services providers should remain in IAS 2.

54 Apart from the comments above, EFRAG thinks that the requirements on accounting for the costs of fulfilling a contract are operational and sufficient.

Question 9 — Paragraph 58 proposes the costs that relate directly to a contract for the purpose of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include and why?

EFRAG agrees that an entity should capitalise contract costs based on the full direct cost method. Similarly, an entity should determine whether a contract is onerous based on the full direct costs.

EFRAG does not agree with the proposal to require the use of the probability-weighted technique for the costs in performing the "onerous test".

EFRAG does not agree with the proposal to require the "onerous test" at a performance obligation level as this could result in recognition of a provision for an onerous performance obligation within an overall profitable contract.

Capitalisation of costs

55 EFRAG agrees that an entity should apply the full direct cost method (i.e., including in the cost of an asset both incremental and allocated costs that relate directly to the asset) as suggested by the ED for measuring contract costs eligible for capitalisation.

56 As mentioned in our response to question 8, we also think that costs of securing a contract should be capitalised in certain circumstances.

Measurement of onerous performance obligations

57 Referring to our previous comments on the use of probability-weighted amounts, we believe that the availability of reliable information is critical for the application of the expected value method and that the expected value approach should not be applied to single items. We do not think that the proposed requirements for onerous tests would result in reliable information in situations where the entity does not have past experience of the type described in paragraph 38 of the ED or the contract does not belong to a large population of similar items. In those circumstances, we believe that contract costs should be estimated on "the most likely estimate" basis.

Onerous performance obligations versus onerous contract

58 In addition, we do not believe it would be appropriate that a performance obligation is deemed onerous, even if the performance obligation is part of a contract that is profitable overall. We also think that the proposed approach is inconsistent with the approach in IAS 37, which requires an entity to consider the unavoidable costs of meeting the obligations and the economic benefits expected to be received under the contract as a whole.

59 For example, consider that an entity enters into a contract containing the following performance obligations:

	Performance obligation 1	*Performance obligation 2*	*Performance obligation 3*
Stand-alone selling price	100	100	100
Costs	95	50	70
Margin	5	50	30

The contract price agreed with the customer is 270 cu. The entity therefore obtains a profit of 55 cu (270 cu – 95 cu – 50 cu – 70 cu) from the contract. The ED requires the transaction price to be allocated to the performance obligations based on their stand-alone selling prices. That is, the allocated transaction price to each performance obligation is 90 cu (270 cu/3, as the performance obligations have identical stand-alone selling prices in this case). Accordingly:

	Performance obligation 1	*Performance obligation 2*	*Performance obligation 3*
Allocated transaction price	90	90	90
Costs	95	50	70
Margin	-5	40	20

This means that performance obligation 1 will be considered onerous and the entity should recognise a provision for it when entering into the contract.

60 We believe that it is inappropriate to provide for an onerous performance obligation if the entire contract is profitable. Instead, a provision for an onerous contract should only be recognised if the entire contract is onerous. We think that, for commercial reasons, it is not uncommon that an entity would enter into a contract where some performance obligations are onerous but the entire contract is profitable. However, it is part of the cost of the contract to satisfy these onerous performance obligations.

61 As noted in relation to question 7, we think that the transaction price should be allocated to performance obligations based the margins of the performance obligations. This would reduce the problem of performance obligations being deemed onerous as a result of the allocation of the overall discount. However, performance obligations may become onerous after the initial allocation of the

transaction price, when the costs of completing a performance obligation become higher than expected. In these cases, we think the loss on one performance obligation within an overall profitable contract should be allocated to remaining performance obligations based on their margins.

Disclosure

Question 10 — The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

EFRAG agrees with the objective of the proposed disclosure requirements and thinks that the disclosure requirements will help in meeting the objective. However, we believe the disclosure requirements should be targeted to ensure that the benefits outweigh the costs.

62 EFRAG agrees with the disclosure objective. In addition, we think that the disclosure requirements proposed by the ED will provide information that will be helpful in meeting the objective. We also note that the costs and benefits of the proposed disclosure requirements vary greatly between industries. We believe the disclosure requirements should be targeted to ensure that the benefits outweigh the costs.

63 Two of the disclosure requirements (the requirements regarding disaggregation of revenue and the maturity analysis of performance obligations) are considered in more detail in our answer to questions 11 and 12.

64 We have discussed whether a reconciliation of contract balances provides decision-useful information to users. We think that it would provide useful information in relation to, for example, construction and defence contracts as the reconciliation could indicate if an entity would be facing different problems (for example, not being able to bill customers for recognised revenue). However, we also note that the disclosure could be costly to prepare. Disclosures about consideration received from customers would require an entity to record direct cash flow information, which is potentially costly but not necessarily useful in all cases. We refer to our general comment about costs and benefits in paragraph 3.

Question 11 — The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

EFRAG agrees with the proposal.

65 EFRAG agrees with the proposal. We have discussed whether the requirement should also apply to contracts with an originally expected timing of less than one year. However, we agree with the IASB's cost/benefit consideration on this issue.

66 We have discussed whether the requirement should apply to contracts with an originally expected timing of less than one year, but where the actual duration at the balance sheet date either is or is estimated to exceed one year. We think that many construction-type entities could easily provide that additional information. However, the disclosure requirement would affect many other types of contracts than construction-type contracts, such as IT service agreements. EFRAG considers that it would often be more difficult for those other types of entities to provide the information, if such information was not based on original expectations. We therefore also agree with the cost/benefit consideration taken by the IASB to require only information for contracts with an original duration of more than one year.

67 We have also considered whether it would be more useful to have information about when performance obligations would result in cash-inflows, rather than when the revenue recognition criteria in the ED are expected to be met. We think that the cash-inflow information is important. However, as paragraph 77(c) of the ED requires an entity to disclose its significant payment terms; we think that it should be possible for users to obtain some information about the expected cash flows from the performance obligations.

68 Finally, we think the wording of paragraph 78 of the ED should be clarified to make it unambiguous that the information should be provided on an aggregate level and not for each performance obligation.

Question 12 — Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

EFRAG agrees with the proposal. However, the wording should specify that a single category could reflect multiple factors – for example, a given product in a given marketplace.

69 EFRAG agrees with the proposal. It is important that an entity can break down revenue into categories that it finds relevant. We think that the requirement is worded in a manner that would allow this. However, we would like to note that the ED could give the impression that the categories could only be based on one factor – for example, geography – and we do not think that this is beneficial. In fact, we think that in order for the information required to be as useful as possible to fulfil the objectives of the notes, it is important that dissimilar items are not grouped together.

70 Consider an entity, which has two very different products (A and B) that are sold on very different markets (X and Y). The entity considers that it has three different streams of revenue that are affected differently by economic characteristics (revenue from Product A on Market X; Product A on Market Y; and Product B on Market X and Y).

71 We therefore recommend that final requirements are clarified so that disaggregation is to be based, beyond any possible doubt, on a single or multiple factor basis, whichever makes the information disclosed relevant.

Effective date and transition

Question 13 — Do you agree that an entity should apply the proposed requirements retrospectively (that is, as if the entity applied the proposed requirements to all contracts in existence at the effective date and in the comparative period)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue, but at a lower cost to preparers? If so, please explain the alternative and why you think it is better.

EFRAG agrees that the proposed requirements should be applied retrospectively.

72 EFRAG agrees that a new standard on revenue recognition should be applied retrospectively. If prospective application were to be required, this could result in the same revenue being recognised twice (or not at all) in the same set of financial statements. Alternatively, if the prospective application would require the new revenue recognition model to be applied only for new contracts, an entity could apply different revenue recognition criteria to identical contracts agreed at different times. To avoid these types of anomalies, which cause confusion among users, we favour retrospective application.

Question 14 — The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposal operational? If not, what additional guidance do you suggest?

EFRAG generally thinks that, where the standard is unclear, this should be addressed by clarifying the principles rather than by way of application guidance. However, we are aware that it may be necessary to include some guidance to address industry-specific issues.

73 As it appears from our other comments, we think that some changes and clarifications are required before a standard is issued. Generally, we prefer a standard with clear principles and no application guidance to a standard with weak principles and elaborate application guidance. Accordingly, where the proposal is unclear, we think that the IASB should first consider clarifying the principles rather than adding application guidance. However, we are aware that application guidance may be needed for particular industries.

74 One issue, which is not addressed in the proposed standard or the application guidance, and which we believe requires specific attention, is the accounting for contracts in which the customer does not pay the full amount of consideration for goods or services received. This happens when part of the amount is paid by a third party (e.g. in some jurisdictions part of the consideration for the production of renewable energy is paid by a third party).

Question 15 — The Boards propose that an entity should distinguish between the following types of product warranties:

(a) **a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation, but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.**

(b) **a warranty that provides a customer with coverage for faults which may arise after the product is transferred to the customer. This gives rise to a performance obligation, in addition to the performance obligation to transfer the product specified in the contract.**

Do you agree with the proposed distinction between the different types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

EFRAG thinks a distinction should be made between statutory warranties and other (extended) warranties. Statutory warranties should not be accounted for as separate performance obligations and should not result in deferred revenue, but rather in a liability representing the cost expected to be incurred to meet the statutory warranty obligation.

75 EFRAG believes a distinction should be made between statutory warranties and additional warranties. In EFRAG's view, statutory warranties are intended to provide cover for latent defects, which may arise in the product.

76 EFRAG agrees that only warranties that are separable services, with a distinguishable stand-alone selling price/margin, should be accounted for as separate performance obligations. We do not believe that statutory warranties qualify as separate performance obligations under the proposals; hence, revenue should not be deferred. Instead, the liability reflecting the statutory warranty obligation should be measured by reference to the cost of repairing or replacing an item (i.e. it should not include a profit margin). Indeed, in EFRAG's view the warranty obligation is an integral part of the good being delivered.

77 EFRAG is aware of the IASB's proposal to exempt warranty obligations from insurance contract accounting. EFRAG will comment on that proposal as part of its comments in response to the Exposure Draft *Insurance Contracts.*

Question 16 — The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) **if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and**

(b) **if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and satisfies that obligation when the customer is able to use and benefit from the licence.**

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

EFRAG thinks that the right of use of an intangible asset should be dealt with in the IASB's forthcoming standard on leases.

78 EFRAG understands that the IASB's intention when preparing the ED was to require the same accounting for licences and leases. In addition, we think that a 'right to use' is, in substance, a leasing agreement regardless of whether the right

relates to the use of a tangible or intangible asset. EFRAG's tentative view is therefore that the issue should be dealt with in IASB's forthcoming standard on leases. We think, however, that depending on the further deliberations of the leases project, it may be necessary to examine the issue further. We therefore urge the IASB to reconsider the June 2011 deadline for the lease project.

Question 17 — The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

EFRAG agrees with the proposal.

79 EFRAG agrees that, if IAS 18 *Revenue* is replaced by a new standard on revenue recognition, the requirements for recognition and measurement of gains or losses on the sale of some non-financial assets should be consistent with the requirements of this new standard.

APPENDIX 2

Additional issues

1 In addition to the questions raised in the ED, EFRAG would like to make some comments in relation to the definition of stand-alone selling price and the distinction between a contract asset and a receivable.

Stand-alone selling price

2 *The ED defines the stand-alone selling price (of a good or service) as the price at which the entity would sell a good or service separately to the customer.*

EFRAG agrees overall with the definition of a standalone selling price. However, for the avoidance of doubt, we recommend that it be clarified in Appendix A of the ED that the stand-alone selling price is the price at which the entity would sell that good or service if it was sold separately to that particular customer.

3 EFRAG has debated what the reference to the entity's standalone selling price might mean in certain circumstances. For example, we think that in many cases a stand-alone selling price would depend on the customer, so it is necessary to decide whether to account for this 'customer' effect. EFRAG considers that the standalone selling price should refer to the price that the entity charges the customer, if that particular customer—and not any other customer—would buy the good or service separately. Our rationale is based on the likely difficulty in estimating a stand-alone selling price, without considering the customer. For example, we believe that the stand-alone selling price of a carport would be different if it were ordered by a customer where the entity is already carrying out a construction, and therefore has its equipment on the site, than if it were ordered by another customer.

4 We think that the ED considers the 'customer' effect in the definition of a standalone selling price. However, we suggest that this point be clarified in the definition included in Appendix A. This could, for example, be done by defining stand-alone selling price as "the price at which the entity would sell that good or service, if it was sold separately to *that* particular customer".

Distinction between a contract asset and a receivable

5 *The ED defines a contract asset as an entity's right to consideration from a customer in exchange for goods or services transferred to the customer. However, when the entity has an unconditional right to consideration, a receivable shall be recognised. A right to consideration is unconditional when nothing other than the passage of time is required before payment of that consideration is due.*

EFRAG notes that the proposed definition of a contract asset is not different from the definition of a financial asset in paragraph 11 of IAS 32, as IAS 32 does not require the contractual right to be *unconditional*. The ED introduces an additional criterion for the definition of a receivable – the requirement for the right to consideration to be unconditional. It is not clear how this requirement interacts with the requirements in IAS 32 and how this proposal could be made operational.

6 EFRAG notes that the proposed definition of a contract asset is not different from the definition of a financial asset in paragraph 11 of IAS 32, as IAS 32 does not

require the contractual right to be *unconditional*. The ED introduces an additional criterion for the definition of a receivable – the requirement for the right to consideration to be unconditional. It is not clear how this requirement interacts with the requirements in IAS 32 and how this proposal could be made operational.

APPENDIX 3

An alternative model for revenue recognition

1 The proposals in the ED would prevent entities recognising revenue when performing under the following types of contracts:

(a) construction-type contracts under which the asset under construction is not transferred to the customer on a continuous basis; and

(b) contracts for services where there is no continuous delivery.

even when the entity has established an irrevocable right to consideration for work carried out, subject to continued performance.

2 EFRAG does not believe that this will result in decision-useful information. We consider that an entity, which has progressed towards satisfying a performance obligation under a contract and has established an irrevocable right to consideration subject to continued performance, and therefore should report an increase in net assets that shows that it is 'better off' than an entity that has not established an irrevocable right to consideration under a contract.

3 We therefore propose an alternative model for revenue recognition, which we believe would result in decision-useful information *in all circumstances* within the scope of the ED. Under our alternative model:

> Revenue is a measure of the establishment of an irrevocable right to consideration, subject to continued performance, that arises as the entity fulfils the contract with the customer.

4 Accordingly, the following criteria should be met before an entity recognises revenue:

(a) a contract with a customer must exist in order for an entity to recognise revenue;

(b) the entity's performance should have resulted in an irrevocable right to consideration, subject to continued performance (see paragraphs 5-9 below);

(c) there should be reasonable assurance that the entity will perform (see paragraphs 10-11 below); and

(d) goods or services in progress should be closely associated with the relevant contract (see paragraphs 12-13 below).

Criteria (b) to (d) are explained in detail below.

Irrevocable right subject to continued performance

5 A right to consideration becomes irrevocable when the customer has no choices, other than:

(a) to take delivery of goods or services under the contract and pay in accordance with the contract terms; or

(b) to default and breach the contract (thereby having to pay compensation).

6 Contractual terms, or the legal framework that applies to a particular contract, define when rights to consideration become irrevocable. This could happen:

(a) when goods or services are completed and transferred to the customer; or

(b) continuously, subject to the entity's continued performance.

7 Accordingly, if the customer has the discretion according to a contract to withdraw from the contract by incurring a penalty that is less than the value of the work performed, the right to receive consideration in excess of that penalty is not irrevocable at that point in time.

8 If an entity, for example, constructs an asset for a customer and the customer can withdraw from the contract during the construction with no other costs than the loss of a down payment, no irrevocable right to the consideration exceeding the down payment exists. Therefore, revenue in excess of the down payment cannot be recognised as the construction takes place. However, revenue can be recognised up to the amount of the down payment, provided that the other criteria for recognising revenue are met.

9 On the other hand, if an asset is constructed for a customer and the customer cannot withdraw from the contract during the construction, but is only required to pay for the asset when it is completed, an irrevocable right to consideration subject to future performance exists. If the other criteria for recognising revenue are met, the entity should recognise revenue as the construction takes place.

Reasonable assurance that the entity will perform

10 If the entity (the seller) fails to perform, there may be no right to consideration. Accordingly, we would require that there is reasonable assurance that the entity will perform.

11 If the contract includes customer acceptance clauses, revenue can only be recognised when there is reasonable assurance that the entity will be able to construct assets that will be approved by the customer.

Goods or services should be closely associated with the relevant contract

12 The fact that revenue relates to the fulfilment of a particular contract with a particular customer means that in order to recognise revenue on work in progress, the work in progress must be appropriated to the relevant contract. This means that there is a low possibility that in the ordinary course of business the work in progress can be reassigned to a different contract. In effect, the supplier has lost some element of control over the goods and services and no longer has complete freedom as to what they are used for.

13 The criterion does not mean that the good constructed should necessarily be customer-specified to be appropriated to a contract. If an entity is constructing a building on a specific plot of land, and a customer agrees to buy the building when it is finished, this building is appropriated to a particular contract specified as the particular building on that plot of land.

Estimating the established right to consideration

14 When the criteria above are met, an entity recognises revenue as it performs under the contract and thereby establishes a right to consideration. Should the criteria be met before or during the production of a good or the delivery of a service, the right to revenue established by the entity is estimated using the guidance available in the ED, on how to measure revenue arising from continuous transfer of revenue.

15 According to the IASB framework, revenue arises because there have been certain increases in the net assets of the entity. In the alternative model, it is considered that, as an entity carries out activity pursuant to a contract with a customer, the entity progressively builds up the asset (the right to consideration). Revenue measures that progression.

Comparison with the model suggested in the IASB's ED

16 The alternative model would use many of the concepts developed in the IASB's ED. For example:

(c) 'a contract' should be defined either in the way IAS 32 defines it or in accordance with the ED;

(d) the total amount of revenue recognised on a contract should equal the transaction price of that contract;

(e) if a contract comprises more than one distinct performance obligation, those performance obligations should be treated as separate performance obligations and accounted for separately. For this purpose, the criteria for unbundling performance obligations should follow those set out in the ED, considering our comments on these criteria;

(f) performance obligations and contract assets would be measured under the alternative model in accordance with the ED;

(g) the carrying value of a performance obligation should be re-measured only as proposed in the ED;

(h) the requirements for satisfaction of performance obligations will be identical to the ED; and

(i) the measurement of progress would be made using the guidance available in the ED on how to measure revenue arising from the continuous transfer of goods or services.

17 As the alternative model uses many of the concepts developed in the IASB's ED, it also differs from the model of IAS 11 in that it results in more unbundling than paragraphs 8 and 9 of IAS 11 would require. Under the alternative model, a contract that covers a number of assets that are transferred to the customer at different points in time and that could be sold separately would be separated into discrete performance obligations that are accounted for individually.

18 However, contrary to the model proposed in IASB's ED, the satisfaction of a performance obligation would not be the event that would trigger revenue recognition under the alternative model. Despite this difference, EFRAG considers that revenue recognition, under the model proposed in the ED, and under this alternative model, will frequently coincide. This is because an entity frequently does not receive an irrevocable right to consideration before control of goods or

services passes to the customer and because the time span of some contracts is short. In a cash sale, for example when a customer buys items in a supermarket, the alternative model would not result in a different timing of revenue recognition, because the time span of the transaction is so short.

19 Although the transfer of control of goods and services does not trigger revenue recognition under the alternative model, transfer of control is considered as an important economic event that would be appropriately depicted by transfers within the statement of financial position. When control transfers, the entity would derecognise the asset it has been building up to the finalisation stage. It would recognise instead, either a contract asset or a receivable, as defined in the ED. As a result, information regarding the transfer of control will also be disclosed under the alternative model.

20 Information provided to users would, however, not be limited to depicting transfers of the control of assets between suppliers and customers. The income statement would convey supplementary information – i.e. how the entity establishes an irrevocable right to consideration, subject to continued performance, pursuant to a contract. This information would prove to be more useful to users in determining sustainable streams of future cash flows. In addition, the statement of financial position would show inventory, for which no irrevocable right to receive payment contingent on continuous performance exists, separately from inventory (work in progress) for which such a right exists. The ED may only result in distinction between work in progress for which a contract exists and work in progress for which a contract does not exist.

21 To illustrate the proposed model, consider the following example. An entity is producing an asset and the contract provides for an irrevocable right to consideration as the work progresses, subject to continued performance. The entity uses 100 cu of inventory and 90 cu of labour to produce the good that is sold for 440 cu. The item under construction is 50 percent completed at the end of the year and the entity applies the mile-stone method to recognise revenue and the entity has just reached a milestone at the end of the year.

During production (before a milestone is met):		
Dr Inventories (salaries)	90	
Cr Salary payable		90
Dr Inventories (goods)	100	
Cr Payables		100
When a milestone is met:		
Dr Work in progress at sales value	220	
Cr Revenue		220
Dr Cost of goods sold[1]	190	
Cr Inventory		190

[1] 'Cost of goods sold' does not necessarily represent derecognised goods. The amount reflects the cost of goods transferred to work in progress at sales value. When revenue is recognised, the increase in 'work in progress at sales value' and the decrease in 'inventory' are measured gross. This ensures a meaningful gross margin ratio, as revenue will represent the gross increase in work in progress at sales value and not just the profit margin added.

22 It follows that when a milestone is met, a reclassification from inventory to 'Work in progress at sales value' through 'Revenue' and 'Costs of goods transferred to work in progress at sales value' takes place.

23 Some of the differences between the alternative model proposed in this Appendix and the model proposed by the IASB can be illustrated by the following examples

Example	Model proposed by the IASB	Alternative model
Entity A is a developer. It buys a tract of land and constructs houses on the land according to its own designs. Entity A enters into a sales contract under which control of the building and the land on which it is built is transferred to the customer when construction is completed. From contract inception, the customer is obliged to pay (the full amount) for the house when the house is completed (that is, the customer cannot pay a lower penalty and then withdraw from the contract).	As no control is being transferred during construction, revenue is recognised when the construction is complete.	Revenue should probably be recognised on a percentage of completion basis as the entity has an irrevocable right to consideration subject to continued performance; there is reasonable assurance that the entity will perform; and the asset being constructed can be designated to a particular customer (the customer has ordered the house on a particular piece of land).
Entity B is manufacturing on its own premises an item designed by the customer. The customer has no contractual right to change the design once the production has started. If the customer wishes to terminate the contract when the work is part-completed, it will have to pay in full for the work done to date and to compensate Entity B for profits lost on the remainder of the contract. In the event of termination, Entity B will have to scrap the item constructed, rather than transferring it to the customer as it contains potentially harmful materials.	Revenue may not be recognised on a percentage-of-completion basis as the work is carried out, because control over the work-in-process may not be transferred to the customer during that phase.	Revenue should probably be recognised on a percentage-of-completion basis as the entity has an irrevocable right to consideration subject to continued performance; there is reasonable assurance that the entity will perform; and the asset can be designated to a particular customer.

Example	Model proposed by the IASB	Alternative model
Entity C provides transportation services by ship to a customer that wants a container shipped from Rotterdam to New York.	It is unclear whether revenue should be recognised based on a percentage-of-completion basis or not.	Revenue should probably be recognised on a percentage-of-completion basis as the entity has an irrevocable right to consideration, subject to delivery of the container in New York; there is reasonable assurance that the entity will perform; and the transportation of the customer's container can be designated to the customer.