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**Your Ref: Comment letter on Exposure Draft ED/2010/6
Revenue from Contracts with Customers**

Dear Sir.

Thank you for giving us the opportunity to comment on your exposure draft Revenue from Contracts with Customers.

The main objective of the ED is to replace the various existing revenue recognition standards (IAS 11 Construction Contracts, IAS 18 Revenue, IFRIC 13 Customer Loyalty Programmes, IFRIC 15 Agreements for the Construction of Real Estate, IFRIC 18 Transfers of Assets from Customers and SIC-31 Revenue-Barter Transactions Involving Advertising Services) with a single, comprehensive, principles-based revenue recognition model which would better reflect economic reality. The boards believe that the proposals would be significant improvement compared with the ad hoc, vague and sometimes inconsistent current revenue recognition guidance, especially as it applies to complex transactions.

The ED proposes that an entity recognise revenue as it satisfies performance obligations by transferring promised goods or services to a customer. This is a model based on the contract with a customer, and where revenue would be recognised when the customer obtains control of the goods or services. I agree with this model, but I notice that the term "contract" is already defined in IAS 32 Financial Instruments: Presentation, in para 13 as:

'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

The definition of contract under IAS 32 is weaker than proposed in this ED, as it only requires that an agreement is usually enforceable by law, whereas this ED requires that the entity can identify each party's enforceable rights.

The ED proposes to effectively measure revenue in relation to balance sheet movements. This is a big change compared with existing guidance, especially for long-

term contracts, and construction contracts, where the percentage of completion method is normally used. The proposals will lead to deferral of revenue recognition in many cases. This is one major area where I expect to see resistance from entities and entities would be expected to respond by managing contracts such that control of goods and services would transfer to the customer continuously, leading to a similar revenue recognition outcome as under the percentage of completion method.

The ED also proposes increased use of expert judgement and estimates. Criteria such as "near" (indicating that two or more contracts have interdependent prices, para 13 (a)), "distinct" (paras 22-23), "control" (paras 25-31), "probability-weighted" (para 35), "reasonably estimated" (para 38), customer's credit risk (para 43), "significantly" (determining whether a contract includes a material financing component, para 45), "estimate" (estimating a stand-alone selling price, paras 51-52), and others, require practical interpretation. Whilst I am in favour of principles-based accounting generally, I doubt that all of the guidance provided is sufficiently robust and operational for entities in practice.

I would prefer to strengthen the proposals concerning onerous performance obligations. For large and long-term contracts, small changes in circumstances can lead to large changes in results. I would recommend that these changes be recognised when they arise for large and long-term contracts, not just when they result in an onerous performance obligation.

Finally, for completeness, I would recommend that the disclosure requirements be expanded to include sensitivity testing on the significant judgments, estimates and assumptions, where relevant. This would provide meaningful information to users of financial statements. I do not believe that the additional disclosures would be onerous for preparers of financial statements. I would argue that having a good understanding of your business and risk drivers, including their dependencies, is vital to managing the business and its risks.

Answers to specific questions raised by the IASB

Recognition of revenue (paragraphs 8-33)

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?

Agreed. I notice that this proposal is similar to the approach in IAS 11 Construction Contracts, but is more complete.

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?

Agreed. The ED proposes a systematic approach which would be applied to all contracts with customers within the scope of the ED.

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 not? What additional guidance would you propose and why?

Partly. I agree with the principle of transfer of control in determining when a performance obligation is satisfied, and revenue is recognised. Control is an objective definition in theory. However determining when a customer obtains control of a good or service in practice is subjective and not straightforward. The proposed guidance in paragraphs 25-31 is very useful in this regard, but determining transfer of control would still be subjective in many cases.

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 revenues when the transaction price is variable and why?

Yes. An entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Such estimates should be robust and verifiable. This contrasts with the current approach under IAS 18 Revenue which requires that revenue can be measured reliably.

I agree with the proposed criteria in paragraph 38, which are complete, and should be reliable.

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?

Yes. I agree that an entity should allow for customers' credit risk by adjusting the transaction price to a probability-weighted amount. I believe this is more robust and complete compared with current practice under IAS 18, and in some cases would allow income or expense to be recognised due to changes in customers' credit risk, which is appropriate.

My only concern is that it may be difficult for entities to reliably assess customers' credit risk. The assessment is subjective, and in many cases difficult to verify.

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?

Yes. This is critical and provides meaningful information to users of financial statements (users), especially for long-term contracts. I also agree that the discount rate used should reflect both the time value of money and credit risk.

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 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?

Generally agree. I agree with the principle for most cases, but I note the following issues:

- 1) Most entities selling a bundle of goods or services do so for a reason – that the customer want to purchase the goods or services as a bundle, rather than individually. Allocating the transaction price to the separate performance obligations can result in subjectivity and spurious accuracy.*
- 2) Some items are sold as part of a bundle, which could not be sold on their own i.e. as stand-alone items. In this case management will have to estimate their stand-alone selling prices. Such estimates are subjective and open to manipulation.*
- 3) The stand-alone selling price needs to be considered and clarified in cases where the entity sells the same good or service to different customers at different prices.*
- 4) Allocating discounts in line with the stand-alone selling prices may cause difficulties where transactions are of varying size, or have very different profit*

margins. An example is the case of a bundle of goods and services where one item is sold with no profit margin, or as a loss leader. This is often the case. A discount may be provided on the bundle, but in reality utilised from the larger or more profitable performance obligation. Allocating the discount to all performance obligations in the bundle would distort the profit reporting of the lower margin performance obligations, which would not be a fair reflection of the business or economic reality.

I understand that the proposals are an inevitable concomitant of the proposed revenue recognition model, however, I think point 4) above is serious enough to require further consideration. I would recommend that an exception be made in allocating discounts to all separate performance obligations in a contract, and that discounts should be allocated in line with the discount pricing methodology adopted by the reporting entity, as long as this is robust and verifiable.

Contract costs (paragraphs 57-63)

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 *Intangible Assets* or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specific criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

Yes. I believe that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient.

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?

Yes. I agree with the costs specified. However, for large and long-term contracts, small changes in circumstances can lead to large changes in results. I would recommend that these changes be recognised when they arise for large and long-term contracts, not just when they result in an onerous performance obligation.

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?

Yes. The proposed disclosures are much more detailed than the current requirements. In general they will provide more meaningful information to users. However I would recommend that sensitivity analyses also be disclosed on the significant judgements, estimates and assumptions used. This will allow users to judge management's effectiveness in understanding, and controlling their business and risks.

I also recommend that more detail be provided in the reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities to provide more meaningful information to users. I do not believe this would be onerous for preparers of financial statements (preparers).

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?

Agreed. This provides meaningful information to users, and is clearly targeted at the potentially more volatile and sensitive long-term contract space.

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?

Agreed. This kind of disclosure is crucial, and provides meaningful information to users. Again, I would recommend that the sensitivity of revenue to significant economic factors be shown to provide more meaningful information to users.

Effective date and transition (paragraphs 84 and 85)

Question 13

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

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

Agreed. This proposal might be onerous for preparers with long-term contracts, but would ensure consistent application to all entities and similar contracts within an entity.

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?

I appreciate the need for some guidance in a principles-based accounting standard, but this guidance is being used to provide proxy objectivity where there is too much subjectivity. Perhaps some of the proposals in the ED could be re-written such that there is less need for extensive, separate and ad hoc guidance?

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 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?

Agreed. This is a significant change compared with current practice, particularly under IAS 18 and IAS 37, where warranties are often recorded as a liability at inception. The ED proposals would instead defer revenue, which would be subsequently recognised over the warranty period, which is appropriate.

The ED proposes to distinguish "quality assurance" warranties from "insurance warranties", which makes sense. In some cases, judgement would be needed in order to determine how to classify a warranty, and whether it is a separate performance obligation.

The ED makes an assumption that all warranties providing coverage for faults that arise after the product is transferred to the customer are insurance warranties, and are separate performance obligations. I would recommend that this assumption is subsumed into the general principle for indentifying separate performance obligations depending on whether goods or services are distinct (paras 22-23).

Question 16

The boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license 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 license and it satisfies that obligation when the customer is able to use and benefit from the license

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why, or why not?

No. I believe in substance over form. In many cases the transactions and economic flows between the entity and customers would be the same. I do not believe that not granting the license to another party during the exclusive license period is a performance

obligation. In other words, I am not convinced that exclusivity brings additional performance obligations.

Consequential amendments

Question 17

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?

Agreed. I note that the proposal would affect the timing of recognition, and the measurement of gains and losses compared with IAS16, IAS 38 and IAS 40, however I will not comment further on this.

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 organisations)? If so, which requirement(s) and why?

N/A

Yours faithfully

C.R. Barnard

Chris Barnard