



EFRAG

35 Square de Meeûs
B-1000 BRUSSELS

Date: 24 September 2010
Ref.: CESR/10-1172

RE: EFRAG's draft response on the IASB's Exposure Draft *Revenue from Contracts with Customers*

The Committee of European Securities Regulators (CESR), through its standing committee on corporate reporting (CESR-Fin), has considered EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Revenue from Contracts with Customers*.

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

Revenue is a key indicator for the financial performance of an entity for users of financial statements. Consistent and comprehensive recognition and measurement principles are important to ensure comparability between companies, at least between those operating in the same industry.

Many entities developed their own accounting methodologies relying on US GAAP in the areas where current IFRS literature is lacking further guidance. However, various US GAAP pronouncements issued by multiple organisations with different authority provide guidance in the area of revenue recognition. We believe that this creates an unsatisfactory situation as it may not be clear to entities whether the guidance provided by US GAAP is in line with the IFRS Framework. We consequently appreciate the joint IASB and FASB efforts to address an area in which many stakeholders have, over the past years, identified a number of application problems.

CESR supports the objective of providing a single principle for recognising revenue from contracts with customers. It might however be challenging to develop a set of principles that can be applied universally to all entities and that can be consistently enforced.

CESR acknowledges that the exposure draft is an improvement to the discussion paper which was published in 2009. However, when commenting on that discussion paper CESR recommended that a conceptual debate should take place on what revenue is and that all the application problems identified in the past (notably those brought to the attention of the IFRS Interpretations Committee) should be addressed. We regret that the IASB has not followed these recommendations.

We are concerned that the current scope of the project seems to address only a limited number of the application issues mentioned above (mainly by eliminating the choice between IAS 11 – *Construction contracts* and IAS 18 – *Revenue* and by providing guidance on some multiple-elements transactions). We note that many of the issues related to revenue recognition that were brought to the attention of the IFRS Interpretations Committee are not addressed by the proposed amendments.



We do not believe that the proposed amendments are refined enough to ensure consistent application in all areas, particularly in the area of long-term contracts. It is our understanding that the IASB believes that in many construction-type contracts control of the asset passes to the customer on a continuous basis. Based on our knowledge of and experience with the characteristics of construction-type contracts we do not understand the rationale that would justify such an assumption (especially when considering the four criteria presented in paragraph 30 of the ED). We therefore encourage the Board to clarify this issue and have provided additional details as part of our response to question 3.

Our impression is that many users find it useful that revenue is reported as the product of price by quantities, and that credit risk should be reported outside the revenue line. However, we believe that this view needs to be tested further with users of financial statements. CESR would support the view that credit losses should be accounted for separately if users of financial information could confirm their preference. If users do not support that view we would not oppose the Board's proposals but would ask the Board to provide additional disclosures on the credit risk expense of the reporting period (as well as comparative figures for that expense).

Our detailed comments on EFRAG's draft response are set out in the Appendix 1.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'F. Restoy', is written over a horizontal line. A long, sweeping flourish extends from the bottom of the signature.

Fernando Restoy

Chairman of CESR's Standing Committee on Corporate Reporting



APPENDIX 1 – CESR’S DETAILED ANSWERS TO THE QUESTIONS IN THE ED

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?

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?

CESR agrees with the IASB that performance obligations are key elements when assessing whether revenue can or cannot be recognised.

Like EFRAG, CESR is supportive of the proposed guidance for combining and segmenting contracts.

CESR also shares EFRAG’s concern that the guidance for interpreting price interdependences should be clarified since the guidance provided in the ED does not seem to be internally consistent and clear enough to make the provision operational. In particular, paragraph 14 of the ED proposes that the price of one contract is not interdependent with the price of another contract solely because the customer receives a discount as a result of an existing customer relationship. On the other hand, example 2 in the application guidance shows that when the customer receives a discount in relation to the extension of an existing service contract that reflects that the current stand-alone selling price of the remaining part of the original contract has decreased, the extension is a separate contract. The two provisions do not seem internally consistent. Further, the same example in the application guidance uses a variant to the original example and concludes that in this case the extension of the contract should be accounted for as a contract modification. The rationale for the different outcomes provided in the second example is not clear to us, and we therefore share EFRAG’s view that it should be clarified.

CESR supports EFRAG's view that in considering whether goods or services are distinct (and thus would form a separate performance obligation), the entity's own customary business practice should be considered rather than the business practice of other entities.

Question 3

Do you think that the proposed guidance in paragraphs 25-31 and related application guidance are 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?

CESR agrees with the IASB that the elements identified are key in assessing whether a performance obligation has been satisfied by transferring a promised good or service to a customer.

We believe that the current proposal is not refined enough to ensure consistent application in areas such as long-term contracts. Indeed, even if paragraph 30 suggests four indicators to assess whether control has passed from the seller to its customer, paragraph 31 indicates that “*not one of the*



preceding indicators determines by itself whether the customer has obtained control of the good or service. Moreover, some indicators may not be relevant to a particular contract.” Like EFRAG, CESR is concerned that the role these indicators play in the assessment of control is not clear. We find the interaction between paragraphs 31 and 30 strange. It seems to us that paragraph 31 weakens very much the indicators included in paragraph 30 and we consequently wonder whether paragraph 31 is necessary. If the IASB believes it is, we would propose clarifying the interaction between these two paragraphs in order to avoid inconsistent application.

We do not believe that the proposed amendments are refined enough to ensure consistent application in all areas, particularly in the area of long-term contracts. It is our understanding that the IASB believes that in many construction-type contracts control of the asset passes to the customer on a continuous basis. Based on our knowledge of and experience with the characteristics of construction-type contracts we do not understand the rationale that would justify such an assumption. We believe that for such contracts continuous transfer of control is rare. Generally, even when the asset is built or developed at the customer’s site, control is not transferred until the customer formally takes receipt of the asset (i.e. when all technical or quality requirements are met). According to the exposure draft, the supplier might not recognise any revenue in such situations until final delivery of the asset. CESR is concerned that such a revenue recognition principle does not provide useful information to users of financial statements since it does not reflect the way these construction-type contracts are managed and presented for reporting purposes. We believe that the IASB should explain the rationale they used in assuming that continuous transfer of control is frequent in construction-type contracts.

Furthermore, although CESR agrees with the IASB that contracts may contain very specific details, and that those specificities should be taken into account when assessing how to recognise revenue, CESR also believes that risks and rewards are important to that assessment. CESR does not see how a customer can “receive the benefit from the good or service” (paragraph 26 of the ED) without also bearing the risks and rewards of ownership. Paragraph 28 of the ED refers to some rights that the seller may keep as a protection against a default from the customer. CESR believes that it is not always easy to distinguish between simple protective rights included in a contract and more substantive provisions. We believe that the assessment of risks and rewards may help differentiate between the two situations. This assessment may also be helpful in other cases.

Question 4

The Boards propose that if the amount of consideration is variable, an entity should recognise revenue for 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? Of so, do you agree with the proposed criteria in paragraph 38? In not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

CESR agrees with the proposals as set out by the IASB in the ED.

This said, CESR notes that the proposals will require the application of management judgment to determine the transaction price when it is subject to variables, and therefore entities with similar transactions may recognise revenue at different times depending on their respective levels of experience with a specific product or market. In this regard, CESR believes that clear guidance is key in helping management apply the requirements consistently. The conditions set out in paragraph 38 of the ED and the factors set out in paragraph 39, are helpful in this regard, however the examples in B76 and B77 seem to be too simple to ensure that a proper level of consistency will be obtained. CESR would encourage the Board to improve the application guidance with the addition of other examples.



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?

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?

We believe that any responses to questions 5 and 6 are linked since both questions refer to the way the cash-flows of an entity should be analysed. CESR is of the opinion that distinguishing between which cash-flows are generated by the entity's activities and which are due to the financing of the entity is very important information to users of the financial statements.

Revenue is a key indicator of an entity's economic activities and a tool to assess how activities change over time. Therefore comparability is very important, and a detailed understanding of changes over time is thought useful by users. It is generally accepted that revenue is made up of a quantity of products sold multiplied by their price. CESR understands that users are usually very keen on obtaining information on the changes to those two elements from one reporting period to the other.

Further, although an entity generally receives cash inflows shortly after transferring the control over the goods sold, there are entity-, customer-, industry- or commodity-specific practices which result in cash inflows being deferred. We believe that the entity finances the customer in those cases. From an economic point of view, a customer that pays cash instead of the usual payment conditions will usually obtain a sales discount. Therefore it can be argued that the difference between the discounted sale price and the price in the catalogue is an interest income. But in many cases the time difference between sale and payment is such that the interest income that would be deferred is not material. CESR believes that when the interest income is material the entity should adjust the amount of promised consideration in order to provide relevant information to users.

Our impression is that many users find it useful that revenue is reported as the product of price by quantities, and that credit risk should be reported outside the revenue line. However, we believe that this view needs to be tested further with users of financial statements. CESR would support the view that credit losses should be accounted for separately if users of financial information could confirm their preference. If users do not support that view we would not oppose the Board's proposals but would ask it to provide additional disclosures on the credit risk expense of the reporting period (as well as comparative figures for that expense).

Question 7

Paragraphs 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?

CESR supports the proposal in the ED that the initial (estimated) transaction price should be allocated to all separate performance obligations in the contract in proportion to the stand-alone selling price to the extent that this represents the entity's own customary business practice (see also our response to question 1). CESR however agrees with EFRAG that after the initial allocation, any change in the estimated transaction price should be allocated to the different separate performance obligations based on all relevant facts and circumstances.



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 those costs of fulfilling a contract are operational and sufficient? If not, why?

CESR agrees and supports the IASB's efforts to specify which costs of fulfilling a contract should be capitalised and which should not.

We however face difficulties in understanding the example provided by EFRAG in paragraph 67 of its draft comment. In particular how commissions paid to an agent before a contract is secured could be capitalised. We have doubts whether such an accounting treatment would be compliant with IAS 38 – *Intangible Assets* or in line with the Framework. We would therefore welcome clarification of this paragraph.

Question 9

Paragraph 58 proposed the costs that relate directly to a contract for the purposes 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 or exclude and why?

CESR shares EFRAG's view that onerous performance obligations should be tested at contract level. Indeed, under the model presented in the exposure draft, any contract that includes an item sold at a loss will result in the recognition of an onerous performance obligation, even if those items are bundled with other profitable items such that the contract as a whole is profitable.

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?

Like EFRAG, CESR agrees with the objective of the proposed disclosure requirements and believes that the disclosure requirements might help in meeting the objective.

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 contract with an original duration expected to exceed one year.

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

CESR agrees with the proposed requirement to disclose the amount of an entity's remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.



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?

CESR agrees with the IASB and EFRAG that entities should disaggregate revenue into the categories that it finds relevant.

Question 13

Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

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

CESR agrees that the proposed amendments as part of a new standard on revenue recognition should be applied retrospectively.

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 proposals operational? If not, what additional guidance do you suggest?

CESR does not entirely agree with EFRAG's draft response to question 14 in two aspects.

- (a) EFRAG starts by stating that where the standard is unclear the problem should be addressed by clarifying the principles rather than by way of application guidance. CESR supports principles based IFRSs but believes that it would be helpful for the readers of EFRAG's draft comment letters to provide background information about the issues where it believes the standard to be unclear.
- (b) We generally do not support industry-specific requirements because we believe that the aim of IFRS should be to achieve a principles based revenue recognition model that can be enforced consistently. However, if EFRAG - thanks to the feedback provided by its constituents - has identified areas that are not properly addressed by the ED, these weaknesses should be reported to the IASB, and additional requirements and/or guidance should be included in the final standard.

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 products. 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 that 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 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?

Like EFRAG, CESR agrees that in theory there is a need to distinguish between a warranty and a failed sale. However, from a practical point of view, this requirement may be difficult to apply in particular for smaller issuers. We would encourage the Board to find simplification for the application of that principle. We believe that this is an area where management judgement may be necessary in order to assess whether a contractual obligation has been met or not. In many cases, when quality controls are efficient and historical data on goods returned by customers is available, assessing the revenue that should not be recognised will be easy. In other less favourable situations, management will have to use judgement and should provide disclosure on the judgements made.

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 an non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and its 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?

In its draft comment letter EFRAG provides an analysis of how the proposals would link the treatment of licenses to revenue recognition according to the satisfaction of the performance obligation and presents three alternatives.

CESR finds it hard to follow the logic presented by the IASB and has sympathy for the second alternative presented in paragraphs 121 and 122 of EFRAG's draft comment letter.

Question 17

The boards propose that in accounting for the gains 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.

CESR agrees that if IAS 18 is replaced by a new standard on revenue, then 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.