Department of Treasury and Finance

The Treasury Building
21 Murray Street, HOBART, Tas 7000
GPO Box 147, HOBART, Tas 7001 Australia
Telephone: (03) 6233 3100 Facsimile: (03) 6223 2755
Email: secretary@treasury.tas.gov.au Web: www.treasury.tas.gov.au

Tasmania

LETTER OF COMMENT NO. 60

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir David

DISCUSSION PAPER: *PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS*

Thank you for the opportunity to comment on the International Accounting Standards Board's Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers.*

The Heads of Treasuries Accounting and Reporting Advisory Committee support the Board's proposals as they attempt to achieve greater consistency in reporting of revenue. However, HoTARAC has several concerns.

In response to the specific questions raised in the Discussion Paper, HoTARAC offers comments on six matters:

- adopting a substance over form approach (Question 1);
- recognising non-contractual revenue (Question 1);
- recognising increases in agricultural and similar inventories (Question 1);
- losing control of an asset (Question 8);
- timing of revenue recognition (Question 8); and
- determining stand alone selling prices (Questions 12 and 13).

Adopting a substance over form approach (Question 1)

The proposed revenue recognition model, being based on contractual arrangements, appears to adopt legal form over economic substance. Paragraph 4.19 notes that legal differences between jurisdictions can create substantive economic differences between two similar contracts. The proposal contains no other discussion on the economic substance of transactions.

HoTARAC considers that any revenue recognition model should be explicitly founded on the economic substance of transactions. The *Framework for the Preparation and Presentation of Financial Statements* notes the importance of accounting for and presenting transactions in accordance with their substance and economic reality and not merely their legal form (paragraph 35).

Paragraphs 4.49 to 4.58 of the Discussion Paper use a painting contract to illustrate the case of sequential performance obligations, such as supplying an asset (paint) before supplying a related service (painting). The Board proposes a rebuttable presumption that an asset that is used in satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation (paragraph 4.56). That presumption would be rebutted if the terms of the contract, or operation of law, clearly indicate that the asset has been transferred to the customer before it is used in satisfying the other performance obligation (paragraph 4.57).

HoTARAC agrees with the proposal in paragraph 4.56, that the substantive performance obligation in the painting contract is to paint the customer's property and that revenue would normally be recognised only after that performance obligation is fulfilled. However, under the proposed rebuttal conditions in paragraph 4.57, revenue recognition could be manipulated. The legal form of the contract could subvert the economic substance of the transaction. Further, because the proposal only deals with revenue and not expenditure, there is potential for the supplier's revenue recognition to be manipulated without affecting the customer's expenditure recognition.

Assume that the contract specifically provides that the paint transfers to the customer's control before the painting starts, but that payment is not due until after the painting is satisfactorily completed. Under the proposal, the supplier might recognise revenue when the paint is transferred. This would be in accordance with the form but not the substance of the contract.

Moreover, the customer might defer recognising expenditure until the painting is completed, in accordance with the substance of the transaction.

The legal form of a transaction might be used to manipulate the timing of transfer of control and consequent revenue recognition. Transactions can be structured to achieve desired accounting outcomes. The existence of two parties to a contract does not necessarily prevent this, especially where one of the parties is monopolistic or otherwise dominant or where the other party is indifferent to, or misunderstands, the timing of transfer of control.

HoTARAC is concerned that a Standard based on the legal form rather than the economic substance of a transaction may allow entities to structure transactions to achieve particular outcomes that may not reflect the economic reality. HoTARAC notes that the IASB's recent ED 10 *Consolidated Financial Statements* is also attempting to address substance over form issues that have arisen in relation to control of entities. Recent history gives many examples of transactions that have been structured in a particular legal form so as to hide the real economic substance. This proposal does little to address this issue.

HoTARAC considers that revenue should be recognised in accordance with the substance rather than the form of a transaction and that the substantive transfer of control should be recognised consistently by both parties.

Recognising non-contractual revenue (Question 1)

HoTARAC is concerned that the proposed model ignores revenue that arises from sources other than contracts with customers.

The *Framework for the Preparation and Presentation of Financial Statements* states that income encompasses both revenue and gains and that revenue arises in the course of the ordinary activities of an entity (paragraph 74). HoTARAC notes that such revenue is not restricted to that arising from contracts with customers.

In addition, IAS 18 *Revenue* deals with some revenues that do not necessarily arise from contracts with customers, e.g. interest, royalties and dividends. A borrower, deposit-taker, or dividend payer is rarely considered to be a customer of the interest-recipient or dividend-recipient. Royalties can sometimes be statutory rather than contractual.

In proposing a "single revenue-recognition model" based on contracts with customers, the Discussion Paper views revenue more restrictively than the *Framework* and IAS 18 do.

Separately, HoTARAC notes that the ordinary activities of many public sector entities, and governments as a whole, give rise to significant, non-contractual revenues from taxes, fines, fees and grants. Contract-based revenue is often insignificant. Therefore, present public sector revenues would largely fall outside the proposed revenue-recognition model as the recipient has no contract, no customer and no performance obligation. This may preclude public sector entities from classifying most of their income as revenue.

HoTARAC acknowledges that the IASB and FASB have not completed their deliberations on the scope of a general revenue recognition standard. However, HoTARAC urges the Board to avoid defining revenue so narrowly that it can only arise from contracts with customers. The Board also needs to articulate the principle to be applied to revenues presently covered by IAS 18 but that do not arise from contracts with customers.

Recognising increases in agricultural and similar inventories (Question 1)

Paragraph 6.15 of the Discussion Paper notes that increases in agricultural and similar inventories can presently be recognised as revenue before those inventories are sold. It also notes that, because of the absence of a customer contract, this would not comply with the proposed revenue recognition model.

In paragraph 6.16, the Board states that it does not intend to change how inventories are measured. However, it acknowledges that it needs to consider whether such increases should be treated as another form of comprehensive income rather than revenue.

HoTARAC considers that the Board should be explicit on the treatment of income from increases in agricultural and similar inventories. The Board should either specifically exclude the matter from the scope of the proposal, or specifically include it within the proposal and address it fully.

Losing control of an asset (Question 8)

The proposed model requires an entity to recognise revenue from the sale of an asset (a good or a service) when it transfers (i.e. loses) control of the asset. Paragraph 4.10 distinguishes between transferring control and transferring the risks and rewards of ownership and notes that, in some cases, those notions do not coincide. Consequently, the proposal avoids using the risks and rewards of ownership as an indicator of control.

HoTARAC agrees that loss of control is the fundamental principle for determining when to derecognise an asset and to recognise the associated revenue. This conforms to the *Framework for the Preparation and Presentation of Financial Statements*. However, HoTARAC considers that having the significant risks and rewards of ownership of an asset evidences an entity's control of the asset. Therefore, losing the significant risks and rewards indicates loss of control. IAS 18 *Revenue* presently incorporates this principle.

IAS 17 *Leases* and IAS 39 *Financial Instruments: Recognition and Measurement* also approach asset recognition or de-recognition on the basis of risks and rewards of ownership.

Paragraphs 4.11 to 4.13 of the Discussion Paper examine the case of goods returnable at the customer's option during a certain period after purchase. Paragraph 4.13 asserts that control transfers on delivery of the goods but that risks of return and consequent reduced value do not transfer until the return period expires. Therefore, control is said to be distinguishable from the risks and rewards of ownership of the goods.

However, HoTARAC suggests that the proposal should acknowledge that loss of control of an asset may be evidenced by the loss of the risks and rewards of ownership of the asset.

HoTARAC is not convinced by the example in the Discussion Paper, for three reasons:

(a) Arguably the transaction has two components, the sale of a good and the sale of a repurchase warranty for the return period. The risks and rewards of ownership of the goods transfer to the customer immediately. This is also when control transfers. However, an equivalent warranty obligation (expense) immediately arises and remains for the duration of the return period, whereupon it is reversed.

(b) The retained risk (of return and consequent reduced value) may, based on past experience, be insignificant. Control may transfer when the significant risks and rewards of ownership transfer, as per IAS 18.

(c) It is also arguable that the risk of return (and consequent reduced value) is not even a risk of ownership. Such risk is vendor-specific and, although it may diminish to zero, it can never be transferred. It can never be part of the customer's risks and rewards of ownership. Such a vendor-specific risk is a contingent liability arising from the contract itself rather than from ownership of the goods.

Timing of revenue recognition (Question 8)

HoTARAC requests that the Board provides more analysis of, and guidance on, the timing of revenue recognition under the proposed model.

For example, it is unclear whether recognising revenue progressively on a straight line basis would be acceptable under a long-term service contract. Arguably, where the provider continuously performs a service, or continuously stands ready to perform a service, it would be appropriate to progressively recognise the revenue on a straight-line basis. Alternatively, it might be argued that revenue should not be recognised until the entire service is delivered. Despite some examples in Appendix A and a passing comment in paragraph 4.38, this issue is not examined at all in the body of the Discussion Paper. HoTARAC considers the timing of revenue recognition under service contracts to be a significant issue of principle that warrants analysis in the Discussion Paper.

Moreover, in the simple painting contract discussed in paragraphs 4.49 to 4.58, the timing of revenue recognition is also open to debate, depending on whether the contract or operation of law is considered to rebut the suggested revenue recognition principle. If the treatment of such a simple contract is arguable, it is questionable whether the proposed revenue recognition principles can be consistently applied in practice.

The Appendix to IAS 18 *Revenue* presently gives numerous practical examples to illustrate the timing of revenue recognition in various transactions. Such examples are more comprehensive than those given in the proposal.

Therefore, HoTARAC suggests that similar examples be given in the proposal to illustrate the application of the revenue recognition principles. HoTARAC also suggests that the issue of continuous recognition of revenue from service contracts be explicitly discussed in the body of the proposal.

Determining stand alone selling prices (Questions 12 and 13)

Paragraphs 5.43 and 5.46 propose that the transaction price be allocated to non-concurrent performance obligations on the basis of the entity's stand-alone selling prices of the goods and services underlying those obligations. Where the goods or services are not sold separately, the entity would need to estimate the stand-alone selling prices.

HoTARAC acknowledges that price allocation is necessary but considers that estimating stand-alone prices may often be impracticable, risky and unverifiable.

Goods and services can be sold as a package with no clear prices for the components. Sometimes, if the components are also sold separately, the price of one component may cross-subsidise another. Sometimes one component is purportedly free. Unbundling such transactions may be difficult when prices are not easily determinable or when the prices do not reflect the underlying cost of the performance obligation.

Estimating prices that do not routinely exist may result in manipulation to favour earlier recognition of revenue.

It may also be difficult for auditors to independently verify such estimates.

HoTARAC considers that price allocation is a fundamentally important issue that needs to be clarified. HoTARAC therefore recommends that the Board deliberates further on price allocation with a view to developing a more robust approach.

HoTARAC supports the other proposals in the Discussion Paper.

Please contact Robert Williams from the New South Wales Treasury on 612 9228 3019 if you wish to discuss these matters further.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

24 April 2009

Encl

Contact: Craig Jeffery
Phone: (03) 6233 3638
Our Ref: BH/CJ 09/62566