
Memo



FirstRand Banking Group

Group Finance : Technical Accounting

To: International Accounting Standard Board (“The Board”)
From: Technical Accounting
Date: June 2009

COMMENT LETTER: PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

1 Introduction

We thank the Board for the opportunity to comment on the Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (the discussion paper).

In general we support the Board’s initiative to develop a single revenue recognition model for contracts with customers and to eliminate the inconsistencies in the current revenue recognition models in *IAS 18 Revenue* (“IAS 18”) and *IAS 11 Construction Contracts* (“IAS 11”).

However as detailed in our response to Question 2 it is our view that insurance contracts have elements which are so fundamentally different to other contracts with customers such as discretionary participation and unit linking features that a different standard is warranted. We further believe that the scope exemption should apply to all insurance contracts and all elements of insurance contracts and there should be no split between the insurance contracts in the scope of the new insurance standard and the new revenue standard. We believe that such a split may result in unnecessary and arbitrary distinctions between the two standards. We have answered the detail questions below on the basis that all insurance contracts will be excluded from the scope of this project and our answers might change if that were not to be the case.

Further we note that the discussion paper makes no reference to the unit of account to be used when identifying the performance obligation or revenue recognition. It is our view that any revenue recognition model should clearly identify the unit of account. Further we believe that it is appropriate for revenue recognition to be considered based on a portfolio of contracts with broadly similar risks and rewards.

We have also noted that in a number of exposure drafts and discussion papers issued by the Board recently much focus is given to control, for example Consolidations, Derecognition, Leases and

Revenue Recognition. It is our view that if the principle of control is going to become a significant and overriding consideration in the recognition of assets, liabilities and income, the Board should specifically set out the notion of control and its place in IFRS in the Conceptual Framework as part of the Board's ongoing efforts on the Conceptual Framework.

2 Responses to detail questions

Question 1

Do you agree with the board's proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We agree with the Board's proposal to base a single revenue recognition principle on changes in an entity's contract asset or liability. We agree with the assertion that, while judgement still exists in determining a change in a contract asset or liability, it is less subjective than the current principle of identifying the earnings process and when that is complete.

Question 2

Are there any types of contracts for which the board's proposed principle would not provide decision useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

We believe that many of the characteristics of the revenue recognition model proposed may be appropriate for insurance contracts. However the uncertainty related to insurance contracts as well as the long term nature of insurance contracts means that many of the principles described in the discussion paper may not be appropriate for insurance contracts, for example the inability to re-measure performance obligations unless onerous would not provide decision useful information to the user's of insurer's financial statements.

While we believe that the building blocks identified in the discussion paper "Preliminary Views on Insurance Contracts" are not inconsistent with the principles in this discussion paper the specific guidance relating to margins and the re-measurement of insurance contract obligations is an important feature of insurance accounting. The following is a list of other areas where we believe that the specific characteristics of insurance contracts result in the guidance in the discussion paper possibly being inappropriate for insurance contracts:

- Insurance contracts have a much longer term than most other contracts with customers, even a longer term construction project is unlikely to have a term of 20 years which is possible in an

insurance environment, as mentioned above a measurement model which does not allow for re-measurement would therefore be inappropriate;

- There is much greater uncertainty in an insurance contract than other contracts with customers this makes the measurement and recognition of margins in insurance contracts much more complex than many other contracts with customers;
- Concepts such as policyholder behaviour and elements such a discretionary participation features are unique to insurance contracts and would require additional guidance possibly in a separate standard.

It is for these reasons that we believe that insurance contracts should be scoped out of the project on revenue recognition but that any revenue recognition model in respect of insurance contracts should be consistent in principle with the guidance in this discussion paper.

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We agree with the definition of a contract.

We ask the Board to make it clear in the guidance relating to the definition that future contracts and executory contracts are outside the scope of the definition.

For example if an entity enters into a contract which is renewable annually only the obligations and rewards related to this year's contract should be included in the net contract position. Any obligations or benefits relating to future years should not be included as there is no present contract only a possible future contract.

Furthermore contracts may exist for which an annual fee is payable without specific renewal, for example a credit card, in any one year the benefit is limited to the annual fee and the performance obligation to the obligation to provide services relating to the credit card for a year. The future annual payments relate to a contract in terms of which neither the customer nor the credit card provider has performed in terms of and therefore can not give rise to a contract asset or liability.

Question 4

Do you think the board's proposed definition of a performance obligation would help entities to identify consistently the deliverables (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

We agree that the proposed definition of a performance obligation would help entities identify the deliverables in a contract.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating the performance obligations?

We agree that the basis of when the assets are transferred to the customer is a useful basis on which to separate performance obligations. We believe that this provides a consistent principle that can be universally applied by all entities. We believe that the separation of obligations based on the time of performance provides useful information about real obligations without requiring the arbitrary separation of goods and services transferred at the same time.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customers consideration is a performance obligation? Why or why not?

As per our response on Question 3, we believe that there should be a clearer distinction between executory contracts and contracts giving rise to performance obligations. We believe an obligation to accept a return and pay refund, other than because of a warranty obligation, is more of an indication that the sale never took place than an indication that an entity has an obligation under a sale agreement. We believe this is also relevant for cooling off periods which are imposed in certain jurisdictions where the rights and obligations are only established after the cooling period.

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

We agree with this principle. It is consistent with the current principles of *IFRIC 13 Customer Loyalty Programmes* ("IFRIC 13").

Question 8

Do you agree that an entity transfers an asset to a customer (an satisfies a performance obligation) when the customer controls the promised good or when the customer receives the

promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

We agree with the principle that the transfer of an asset takes place when the customer controls the asset and a service obligation is satisfied when the customer receives the promised service.

We have noted that in a number of the recent discussion papers and exposure drafts issued by the Board the notion of control is becoming more prevalent in determining the appropriate accounting treatment, for example the exposure draft of consolidation and derecognition are both based on the notion of control rather than risks and rewards. If control is going to be a more important concept in the future of accounting than in the past, it is our view that this should be clearly articulated and published in the conceptual framework and that consequently the notion of control is brought into the scope of the project on the conceptual framework.

Question 9

The board proposes that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision useful information? If so please provide examples.

We have not identified any examples of contracts for which that would not provide decision useful information.

Question 10

In the board's proposed model, performance obligations are measured initially at the original transaction price. Subsequently the measurement of a performance obligation is updated only if it is deemed onerous.

- a) Do you agree that the performance obligation should be measured initially at the transaction price? Why or why not?***
- b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?***
- c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.***
- d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.***

- a) We believe that the sum of all separately identifiable performance obligations equal the transaction price in initial recognition after an allowance for initial costs, refer question 11 below.
- b) We agree with the principle of re-measurement of onerous contracts. We acknowledge that for short term contracts whose outcome can be estimated with a reasonable amount of certainty there are unlikely to be large differences in the value of the obligation from period to period.
- c) As per our response in Question 2 we don't believe this approach is appropriate for insurance contracts. We also note that many construction contracts run over a period of time and many commodity prices, for example steel, may be very volatile, therefore the expected margin at the outset of the contract may change during the performance of the contract as the commodity prices change, we believe that information in respect of those changes, even if it does not result in an onerous contract, is useful.
- d) We believe that for certain volatile and longer term contracts annual re-measurement provides more relevant and useful information to the users of the financial statements. We are however concerned practically how two different approaches may be implemented and are concerned that the additional definitions and guidance required may result in arbitrary splits between those contracts re-measured annually and those re-measured only when onerous. We believe that a single principle which requires mandatory re-measurement when the changes in the outcome are expected to be significant would be preferable to two approaches. This is similar to the approach followed by the Board in the discussion paper on Insurance contracts where the Board concluded that the best estimate of the future cash flows should be discounted, however materiality of the impact of discounting would remain a consideration in the measurement of insurance contracts.

Question 11

The board proposes that an entity should allocate the transaction price at the contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contracts (eg selling costs) are included in the initial measurement of the performance obligations. The board proposes that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- a) ***Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?***
- b) ***In what cases would recognising contract origination costs as expenses when they are incurred not provide decision useful information about an entity's financial position and performance? Please provide examples and explain why?***

- a) We strongly disagree with this principle and believe that some relief be given for costs incurred to acquire a contract with a customer. The notion of deferring direct and incremental costs on initial recognition is common in accounting, for example leases; financial instruments and borrowing costs. We don't believe that contracts with customers should be any different. We further believe that such a treatment will distort the performance of many companies, refer b) below. We note that the Board is considering separately the treatment of acquisition costs for insurance contracts and those should be considered separately for this project as well.
- b) The proposed treatment would not provide decision useful information about the financial position or performance of an entity that issues any contracts where the initial direct and incremental costs are material and the contracts run over a long period of time.

It is expected that an entity's pricing model will make provision to recover direct and incremental acquisition costs, other costs relating to the performance obligations and a profit margin. By not recognising that portion of revenue attributable to acquisition costs on the transaction date the statement of comprehensive income will reflect a loss in the early years of the contract and in the later years of the contract a profit which exceeds the entity's profit margin as per its pricing model. The statement of financial position will in turn reflect a performance obligation which is overstated.

If an entity has not appropriately priced for the recovery of acquisition costs and is allowed to recognise the portion of revenue related to those costs on initial recognition the financial statements will still provide decision useful information because the contract will become an onerous contract as soon as that revenue is recognised. As such the performance obligation will have to be re-measured and the financial statements will reflect the loss incurred on not pricing for acquisition costs and the performance obligation will not be understated but measured at the amount based on the obligations which the entity is still required to fulfil.

We believe that the information provided by the Board's proposed model becomes more distorted in contracts such as investment management contracts and construction contracts where the performance obligations are performed over many financial reporting periods and the acquisition costs are a material portion of the costs incurred in respect of the contract.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Stand-alone selling prices will provide decision useful information, it is however our view that the relative fair values of the performance obligations is probably a conceptually more correct method of allocation. In many instances it may be difficult to determine fair value in which case stand alone selling prices would be a reasonable approximation. It is our recommendation that the standard require relative fair values with a provision that if fair values are not available or determinable the stand alone selling prices be used.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever should the use of estimates be constrained?

As per our response in Question 12 we believe that the relative fair values of the performance obligations will provide more decision useful information than entity specific selling prices, unless the determination of fair value is impracticable.