

Accounting Standards Board

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Dear Henry

IASB's Exposure Draft 'Revenue from Contracts with Customers'

This letter sets out the Accounting Standards Board's (ASB's) comments on the Exposure Draft (ED) '*Revenue from Contracts with Customers*'.

The ASB is supportive of the IASB's ambition to develop a single approach to revenue recognition based on the contract-based approach proposed in the ED, and supports many of the ED's specific requirements. However, we have some significant concerns. In our view, it is essential that the IASB should take the time needed to refine the ED to provide a high quality principles-based standard.

Our main concern is that we do not believe that the ED has adequately demonstrated that the 'transfer of control' provides adequate guidance for determining when a performance obligation has been satisfied. It is not clear how it should be applied in the case of contracts for services, which often give rise to significant questions about revenue recognition. Most of the indicators proposed (paragraph 30 (a -d)) cannot be applied to service contracts. It is also unclear how it is determined that control has been transferred during production, or whilst a long-term construction contract is in progress. Whilst we acknowledge that accounting for such contracts has been addressed in Example 11 of the application guidance, in our view the principles for such an important class of contract should be clear from the standard itself.

In our view, 'risks and rewards' should still play a role in providing answers to the more difficult cases for revenue recognition by providing a secondary check to the notion of when control has been transferred to the customer. This should alleviate the need to include lengthy guidance and limit the judgement that the preparer needs to make in deciding when control has been transferred to the customer.

Please find attached, as an appendix to this letter, our detailed responses to the invitation to comment questions, but to summarise our other main concerns:

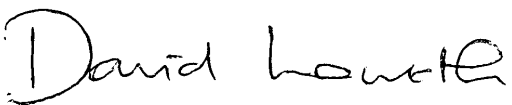
- The ASB is not convinced that the initial estimated transaction price should be allocated to all separate performance obligations in a contract in proportion to the stand-alone selling price. In our view, the stand-alone selling margin should be used instead (see our answer to Question 7);

- We consider that requirements regarding capitalisation of contract costs, should be appropriately dealt with in the standards for costs (for example, IAS 2 *Inventories*) and not in a revenue standard (Question 8);
- The ASB considers that onerous contracts should be dealt with at contract level in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* rather than at performance obligation level in a revenue standard, which would avoid the problem of having an onerous performance obligation within an overall profitable contract (Question 9);
- The ASB believes that the definition of Revenue found in Appendix A to the ED is very general, and should be clarified, notably by making clear that it refers to the 'top-line' of the Statement of Comprehensive Income (Question 14)

In addition, we would like to register our interest in participating in the round-table event due after the end of the comment period and would appreciate if the IASB can reserve a seat for an ASB Board member and a member of staff to participate in such an event.

Should you wish us to expand on any aspect of this response, please contact me or Jennifer Guest j.guest@frc-asb.org.uk

Yours sincerely



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Appendix

RESPONSE TO SPECIFIC QUESTIONS IN THE EXPOSURE DRAFT 'Revenue from Contracts with Customers'

This Appendix sets out the ASB's responses to the questions set out in the exposure draft's Invitation to Comment.

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?

The ASB agrees with the principle of price interdependence and supports the proposed guidance on combining, segmenting and modifying contracts.

Question 2 – The boards (IASB & FASB) 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?

The ASB agrees with the principle of identifying performance obligations based on whether the good or service is distinct and supports the proposed guidance for separating performance obligation. However, the ASB believes that in considering whether goods and services are distinct the entity's own customary business practice should be considered before the business practice of any other entity. This is because, in our view, it is more pertinent and relevant to the contract under consideration.

Whilst we acknowledge that paragraph 23 (b) (i) refers to utility to the customer either on its own or together with other goods and services, we are concerned that if part of the goods or service are transferred revenue may be recognised before the customer gains any utility.

Question 3 – Do you think that the proposed guidance in paragraphs 25–30 and related application guidance is 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?

Although the ED is somewhat clearer than the Discussion Paper on when control has transferred, we believe that there still is much more to be done. In particular, for contracts where a customer obtains control during production and long-term construction contracts application of the control test, as explained in the ED, will be difficult.

The lack of clarity in the ED for the point at which control is transferred to the customer additionally raises concerns about the application of the proposed guidance to service contracts. In particular we consider that the indicators proposed (paragraph 30 (a –d)) are not helpful for service contracts.

The IASB has rejected an approach based on ‘risk and rewards’ because it could conflict with identifying separate performance obligations (paragraph BC60(c)). However, the ASB continues to believe (as stated in our response to the IASB’s DP) that an assessment of risk and rewards could provide a helpful secondary filter to determine when control has passed to the customer.

In the IASB’s *Leases* ED (paragraph 29 and B22 –24), the IASB proposes that in order to determine whether to use a performance obligation or a derecognition approach to a lease; the differentiator should be if a lessor retains exposure to significant **risk and benefits** associated with the underlying asset. The ASB is still considering a response to the leasing ED; however, we note the similarity in principle between the differentiators.

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

The ASB agrees with the proposal that when the transaction price is variable, revenue should only be recognised if the transaction price could be measured reliably. In addition, the ASB agrees with the criteria for being able to recognise revenue when the transaction price is variable.

As a matter of drafting, the standard needs to be clear that the restrictive conditions in paragraph 38 only apply to contracts with variable consideration.

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?

Please see our answer to Question 6.

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?

The ASB agrees that the transaction price should be adjusted for the time value of money if material to the transaction and, at least conceptually, the customers’ credit risk. This conclusion is consistent with the economic substance of the transaction and accords with the current UK requirements in FRS 5 Application Note G.

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?

The ASB is not convinced that the initial estimated transaction price should be allocated to all separate performance obligations in a contract in proportion to the stand-alone selling price. Paragraph BC 113 argues that an allocation based on stand-alone selling prices faithfully depicts the different margins that may apply to the promised goods or services. On that basis, the ASB considers that a more faithful depiction would be to allocate the initial estimated transaction price on the basis of the stand-alone margin, rather than the stand-alone selling price. In any event, we consider that any subsequent changes should be allocated to different performance obligations based on the relevant facts and circumstances. This allocation requires more judgement than the ED's proposal however, we consider that it should be relatively clear which performance obligations is affected by the change in the transaction price.

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 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?

The ASB considers that requirements regarding capitalisation of contract costs should be appropriately dealt with in standards for costs and not in a revenue standard.

Question 9 – Paragraph 58 proposes the costs that relate directly to a contract for the purpose 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 and why?

The ASB does not agree that the costs of securing a contract (paragraph 59 (a)) should always be expensed as incurred. The proposal to exclude from the list of eligible costs any costs incurred before contract inception (unless they are used in the process of satisfying performance obligations related to the good or service delivered to the customer) does not seem correct. We consider that if expenditure is directly related to securing a contract, it should be accounted for as part of the contract. This is consistent with paragraph 21 of IAS 11.

The ASB does not agree with the proposal that onerous contracts should be assessed at the performance obligation level. Instead, the ASB considers that onerous contracts should be dealt with at contract level in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* rather than at performance obligation level in a revenue standard. Including the 'onerous test' at performance obligation level could result in the recognition of a provision for an onerous performance obligation within a contract, which remains profitable overall.

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?

The ASB considers that the disclosure requirements proposed in the ED meet the IASB's desired objective. In addition, they should provide the user with relevant and useful information. However, significant judgements are necessary in applying the proposals and, given the volume of proposed disclosures, the ASB believes that the IASB should explain more fully how the proposals in the ED are an improvement on current standards.

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?

No. The ASB is concerned that this proposal will not necessarily provide useful information to users of financial statements. The order books of different companies are not necessarily comparable and there could be particular challenges for companies with a large number of small contracts. The information required is forward-looking and may prove difficult and costly to gather. In addition, the proposals could lead to auditability difficulties.

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?

Yes. The ASB considers that disaggregating revenue into the above categories should provide users with the information they require.

Question 13 – Do you agree that an entity should apply the proposed requirements retrospectively (that is, as if the entity applied the proposed requirements to all contracts in existence at the effective date and in the comparative period)? If not, why?

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

In principle, the ASB agrees that the proposed requirements should be applied retrospectively. The amount of and trends in revenue—the top-line of the Statement of Comprehensive Income — is very important information for users of financial statements. Comparability between periods is therefore also important. That said, it would be useful if the IASB could outline the extent of the retrospective application practicable.

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 proposal operational? If not, what additional guidance do you suggest?

The ASB considers that a standard should have strong underlying principles and this generally will diminish the need for detailed application guidance.

The ASB considers that the definition of Revenue found in Appendix A to the ED is very general and could be improved. We suggest that it would be helpful for the definition to refer to the 'top-line', which would clarify the meaning of revenue and provide a foundation for adopting a 'contract-based approach'. This suggestion, together with our suggestion of advocating 'risk and rewards' as a secondary filter to control (response to question 3), should help alleviate the need for lengthy 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?

The ASB agrees with the distinction the IASB has proposed between a warranty covering latent defects and a warranty, which provides coverage for faults, which arise after the product sale, and considers that in theory the proposals are correct. However, the way the proposals are drafted in the ED are too complicated and practically it will be very difficult to determine the outcomes for many given situations. The ASB believes that a more principled approach may be more appropriate.

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 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 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?

The ASB considers that this issue should be dealt with in the proposed leasing standard because the 'rights to use' an intangible asset is in substance a leasing agreement.

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?

The ASB considers that the principles of the proposed model should also apply to the recognition of gains and losses arising from the sale of non-financial assets.