



27 October 2010

Our ref: ICAEW Rep 117/10

Your ref:

Mme Françoise Flores
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By email: commentletter@efrag.org

Chère Mme Flores

ED/2010/6 *Revenue from Contracts with Customers*

- 1 ICAEW is pleased to respond to your request for comments on the Exposure Draft *Revenue from Contracts with Customers*.
- 2 ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
- 3 Attached as an appendix to this letter is a copy of ICAEW's response to the IASB. The principal themes and specific detail of our response is set out in that document; in this letter we respond specifically to the points raised by EFRAG in their draft comment letter to the IASB, and set-out our answers to the questions that EFRAG has posed to its constituents.

We support the control based model

- 4 EFRAG expresses opposition to the control based model proposed by the IASB, and suggests instead an alternative model. We do not support this position. We believe that a control based model does provide a workable basis for a standard on revenue. Granted the current exposure draft is deficient in its articulation of that model, and we set out in paragraphs 28 to 34 of our attached letter how that may be remedied, but wholesale abandonment of the control model at this stage is not a viable proposition. It should be noted that this is a key exposure draft, at a

late stage in its development, and that there is a great deal of momentum from both Boards toward its finalisation.

Distinctness must be assessed with reference to the external market

- 5 EFRAG posits that an element of a contract is only distinct if it the entity itself sells that element (or something similar) separately. This is divergent from the ED which considers a contract element to be distinct even if it is only sold separately by another entity. EFRAG's objection to this point is not workable in practice. Whether elements are sold in combination or separately is likely to be largely dependent upon the business model of the entity. Garage A may offer warranties as an optional extra while garage B may always include one with the sale of a car. Following EFRAG's suggestion garage A would have two performance obligations while garage B would have only one – even though the selling price of car and warranty may be identical in both cases. This treatment creates diversity in practice which is avoided by the sensible principle in the ED.

RESPONSES TO SPECIFIC QUESTIONS

General comments - Do you support:

(a) The approach of developing a new standard on revenue recognition, or do you think that amending IAS 11 and IAS 18 to address existing practical issues would be preferable?

- 6 We agree with EFRAG that development of a new, unified standard for revenue recognition is a worthwhile exercise. Consistency in approach can be achieved by bringing together the two standards IAS 11 and IAS 18 and incorporating the existing IFRIC interpretations. Other current practice issues such as the treatment of contract costs, onerous contracts, and customer credit risk can also be usefully addressed as part of the project.

(b) The alternative revenue recognition model presented in Appendix 3 or the model proposed by the IASB in the ED?

- 7 We do not support EFRAG's proposed alternative model as we set out in paragraph 4 above.

Q6 - Do you think that the proposals in the ED requiring adjusting revenue for the time value of money would result in significant costs compared to the current practice? If so, why, and do you have any suggestions on how the principle could be applied in a less costly manner?

- 8 We agree with EFRAG that the transaction price should be adjusted to reflect the time value of money where applicable. The ED makes it clear that this would only be done where material, and for those contracts where payment is delayed or advanced to the extent that revenue is affected to this degree, it would be only appropriate for the effect of the time value of money to be reflected.

Q9 - Do you agree with EFRAG that the onerous test should be carried out at contract level, and not at performance obligation level? If so, do you, as EFRAG accept that nevertheless loss making performance obligations are reported as such when performed, disregarding when in the course of the contract that performance obligation is satisfied?

- 9 We agree that onerousness should not be assessed at the performance obligation level. This does not reflect commercial reality and would be extremely impractical to apply, as when entering into a contract businesses are likely to consider profitability in the round. Like EFRAG we accept that loss making performance obligations be recognised as such when performed; this is a natural result of the segmentation of the contract and should not prove particularly problematic. It is the anticipation of losses at the performance obligation level that we object to.

Q10- EFRAG would welcome comments regarding the usefulness and the cost of preparing the disclosures required by the ED and an assessment of whether an acceptable trade-off between costs and benefits is met.

10 We believe that users will welcome the extended disclosures required, and our views in this regard are set out more fully in paragraphs 53 – 57 of our draft response. The costs to preparers of providing the disclosures will vary. We have noted that the reconciliation proposed by paragraph 75 may be onerous for smaller entities and therefore suggested its omission from the IFRS for SMEs when that standard is updated to reflect the new revenue standard. We also note that the forward looking information required by paragraph 78 may prove difficult to gather and collate for those entities with large numbers of small contracts. We suggest limiting this disclosure to those contracts expected to continue for more than 12 months after the balance sheet date.

Q13 - Assuming that the proposals are to be applied retrospectively, how many years do you think would be necessary to implement the new requirements?

11 The practicality of retrospective application will depend upon the profile of contracts that a company has. For those companies with contracts that span several years, the re-examination of these contracts to determine the effects of adoption is likely to be an extensive exercise. Therefore we would welcome an extension of paragraph 85, acknowledging that significant estimation may sometimes be required in full retrospective application, that this is acceptable and that, where it is significant companies should disclose the approach they have taken in determining the retrospective amounts. We believe that this approach is preferable to deferring adoption for an extended number of years, which risks reducing comparability where some entities choose to early adopt.

Q14 – Do you think that the application guidance is sufficient to make the proposals of the ED operational in particular industries or are there any issues requiring specific consideration? If so, what are the issues?

12 In general we favour clearly articulated principles over voluminous guidance. As currently drafted some of the principles expressed in the ED, notably that surrounding the transfer of control, are not sufficiently well articulated to ensure consistent application, these deficiencies are individually identified in our attached letter to the IASB. However, notwithstanding any amendments to the ED that may be desirable, application of the new standard will require the exercise of judgement in many cases. This may lead to calls for further guidance material, which may be concentrated in specific industry groups. We have not identified any significant omissions in the current selection of guidance material, which does to some extent already consider certain industries, and therefore we would not support its extension.

Q15 - Do you agree with the proposals in the ED regarding accounting for and distinguishing between a warranty and a failed sale? If so, on what basis should the distinction be made?

13 We agree with EFRAG's conclusion in paragraph 110. In reality the effect on revenue of both types of warranty will be similar – a portion of revenue will be deferred in both cases. Therefore, focusing on a distinction between pre and post-sale defects, which in practice may be difficult to determine, is unhelpful. In paragraphs 66 to 69 of our attached response we suggest the Board reconsiders whether the distinction is in fact necessary.

Q16 - Which of the alternatives (Alternative 1 to 3) do you prefer?

14 We do not agree that exclusivity is the correct criterion for determining the pattern of revenue recognition. Exclusivity represents a bright-line distinction that may not be reflective of the performance obligation pattern of the underlying contract. Further, criterion A appears to be artificial. A supplier may or may not have an ongoing performance obligation, but does not necessarily have one just because an exclusive licence has been supplied. An appropriate solution, in our view, would be to align the accounting with the pattern of obligations the supplier has in relation to the licence. Where it merely needs to be supplied at a discrete point

in time with no further support, maintenance or other requirement, then all performance obligations may be deemed to have been met on supply. However, where the vendor retains ongoing responsibilities, it would be appropriate to recognise these as separate performance obligations and to defer revenue accordingly.

Appendix 3 - Are there issues that you would see in applying the proposed alternative model? If so, how could the model be further developed?

15 We support the control based model proposed by the IASB and therefore we would not favour the alternative proposed by EFRAG.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

A handwritten signature in black ink, appearing to read 'J. Boulton', with a stylized flourish at the end.

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27 October 2010

Our ref: ICAEW Rep 116/10

Your ref: ED/2010/6

Sir David Tweedie
Chairman
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Dear Sir David

REVENUE FROM CONTRACTS WITH CUSTOMERS

The ICAEW is pleased to respond to your request for comments on the Exposure Draft *Revenue from Contracts with Customers*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ED/2010/6 *REVENUE FROM CONTRACTS WITH CUSTOMERS*

Memorandum of comment submitted in October 2010 by the ICAEW, in response to the IASB's Exposure Draft *Revenue from Contracts with Customers* published in June 2010.

Contents	Paragraph
Introduction	1
Who we are	2
Major points	4
Responses to specific questions	17

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the Exposure Draft *Revenue from Contracts with Customers* published by the IASB ('the Board').

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Broad support for the Exposure Draft

4. ICAEW supports the framework that the Exposure Draft ('the ED') has established for revenue and the overall direction of travel. We believe that significant improvements are necessary in some areas but acknowledge that the IASB and the FASB ('the Boards') have made considerable progress in presenting for exposure a fully converged standard in this complex and important area of financial reporting, and we are particularly mindful of the extent of the achievement in condensing the extensive requirements of US GAAP. For these reasons, we accept the contract-based five-step model as being an appropriate foundation for a converged standard on revenue.
5. Revenue recognition is a pervasive topic of relevance to virtually all companies. As such the new standard will have potentially a very broad audience. In the interests of consistency of interpretation we therefore urge the Board to ensure that the final standard is drafted in a way that is clear and understandable to a wide range of readers. We would also point out in this context that we have assessed the proposals first and foremost in the context of reporting by entities with public accountability required to apply full IFRS. However, in paragraphs 53 and 60 below we draw attention to disclosure requirements and transitional arrangements that may not be suitable for smaller entities, and indeed we recommend that all aspects of the final standard are considered very carefully by the Board with due reference to practicality and cost / benefit considerations when in due course the IFRS for SMEs is updated. With this in mind, it is essential that the final standard articulates its principles in clear, unambiguous terms, such that once these are introduced into the IFRS for SMEs they may be easily applied by smaller entities with straightforward activities.

Acceptance of the performance obligation approach

6. We accept the satisfaction of performance obligations as a suitable principle for the recognition of revenue. In many cases performance obligations can be identified with reasonable objectivity. With appropriate application guidance we feel that the principle can function effectively in practice.

Further development needed of the 'control' concept (Q3)

7. In our view, the single biggest deficiency of the ED is the inadequate development of the 'control' concept. If an effective standard is to result from the proposals, it is essential that this aspect be improved. In the ED, 'control' is the main driver for revenue recognition, so it is very important (a) that the concept is properly developed so as to lead to appropriate accounting and (b) that it is explained in a way that is clear and meaningful to preparers and users of the standard, particularly preparers of financial statements.
8. The ED attempts to deal with control by setting out a principle and listing four indicators. However, the intended meaning of the principle is not sufficiently clear and it is expressed in terms that preparers of financial statements may find very hard to translate into real situations. Further, the indicators are neither well developed nor well explained, and there is little or no guidance on the accounting that should be adopted when some, but not all, of the indicators are present. Whilst we do not advocate excessive guidance or prescriptive rules, which may add to complexity and difficulties in application in all cases - for such an important topic, more guidance will be required. Unless the standard is improved, it is likely to result in confusion and considerable diversity in practice. We note that it is particularly difficult to interpret the guidance in the context of contracts for services.

The allocation of discounts should not be mandated by the standard (Q7)

9. We agree with the Boards that the stand-alone selling price of individual performance obligations is an appropriate starting point for allocating the transaction price to performance obligations. However, we do not believe that the standard should mandate that discounts should similarly be allocated on the basis of stand-alone selling prices. Rather, judgement should be applied such that the allocation is made on the basis of the commercial substance of the arrangement as a whole.

The accounting for contract modifications should be driven by the underlying economic circumstances (Q1)

10. We do not agree that the effect of contract modifications that are price interdependent with the original should be recognised retrospectively in every case. Contract modifications occur for a wide variety of reasons, some of them purely forward looking. Where this is the case it would be anomalous for part of the effect of the modification to be allocated to previous periods, and it could lead to results that are distorted and lack meaning where the modification accompanies a material change in the cost structure. It would be preferable for the standard to require the application of appropriate judgment to ensure that the accounting reflects the underlying economic circumstances of the modification.

Revenue should not be recognised for amounts that the customer can choose not to incur (Q4)

11. Reasonable estimation may be possible for amounts of variable consideration that the customer can choose not to incur, such as royalties payable based on customer

usage. Paragraph 38 of the ED suggests that these could be recognised, but we do not believe that this is appropriate. The standard should preclude the recognition of revenue for variable consideration to the extent that the obligating event by the customer has not yet occurred.

Assessment of onerous features should be at the contract level

12. We strongly disagree with the principle in paragraph 54 of the ED that onerous contracts be assessed at the performance obligation level. Such an approach is not reconciled with the commercial substance of the underlying activity and could lead to the counter-intuitive situation where 'day one losses' are recognised on a profitable contract.

Guidance relating to warranties could be more clearly drafted (Q15)

13. As currently drafted, the guidance relating to warranties in paragraphs B13-B19 is unclear. In particular, we note that there is widespread concern that distinguishing between latent and post-sale defects will prove problematic in practice. We believe that the Board had in mind a warranty concept that was in fact relatively straightforward to apply and therefore we feel that the deficiency lies in the drafting of these paragraphs. We strongly suggest that the drafting be revisited to ensure that the warranty concept is articulated in terms that can be widely understood and applied.

'Exclusivity' is not an appropriate criterion for determining the pattern of recognition for revenue from intellectual property rights (Q16)

14. We do not agree that the pattern of revenue recognition from the sale of a licence should depend upon whether it has been granted exclusively. This is an arbitrary and unconvincing distinction. In particular, control of a 'right to use' has either been transferred or not, and this has nothing to do with whether the arrangement is exclusive. The example in B31-B39 should be re-visited, and it should be possible to apply the principles in the ED without this artificial distinction.

Revenue is inadequately defined

15. We believe that an appropriate definition of revenue is important for the effective interpretation of the standard. The current definition contained in appendix A of the ED is inadequate. Firstly, we believe that the term 'ordinary activities' does in fact encompass all activities and is therefore not meaningful. Secondly, we do not believe that the definition of 'income' allows users of the standard to determine what revenue actually is. Clarity on this key point is important.

Re-exposure should be considered if significant changes are made to the Exposure Draft

16. We are aware that in addressing cumulatively the points in this letter and those raised by other constituents, significant changes may be necessary to the current drafting of the ED. In light of this, we believe that it is desirable for the Board to assess the scale of change necessary, and if appropriate to consider re-exposure. We are conscious that the Board is facing timetable pressures for this project, but in view of its significance, would prefer the Board to take the time necessary to ensure that constituents have adequate opportunity to comment on revised proposals. Undue haste may lead to unintended consequences and criticism of the Boards' due process.

RESPONSES TO SPECIFIC QUESTIONS

Q1: 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 the 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?

17. We agree with the principle of interdependence as set out in paragraph 13 of the ED. As the draft standard focuses on the individual sales contract in assessing whether or not to recognise revenue, it is important that it contains a mechanism for determining when contracts should be segregated or combined and how to treat modifications. It should generally be possible, by reference to price lists or other evidence, to determine with reasonable objectivity whether prices are interdependent.
18. We feel that some clarification may be necessary in relation to paragraph 19. At present it refers back to paragraph 13, but does not make sufficiently clear whether it is referring only to the principle of interdependence or to both the principle and the indicators listed. We believe the intention is the former, because the indicators listed in paragraph 13 would seem to be of little or no assistance when assessing a modification. This could be addressed by splitting paragraph 13 into two paragraphs, so that the indicators are dealt with in a separate paragraph.
19. It may be particularly difficult to assess interdependence in the case of loss making contracts. If a company decides to enter into a contract which it knows at inception to be loss-making there is a commercial rationale underlying this decision, and an expectation that the loss will be recouped elsewhere. Where there is merely hope of a future profitable contract, there is no price interdependence at the outset, because that later contract does not yet exist. However, the guidance does not make clear, if a further profitable contract is subsequently obtained, whether, and in which circumstances, the later contract should be regarded as interdependent with the earlier contract. This may be particularly relevant, for example, when an entity has a contract in respect only of the initial stage of a project, and may or may not be awarded a contract in respect of subsequent stages. The pricing in the initial loss-making contract is likely to be interdependent with that applied to the further sales, if the later contract is obtained.
20. We find the intended interaction between paragraphs 13 and 14 unclear, and we suggest that the Board reconsiders the drafting of these paragraphs. In particular, paragraph 14 can be read as undermining paragraph 13, and it is not clear to what extent it can be used to 'overrule' paragraph 13.
21. More generally, we are concerned that the proposed approach may require too many contracts to be combined, over a long period of time. For example, if a contract allows a customer to make future purchases at a discount over a long period, those contracts are apparently interdependent, but it may be a considerable accounting burden to keep the accounting for the first contract open until the last purchases have been made. To simplify this, we suggest that where a contract grants a customer a valuable option to make future purchases, the seller should be allowed not to treat the contracts as interdependent and, instead, to allocate an appropriate amount of revenue to the

valuable option. That revenue would then be recognised on an appropriate basis over the option period, without having to make further adjustments as a result of the subsequent purchase contracts. We note that such an approach would be consistent with that currently required by IFRIC 13 *Customer Loyalty Programmes*.

- 22.** Finally in this context, we do not agree with the approach proposed in respect of modifications. Although acceptable where a modified contract is judged to be independent of the original, where this is not the case it may very often lead to inappropriate accounting. For example, it is possible that, some years into a multi-year contract, there may be a significant change (up or down) in the seller's direct costs, and the seller and customer may agree to amend the contract price to reflect this, but without rebasing the contract to market price. If the price charged to the customer for years 5 to 10 is higher (or lower) because the seller's direct costs for years 5 to 10 are higher (or lower), we believe the contract price adjustment should be allocated across years 5 to 10. The ED, however, would allocate the adjustment across all ten years, resulting in super-profits for some and possibly losses for others.
- 23.** The commercial reality is that contract pricing can be modified for many different reasons, and we do not believe it is possible to specify a single rule that can adequately capture all of these. Instead, the proposed standard should require judgement to be applied when dealing with contract modification so as to reflect the underlying economics of the modification. The Board could then illustrate how some common examples of contract modification might be dealt with, such as the situation described above.

Q2: 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?

- 24.** We agree in general with the principle in paragraph 23 of the ED for determining when a good or service is distinct. We believe that this is an important element of the draft standard and that it is essential a clear principle is established in this area.
- 25.** We note however, that certain aspects of criterion (b ii) lack clarity. It is difficult to interpret what the reference to 'distinct risks' could mean in practice and furthermore it is not clear that this additional criterion is actually necessary. The key determining factor here is utility, as expressed by (b i). Utility is a binary concept that should be capable of being determined with reasonable objectivity for most goods or services. It is not entirely clear why an additional criterion would be necessary in this test. The references to profit margin and resources suggest that it may be about reliable measurement but, if so, we disagree with its inclusion, because reliability of measurement is already adequately dealt with elsewhere in the exposure draft. Without further clarification, the inclusion of (b ii) risks introducing unwelcome subjectivity and confusion into this key area.
- 26.** In particular, we find example 11 unhelpful and unconvincing in illustrating the requirements of (b ii). It is unclear why contract management, site preparation and site finishing should be regarded as different from the other contract activities.

27. One of the consequences of the approach proposed is that it may be possible to unbundle an extremely large number of performance obligations in a particular contract. This might involve a great deal of accounting effort for relatively little benefit, particularly in estimating standalone selling prices for stages that are not sold separately in practice. We suggest, therefore, that the Board makes clear that an entity need only account for performance obligations separately to the extent that, overall, this will materially affect how revenue is reported. In particular, where a contract involves the continuous transfer of control it will only be necessary to account for stages of the contract separately if they might reasonably be expected to have very different margins.

Q3: 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?

28. No; we are concerned that the guidance in paragraphs 25-31 is not well enough developed, and not sufficiently clearly expressed, to allow in all circumstances an adequate assessment of when control has passed. We agree that revenue should be recognised on the satisfaction of performance obligations, and agree that a robust principle for the identification of when these obligations are satisfied is imperative. However, in the context of, for example, construction contracts or contracts for the delivery of services, control can be an imprecise concept and there is a danger that without improvement, the guidance as currently drafted may be difficult to apply. This could lead to it being interpreted in some circumstances in a way that appears inconsistent with the underlying economic substance of the transactions to which it is applied. Our preferred outcome would be principles which can be applied without undue cost or effort to simple transactions – and are therefore appropriate for SMEs - while providing guidance and examples sufficient to permit their application to more complex transactions.

29. Paragraph 30 of the ED lists four indicators of control but does not consider this list to be exclusive; neither does it consider one of these indicators in isolation to be sufficient nor even suggestive in concluding upon the transfer of control. In short the guidance appears to be insufficient to enable reasonably consistent judgements to be made. We believe it is important that a final standard should provide considerably more clarity on how the indicators relate to the control principle, including in relation to situations where some of the indicators are present but others are not. In practice the relevant factors are often not indicators *per se* but rather circumstances that accompany the transfer of control. There is a danger that readers of the standard, as currently drafted, may focus exclusively on the indicators, using them almost as a checklist. This would be inappropriate, particularly as indicators other than the four listed will often be relevant. Whilst we do not advocate excessive guidance or prescriptive rules, it is essential that the underlying principle is described in a way that is meaningful to readers, and that the indicators are clearly explained in the context of that principle.

30. Customer-specific products are a case in point. An example would be tooling constructed for a customer; if this is built on the client's premises the criterion in paragraph 30c may be met, and in conjunction with 30d may be sufficient to allow recognition. However, if construction takes place off the client's premises then only 30d may apply and recognition might be precluded. There is little difference in

substance between these two examples and under the current 'percentage of completion' method recognition is likely to be identical between the two.

- 31.** We also believe that the references in paragraph 30(a) to an unconditional obligation to pay need clarification. In particular, it is not clear whether or not the fact that a customer payment might subsequently become refundable should be considered. A contract may require a customer to make payments at certain stages, but some or all of those payments may later become refundable, perhaps in the form of damages if the supplier fails to honour its obligations. If such 'refundability' should be considered, then it will be very rare that the indicator in paragraph 30(a) will be met. An alternative approach might be to regard an unconditional obligation as existing if there is no course of action open to the customer that will avoid payment being required (with the question of the customer subsequently becoming a bad debt to be entirely separate). For a supply of relatively generic goods, it is often the case that the customer can cancel a contract at minimal or no cost because the asset can be sold elsewhere – thus the indicator would not be present in such circumstances. Conversely, for a supply of services, the contract will often require customer stage payments that relate to work performed to date, which would not be refundable if the customer sought to cancel the contract at a particular stage. In these circumstances, the indicator would be present. We would emphasise here that we are merely seeking clarity on what the Board means by an unconditional obligation, rather than calling for guidance on each and every eventuality.
- 32.** Similarly, it might be possible to express the intended meaning of paragraphs 26 and 27 and of indicator (d) in paragraph 30 more clearly, as illustrated by the following scenario. Suppose that a seller is manufacturing on its own premises an entirely bespoke item of equipment to a customer's design, with most of the payment to be made on physical delivery at the end of the contract. The customer has no contractual right to change the design but, in practice, if the customer wished to do so, the seller would be prepared to negotiate revisions to the contract. If the customer wishes to terminate the contract when work is part-complete, it can do so but will be required to pay in full for the work done to date and to compensate the seller for profits lost on the remainder of the contract. In the event of termination, the seller would have no alternative use for the 'work in progress' but, in practice, it would be scrapped rather than transferred to the customer. There might be various reasons for this; eg, the nature of the project might be such that, on termination, the customer would always prefer to start 'from scratch'; or there might be legal or regulatory reasons why 'work in progress' could not be transferred, such as for a device containing potentially harmful materials. Various different readings of the exposure draft appear possible here:
- The customer has control of the 'work in progress' asset, because it can in practice dictate whether work continues on that asset and becomes obliged to pay for work as it is done. The seller does not determine what is done to the asset – rather, the customer does.
 - The customer may have control of the 'work in progress' asset, for the reasons noted above, but only if it also has the right on termination to demand physical delivery of the part-complete asset. The fact that the customer would not generally wish to take physical delivery is not relevant in this assessment.
 - The customer may have control of the 'work in progress' asset, for the reasons noted above, but only if it also has the right on termination to demand physical delivery of the part-complete asset and would be likely to exercise that right if it terminated the contract. In other words, it is important that the customer would, in the event of termination, continue to 'build on the work done to date', rather than choosing to start again.

- The customer does not have control of the work in progress because it has neither physical possession nor title to the work done to date.

We believe that all the interpretations above are possible. Again, we would not advocate detailed guidance here, but would urge the Board to consider whether the clarity of the drafting could be improved to prevent undue diversity in practice when a final standard is issued. This example might equally apply to the provision of a bespoke service for which the seller has custody of 'work in progress'.

- 33.** We believe these difficulties and the potential complexities of application arise because of the inherent problems associated with drafting an accounting standard on revenue recognition focussed on 'control'. The concept has little natural meaning in this context, and the attempt by the Board to translate it into a principle in paragraphs 26 and 27 remains opaque in the context of services. This will mean that readers will focus instead only on the indicators of control, which may in some cases lead to inappropriate financial reporting. We recognise that the Board is committed to the underlying concept of 'control', but in developing the final standard it should translate the consequences of control into clear principles that have natural meaning in the context of goods and services. At the very least, the guidance on indicators (a) and (d) in paragraph 30 should be refined to provide greater clarity on the issues described above.
- 34.** Finally in this context, in order to reduce the risk of the indicators being used inappropriately as a checklist, we suggest the Board considers whether it can give more definitive guidance on whether certain combinations of indicators will demonstrate that the customer has control. We believe that the Board may be able to identify combinations that, in themselves, demonstrate that the customer has control under the Board's approach – for example, if the customer has both an unconditional obligation to pay and unfettered physical possession (in that, absent a breach of contract by the customer, such as failure to pay, the seller cannot demand return of the delivered items).

Q4: 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 proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

- 35.** We agree that revenue should be recognised where the transaction price can be reasonably estimated. We note that the language has changed from 'reliably estimate' in the discussion paper to 'reasonably estimate' in the Exposure Draft and that this lowers the bar for recognition. We support this change on the grounds that it improves consistency. Using reliability as a criterion may create a bright line distinction between two contracts with very similar economic substance; reasonableness conversely is more likely to result in a consistent treatment in such circumstances.
- 36.** We note that paragraph 35 requires the transaction price to be calculated as the 'probability-weighted amount of consideration'. Such an expected value approach follows that proposed in the recent consultation on IAS 37 *Provisions, contingent liabilities and contingent assets*. In our response to that consultation (ICAEW REP

46/10) we expressed some reservations with this approach. While we accepted that a reasonable approximation to actual eventual cash-flows could be made for large, homogenous populations, we felt that for smaller populations, particularly those with a high degree of variability, the expected value calculated could potentially be significantly different from the actual outcome.

37. These concerns are equally applicable to the current ED. We agree that an expected value approach can be applied in situations where the probable outcome can be reliably estimated (principally large, homogeneous populations). However, we would suggest that in the case of small populations, and particularly for large or unique items, the expected value approach will in many cases yield a value that is at some variance to the actual outcome, and which, therefore, does not seem appropriate as a basis for revenue recognition. In these cases, valuing the consideration by reference to an outcome that is actually possible would be preferable.
38. A further concern with the approach proposed is that we do not believe it is appropriate for a seller to recognise revenue for amounts that a customer can simply choose not to incur. An example would be royalties based on the level of customer sales if the customer can choose not to make those sales. Thus, we would distinguish between variability of consideration that is within the control of the customer and variability that is outside the customer's control.
39. Finally, we note that the ED is not at all clear on the matter of scope. When a seller has fully performed under a contract, it may nevertheless still be exposed to variability of consideration. We note that the variable amount receivable will meet the definition of a financial asset, but that the ED does not make it clear whether that amount is within the scope of the revenue or the financial instruments standard. We assume the former, but this should be made clearer. Moreover, if instead the latter is true, an explanation will be needed of how to deal with any difference between the carrying amount of such a receivable under the proposed standard and its fair value for the purposes of initial recognition under the financial instruments standards, since the latter will typically be higher.

Q5: 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?

40. We agree with the treatment in paragraph 43 of the ED in circumstances where credit risk is sufficient to influence the transaction price. In these circumstances the transaction in substance commonly represents two elements; i) the sale of the underlying good or service, ii) a loan. An example of this would be a business that retails motor cars or other capital items to individuals with poor credit records. In such a business, in addition to any finance charges, the retail price of the capital good itself may be inflated to compensate for the credit risk assumed. A reduction of revenue in these circumstances to reflect credit risk would be consistent with the economic substance of the transaction.
41. While we express some reservations in paragraph 37 about the use of expected value, these are less likely to be relevant in circumstances where credit risk influences the transaction price. Where a business routinely adjusts its pricing to allow for the credit risk of a customer the provision of credit is likely to be an important part of its business

model. In such a business the size and relative homogeneity of the population would commonly allow expected losses to be modelled to a reasonable degree of accuracy. Indeed, to most credit provision businesses the accurate assessment of expected loss is central to profitability.

42. We do not agree however that the transaction price should be adjusted for credit risk in situations where it has a negligible or nil effect on pricing. Such situations would encompass the majority of transactions on normal commercial credit terms. We do not believe that two entities selling identical goods for the same price should recognise different amounts of revenue simply because they have different (but generally creditworthy) customers. This point was also made in paragraph 16 of our response to ED/2009/12 (IFRS 9); ICAEW REP 60-10.

Q6: 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?

43. We agree that an adjustment for the time value of money is appropriate in circumstances where payment is made significantly in advance or deferred for a period beyond normal credit terms.

Q7: 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?

44. The principle in paragraph 50 of the ED may be applied usefully as guidance in situations where such an allocation is consistent with the underlying economic substance of the transaction. However, this is not the case for all transactions. Therefore we would only support the principle as a rebuttable presumption.
45. In many situations certain items are more commonly sold as a package than individually. The margins made on the individual items may vary considerably from item to item, and when they are packaged together the seller may be much more likely to grant significant discounts on the high-margin items than on the low-margin items. The bundling of a high-margin software licence with lower-margin services is a common example of this. Allocation in proportion to stand-alone selling prices in these circumstances may be simple to apply but would not reflect underlying commercial substance. Allocation in this way could even lead in some cases to an artificial loss being recognised at certain stages of a project, because too large a discount had mechanically been allocated to low margin items; this would be misleading. Therefore an option should be available to make the allocation on another basis if this is more appropriate.
46. However, we would prefer the proposed standard not to mandate how discounts should be allocated between items. Instead, we would require standalone selling price to be the starting point for allocating revenue to an item, but would then require an entity to use judgement to allocate any overall discount on a contract between items in a way that reflects the economic substance of the arrangement as a whole. This allocation would take account of any normal or ongoing discounts available to the

customer in respect of particular items. Where the level of discounts is significant, an entity would be required to explain the approach taken to allocation.

Q8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 380; 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?

47. We support the proposed treatment in paragraph 57 of the ED. However, we question whether the drafting of paragraph 59(a) is sufficiently clear. It seems to us that it is intended to preclude the capitalisation of amounts paid for services such as selling and procurement. However, it might also encompass the direct purchase of a contract from another party. If a company purchases a contract directly from another party, we do not believe the amounts paid to obtain the contract should be expensed as they would be likely to meet the capitalisation criteria in IAS 38.
48. Finally, we believe the interaction of paragraphs 57 and 59 with regard to pre-contract costs should be made clearer. Paragraph 57(a) explicitly states that costs relating to a contract under negotiation may be capitalised if the conditions (a) – (c) are satisfied. However, paragraph 59 (a) then goes on to state that the costs of obtaining a contract must be expensed, including ‘bid and proposal’ costs. We believe that the Board’s intention was for paragraph 59 (a) not to extend to pre-contract costs that relate to the fulfilment of the contract (such as producing a prototype or a design that also has utility post contract signing). This intention should be stated more clearly.

Q9: Paragraph 58 proposes 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?

49. In our view, paragraph 58 (c) is unclear. The paragraph attempts to draw a bright line distinction between general overheads and shared costs that may be directly attributed to the contract. In practice the distinction is often ambiguous. An example is given of ‘contract management costs’, a wide range of items may fall under this heading and it is unclear which would be allowable, indeed ‘management costs’ commonly encompass all manner of overheads. Similarly the example is given of ‘depreciation of tools and equipment used in fulfilling the contract’, in this case a parallel could reasonably be drawn with the costs of leasing a building within which the contract is to be developed.
50. We strongly disagree with the requirement in paragraph 54 that onerous contracts be assessed at the individual performance obligation level. This does not reflect commercial reality and would be extremely impractical to apply; indeed the Board should be aware that repeated calls for additional guidance are likely to result. When entering into a contract, businesses are likely to consider profitability in the round, and not in terms of individual performance obligations. As a result of this artificial allocation

a situation is possible where a loss must be recognised at inception for a contract (or where contracts have been combined in accordance with paragraphs 12–19, for a group of contracts) that will be profitable overall. This is counter-intuitive; it is not clear what is being represented in the accounts by the recognition of a loss in one period when the expectation is that cumulatively the future result will be a profit. An entity that has just signed such a contract is in a stronger position than it was before; it is rather perverse therefore that its effect would be to reduce net assets. This treatment is particularly problematic for the low margin items that we describe in paragraph 45.

Q10: 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?

51. We agree that users are likely to welcome the enhanced disclosure requirements contained in paragraphs 69-83 to the extent that these facilitate a better understanding of revenue related risk. We particularly support paragraph 77, which requires the provision of various narrative information concerning performance obligations. Such information is currently commonly included in narrative reports, but as the requirements in this regard are often less prescriptive, and are in any case not contained within IFRS, we feel that mandating in the notes to the accounts would strengthen the requirement.
52. Some aspects of the proposed disclosure package however are inherently subjective and therefore may not provide useful information to users, other aspects are likely to prove problematic in practice due to their commercial sensitivity.
53. The reconciliation proposed in paragraph 75 is a particular concern due to the commercial sensitivity of the information that would be disclosed. At the level of mainstream IFRS this is likely to be less of an issue as equivalent information is often provided voluntarily by larger companies as part of narrative reporting. However, smaller entities are less accustomed to making such potentially commercially sensitive disclosure. We would therefore urge the Board to consider whether it is appropriate to omit this requirement from the condensed disclosures of the IFRS for SMEs.
54. It should also be noted that the forward looking information in paragraph 78 could prove particularly difficult to prepare and audit. We do not support mandating this information in the revenue standard and believe it would be better placed as management commentary, outside the IFRS financial statements.
55. Therefore we would suggest a moderate relaxation in the current level of mandating. Rather than a template of required disclosures we feel that the focus could more usefully be on the objective in paragraph 69; allowing greater flexibility in how that objective was met. The disclosures in paragraphs 73 to 83 could then be presented as suggestions, strengthened by an over-arching rebuttable presumption that each of these disclosures will be made unless individually impracticable or of disproportionate cost.

Q11: 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 the proposed disclosure requirement? If not, what if any, information do you think an entity should disclose about its remaining performance obligations?

56. We agree that the disclosure proposed in paragraph 78 would provide useful information for users. However, we believe that application will be problematic for those companies with a large number of small contracts. It should be noted that this information is forward looking and therefore may not be contained within financial systems. In some cases it may prove extremely difficult, and costly, to gather the information required to make the disclosure. Auditability is also a concern. Therefore we do not support the mandating of this disclosure within the revenue standard; we suggest that it would be better encouraged as a disclosure in the front-end of the accounts as management commentary.
57. In addition, we believe that there is a lack of clarity in relation to amounts that could be subject to change or termination. For example, a telecoms company may have many contracts with customers that can be terminated by the customer at relatively short notice and for no compensation. Those contracts will also typically include fixed and variable elements (e.g. line rental and calls, respectively). It is unclear whether the disclosure should reflect (1) only contracts that cannot be terminated without compensation, (2) the company's estimate of the proportion of contracts that will not be terminated or (3) all contracts. Similarly, it is unclear whether disclosure should include only the minimum (fixed) amount specified under a contract or also an estimate of the variable amount that customers are likely to request.

Q12: 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?

58. We agree. Disaggregated revenue data provides useful information to users and therefore we agree that it should be mandated in IFRS. We note that the provision of segmental information is addressed in IFRS 8 *Operating Segments*, and would not welcome duplication with the requirements of this standard. However, IFRS 8 is not mandatory for all companies applying IFRS and therefore we recognise the case for separate inclusion of a disaggregation requirement within the revenue standard. We do though suggest that a stronger link be established between the two standards. At present a different disaggregation principle and terminology is employed by the ED when compared with IFRS 8. Greater conformity could be achieved.

Q13: 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 period presented)? If not, why?

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

59. We agree that the requirements should apply retrospectively, otherwise comparability will be impaired during the transition period. However, the practicality of retrospective application will depend upon the profile of contracts that a company has. For those

companies with contracts that span several years, the re-examination of these contracts to determine the effects of adoption is likely to be an extensive exercise. Therefore we would welcome an extension of paragraph 85, acknowledging that significant estimation may sometimes be required in full retrospective application, that this is acceptable and that, where it is significant companies should disclose the approach they have taken in determining the retrospective amounts.

60. It should also be noted that the burden of transition may be greater for smaller companies who may lack the sophisticated systems and other resources necessary to provide the necessary information. Therefore, as and when the requirements are incorporated within the IFRS for SMEs it may be desirable to offer a longer transition period than that provided in the new IFRS on revenue recognition.

Q14: 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 proposals operational? If not, what additional guidance do you suggest?

61. In comparison to other IFRSs, the ED contains extensive application guidance. However, we are mindful that in the context of US GAAP the ED represents a considerable condensation. We also note that the complex nature of the subject is likely to necessitate detailed guidance. Therefore we are generally comfortable with the scope of the additional guidance provided. In fact we are conscious that given the complex nature of the subject there are some areas where further guidance would be helpful – one example being contracts for the provision of services. In addition, we do have some specific comments on certain examples as set out below:
62. Example 11: We have set out in paragraph 26 above our concerns regarding example 11.
63. Example 14: here an entity ends up with half of an asset on its balance sheet, a situation that appears counter-intuitive. This is a helpful illustration of our point from paragraph 39 above concerning the inappropriateness of expected value for small or heterogeneous populations. The entity in the example does not actually have an asset of CU35,000; it either has an asset of CU70,000 or of CU Nil. Unlike the large homogenous population where the final result may reasonably be expected to resemble the expected value, in this case the asset value recognised is substantially different from any possible final outcome. If our suggestion in paragraph 37 is heeded then it will be desirable to revise example 14.
64. Example 23 – this example indicates that a product placement service is judged to be distinct from an associated supply of goods. We question whether this is an appropriate view. Such product placement may be expected to increase sales of that product, but only in the store in question – so the directly associated revenues will flow to the reseller, not to the supplier. There may be a further benefit to the supplier if, as a result of higher sales, the reseller places an order for further goods. However, the benefit to the supplier in that case is captured entirely by the new supply contract – it translates into cash received for goods. Accordingly, in these circumstances, we do not believe that product placement is a distinct service, and we do not believe it would have any stand-alone value. In our view, the principles set out in the ED would require slotting fees to be accounted for as a discount on the original sale of goods.

Q15: 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 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?

- 65.** We do not agree that entities will find it straightforward to apply this distinction in practice. Although, at the extremes, there will be some defects that are clearly latent and others that clearly arise after product transfer, many defects in between will be difficult to categorise. For example, if a part would normally last for at least three years, but fails unexpectedly after two years, it will be difficult for an entity to determine whether that was due to a latent defect.
- 66.** However, given the accounting proposed by the ED, we question whether the distinction is, in fact, necessary. Although question (a) above states that a warranty for latent defects does not give rise to a performance obligation, this appears misleading: the accounting required by paragraph B15 of the ED appears essentially the same as if a warranty for latent defects does give rise to a performance obligation. Specifically, an amount of revenue is deferred to reflect the remaining performance required under that warranty. This might involve replacement of the entire product (in which case all revenue is deferred). However, if only repair is required, B15 requires revenue to be deferred for the portion of the transaction price relating to the repair. For a supply of standard off-the-shelf goods, where it is judged that control passes to the customer at a point in time, it seems to us that the accounting required by B15 can only be consistent with the principles set out in the ED if, in fact, that repair is regarded as a separate performance obligation.
- 67.** Accordingly, it seems to us that, for both types of warranty, the ED proposes that revenue should be deferred in an amount that reflects the future value to be delivered to the customer. Referring back to our opening example, for the part that fails after two years, revenue should be deferred to reflect the value of the part itself and any labour and other costs associated with its replacement. This appears to be true irrespective of whether there was a latent defect. It seems to us that the only significant difference between the types of warranty is that, in practice, it will sometimes be possible to observe directly a stand-alone selling price for a warranty that covers non-latent defects (since this will often be an 'extended warranty' that a customer can choose whether or not to purchase). This is less likely to be possible for a warranty for latent defects, and therefore we suggest that for such warranties stand-alone selling price should be estimated by reference to expected direct costs plus an appropriate margin.

68. For both types of warranty, we agree with the ED that revenue should be deferred. In both cases, it seems to us that there is an outstanding performance obligation to be satisfied. Accordingly, if the distinction between the types of warranty is in practice unnecessary, we encourage the boards to remove it, so that preparers do not incur unnecessary time and costs in classifying warranties. Conversely, if the distinction is important for the accounting, the consequences of the distinction need to be better explained.

Q16: 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 terms 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 it 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?

69. We do not agree that exclusivity is the correct criterion for determining the pattern of revenue recognition. Exclusivity represents a bright-line distinction that may not be reflective of the performance obligation pattern of the underlying contract. Further, criterion A appears to be artificial. A supplier may or may not have an ongoing performance obligation, but does not necessarily have one just because an exclusive licence has been supplied.

70. An appropriate solution, in our view, would be to align the accounting with the pattern of obligations the supplier has in relation to the licence. Where it merely needs to be supplied at a discrete point in time with no further support, maintenance or other requirement, then all performance obligations may be deemed to have been met on supply. However, where the vendor retains ongoing responsibilities, it would be appropriate to recognise these as separate performance obligations and to defer revenue accordingly. We understand that thinking from the leasing Exposure Draft has informed the process of drafting these proposals. We note that this thinking has since been developed further and the Boards will therefore wish to revisit the drafting in this area to ensure consistency.

Q17: 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?

71. We agree. The proposed revenue recognition model should be equally applied to the sale of those non-financial assets covered by other IFRSs. The cross references in IAS 16 *Property, Plant & Equipment* and IAS 38 *Intangible Assets* currently to the sale of goods could effectively be updated as a consequential amendment arising from adoption of revenue recognition standard.

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