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Via email : commentletters@ifrs.org



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Dear Sir David

Exposure Draft: Revenue from Contracts with Customers

We welcome the opportunity to comment on the joint IASB and FASB exposure draft (ED) and support the IASB in its efforts to draft a new revenue recognition standard to replace the existing IAS 11 and IAS 18 moving towards a truly international standard which can be adopted across the globe.

Our responses to the questions raised in the Exposure Draft are set out in the Appendix to this letter.

Whilst we are generally supportive of the move towards a principles based standard, and congratulate the IASB on its work so far, we are concerned at the length of some of the principles, and more importantly whether the fundamental question of what revenue is has actually been asked and answered. We note with interest the draft response from EFRAG which proposes an entirely different model. Whilst we would support an activity based model over a purely contract driven model, we consider that with some limited amendments and guidance the control model as proposed would be a suitable basis for revenue recognition under contracts. To this end, we would encourage the board to consider further guidance to explain how the “continuous transfer” approach would be used in practice as we feel there is a lack of guidance for the most judgemental areas such as construction contracts and service contracts which can cause the most difficulty.

We also question whether a revenue recognition standard is the most appropriate place to include criteria for the recognition of an asset – it would be more suitably included in IAS 2, given that the principles have wider application than revenue recognition. Alternatively, the standard could be renamed as “Accounting for contracts with customers”.

If you wish to discuss anything further please do not hesitate to contact me.

Yours sincerely

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As a general point, and notwithstanding that we consider the examples can prove useful, we are concerned by the large number of examples which are included in the application guidance which forms part of the standard. Clear principles should be understandable, and the use of numerous examples should not be an alternative to a well written, principles based standard.

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?

We agree with the overall principle that contracts should be segmented or separated, however believe that using 8 or 9 paragraphs to determine a principle is of itself evidence of an unclear principle. We would encourage the board to consider a principle which reflects economic reality and commercial substance without setting "rules" of price interdependence which may set thresholds or targets for entities to meet in order to obtain a given accounting result.

For example, UK GAAP contains clear guidance in this area, where separation is the result of the goods or services being capable of being supplied independently and a fair value being attributable to each element.

We also have concerns over the consistency of the examples, in particular, example 2 in the application guidance could be misinterpreted and would suggest clearer explanation is provided to explain why the existence of the discount means that the services are interdependent given the guidance in paragraph 14 of the ED. We presume (and therefore would request clarification) it is because of the size of the discount given rather than the giving of the discount itself. If an entity typically allows a customer a discount then we consider that doesn't necessarily mean that in the contract under review that the discount was given because of the combination of products/services and that they must therefore be interdependent.

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?

We generally agree with the principle that distinct elements should be separately accounted for. However in determining whether elements are distinct, we believe that the accounting treatment should reflect the entities own business model and the commercial substance of a transaction rather than the business practices of other entities as envisaged by paragraph 23.

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?

On the basis that the IASB and FASB are moving towards an asset/liability model we would support the use of "control" in determining the transfer to a customer. However we have concerns that this principle places too much reliance on whether the customer has gained control over the good or service, whereas we consider the test should be from the reporting entities perspective. Whilst we accept this may provide the necessity for more judgement to be involved we consider the risks of manipulation to be outweighed by the benefits of reliable financial statements which accurately reflect the commercial substance of an entities transactions.

We would encourage the Board to develop the continuous transfer model further to ensure that service based contracts and those that are for the construction of substantial assets are adequately reflected in the financial statements as activity progresses against the contract. We would seek clarification as to the point at which control passes to the customer for an asset that takes time to complete, or a service to deliver. We consider there are currently different ways to interpret the standard and whilst we do not consider that it was the IASBs intention to dispense with the percentage completion or continuous transfer of goods or services methods which are currently used this may be an unintended consequence and we would therefore encourage the board to develop separate guidance under the same principles for services and similar contracts. We would also encourage the Board to consider whether "control" is necessarily be the best terminology to use in this regard. Furthermore, in terms of continuous transfer we do not consider the need for milestones or cash payments to determine a stage of completion, however we do agree they can be indicators that the contract activity is progressing to plan, and hence the entity is satisfying the contractual conditions, and so the recognition of a receivable meets the framework definition of an asset.

We would encourage the IASB to consider whether the asset/liability model produces decision useful information. To that end, a discussion on what revenue is to represent would be useful. We note with interest appendix 3 of the EFRAG draft response which supports an

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activity based model. However, we encourage the IASB to achieve similar outcomes from the asset/liability approach without substantial redrafting being required.

Measurement of revenue (paragraphs 34 – 53)

Question 4:

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

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

We generally agree with the proposal, however have some concerns over the use of probability weighted averages in certain situations. We do not consider that the standard requires to be prescriptive in this regard, instead we would be supportive of the accounting of such items reflecting the economic reality of each transaction. This may be the method suggested for refund obligations or returns in a retail business, or may instead be the use of a most likely outcome or best estimate, which would be more suitable when dealing with a small number of large contracts where the outcome of each contract should be assessed individually.

Notwithstanding the above, there is a typographical error in paragraph 40 - "entity's" should be "entity".

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?

We disagree with the proposal. We do not consider that customer credit risk should generally be included in a measure of revenue, and that it would be a rare occurrence for an entity to provide a supply to someone and not expect to be paid. The exceptions to this are similar to those included in UK GAAP, FRS 5 Application note G para G9, where at the time of supply the expectation is that the entity will not recover its costs. In addition we consider that revenue should be adjusted where credit risk of the counterparty is reflected in the pricing structure of the entity, for example in High Street Stores providing goods to customers with a poor credit rating the selling prices are often inflated to reflect the collectability risk.

As another example we would expect utility companies to measure revenue at the amount provided to customers it knows should pay, as by law they may need to provide supply to people that it knows will be unable to pay.

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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 agree with the proposal.

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone 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?

We agree with the overall principle of allocating the transaction price to all separate performance obligations, and at initial recognition the use of the transaction price may reflect the economic reality. However, we would encourage the board to consider a model which allows preparers to reflect the economic substance of a multiple element contract instead of setting a prescriptive and arbitrary methodology which may have unintended consequences. We also consider that accounting for future changes should reflect the relevant facts and circumstances at that time. We note that this will entail management estimation and judgment, however we consider that this will result in more meaningful reporting than the current proposal.

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), and 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?

Notwithstanding our opinion that requirements regarding these costs are satisfactorily covered in IAS 2 etc rather than this revenue standard, we generally agree that only those costs which meet the definition of an asset under the framework should be recognised when incurred. However we envisage situations that pre-contract costs will meet this definition, so would encourage the Board to consider amending paragraph 59(a) to allow capitalisation where costs will be reimbursed where the contract is unsuccessful.

Question 9: 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?

We agree that an entity should capitalise contract costs based on the method suggested. Similarly, an entity should determine whether a contract is onerous based on the full direct costs.

We do not agree with the proposal to require the use of the probability-weighted technique for the costs in performing the “onerous test”.

Furthermore we do not agree with the proposal to require the “onerous test” at a performance obligation level as this could result in recognition of a provision for an onerous performance obligation within an overall profitable contract, which would simply not reflect the economic reality of the contract.

Disclosure (paragraphs 69 – 83)

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?

We generally agree that the proposal will meet the objective, however we have some concerns that the proposed reconciliation may be onerous or too prescriptive.

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

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

We agree with the proposal

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?

We agree with the principle of disclosure about the principle revenue streams however we have concerns that this may add unnecessary clutter when similar requirements are contained within IFRS 8, and perhaps an amendment to this standard would be more suitable for the additional disclosure envisaged.

Effective date and transition (paragraphs 84 and 85)

Question 13: Do you agree that an entity should apply the proposed requirements retrospectively (i.e. 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 lower cost? If so, please explain the alternative and why you think it is better.

We agree with the proposal.

Application guidance (paragraphs B1 – B96)

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

As already noted in our covering letter we generally think that where the standard is unclear this should be addressed by clarifying the principles rather than by way of application guidance. However, we are aware that it may be necessary to include some guidance to address industry-specific issues, and would welcome further guidance (and examples) on construction contracts.

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

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

We generally agree with the proposed distinction between the two forms of warranties. We do however consider that in calculating its provision and decrease to revenue the entity should consider how it expects to address the latent defect i.e. by repair, refund or replacement and that method should determine the amount of revenue deferred or indeed whether a provision for costs is required – i.e. if by repair or replacement then an amount should be provided to cover the costs expected to be incurred consistent with IAS 37 (as it is probable that an outflow of resources will occur); if by refund then provision should be made

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for the refund of the selling price of the product (akin to a credit note provision for returned faulty items).

Appendix C and the example in paragraph 39 of IAS 37 and paragraph 24 (which refers to a provision for costs in respect of product warranties) may require amendment if revenue is deferred for all warranties under the new revenue standard rather than provision made for costs. If revenue is deferred for latent defect warranties because the entity on evaluation of whether it has performed its obligations decides that it hasn't then presumably a provision for warranty costs ceases to be an issue because the revenue is deferred until the period in which the repair/rectification costs are incurred?

Finally, we consider that the reference to 'performance obligation' in the explanation of a latent defect warranty could be confusing. Specifically, the ED explains that such a warranty is not a performance obligation but then requires an evaluation as to whether the entity has performed its obligations in deciding when to recognise revenue. We would suggest that another form of words is chosen to avoid confusion.

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 license; and**
- (b) if an entity grants a customer a non-exclusive license 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?

We consider that the principle in paragraph 32 of the ED - continuous involvement - should be the overriding factor. We do not consider that exclusivity bears any reflection on the economic reality of the situation where the entity has performed its obligations under a contract, and therefore has entitlement to income. We note the discussion in BC 223(b) however consider the logic to be flawed since for rental or leasing companies, the exclusivity is not an overriding factor in leasing equipment or vehicles which are effectively homogenous.

We would support further consultation on this topic.

Consequential amendments

Question 17: The boards propose that in accounting for the gain or loss on the sale of some nonfinancial 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?

We agree with the proposal.

Non-public entities

Question 18 [FASB ONLY]: Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organisation)? If so, which requirement(s) and why?

Not applicable.