

21 October 2010

International Accounting Standards Board 30 Cannon Street London EC4M 6XH

Dear Sirs

Exposure Draft ED/2010/6 'Revenue from Contracts with Customers'

With a membership of in excess of 30,000, the London Society of Chartered Accountants (LSCA) is the largest of the regional bodies which form the Institute of Chartered Accountants in England & Wales (ICAEW). London members, like those of the Institute as a whole, work in practice or in business. The London Society operates a wide range of specialist committees including Technical (accounting and auditing), Tax, Regulation and Ethics Review and Financial Services and Insolvency, which scrutinise and make representations to bodies such as yourselves.

GENERAL COMMENTS

The LSCA is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2010/6 'Revenue from Contracts with Customers' (the ED). We support the objective of the IASB and FASB to develop a single revenue model that can be applied across virtually all industries. However, we have some serious concerns in respect of certain proposals within the ED. In our view, some of the guidance is neither adequately developed nor clearly explained, and some of the proposals will lead to accounting that does not properly reflect the underlying economics of a revenue transaction.

- The control model is inadequately developed
 - In our view, the principle set out in the ED in relation to control is not well enough explained, and the associated guidance in relation to indicators has not been sufficiently developed. As a consequence, for many contracts (and particularly contracts for professional services) it seems possible to justify more than one interpretation of how the ED would be applied. Unless this guidance is improved, the result will be significant diversity in practice.
- The final Standard should be drafted using language that is considerably more user-friendly In places, the ED is drafted using language that is very theoretical. The final Standard will need to be used by a wide range of accountants and businesses. We encourage the boards to look again at the drafting and to do what they can to make it as user-friendly as possible. The risk of unintentional non-compliance with the final Standard will be significantly reduced if the boards are able to draft it using the language of everyday business wherever possible, rather than the theoretical language of standard-setters.

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• The final Standard should not mandate a single methodology for allocating the transaction price to performance obligations

For revenue recognition to reflect properly an entity's contractual performance, it is essential that revenue be allocated between performance obligations on a basis that reflects the underlying economics of the contract. In some cases, the methodology mandated by the ED will not achieve this. We believe alternate methodologies should be permitted in such cases. We believe that this is sufficiently important that, if such an approach proved unacceptable to the FASB, it would be better for the IFRS and US Standards not to be fully converged.

• The final Standard should not mandate a 'one size fits all' approach to contract modifications

The approach proposed by the ED will sometimes result in an inappropriate allocation of revenues when contracts are modified. We believe the final Standard should require judgement to be applied to determine the appropriate accounting in respect of a modification.

- Provision should be made for onerous contracts, not for onerous performance obligations In our view, it is not representationally faithful for an entity to recognise a loss upon entering into a profitable contract. We believe provision should continue to be made only where a contract as a whole is onerous, as at present.
- More guidance is needed around the disclosure requirements

 The extent of disclosure required by the ED is very unclear. We encourage the boards to provide further guidance and some realistic illustrative examples in order to make clearer what is intended.

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DETAILED COMMENTS

We give our comments on the specific questions raised in the Exposure Draft below.

Questions 1 to 3: 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 the 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?

Combining contracts

We agree that it is important to identify circumstances in which contracts should be combined and accounted for together. For example, it would not be appropriate for an entity to be able to report differently merely because it agreed with its customer artificially to split a single agreement into two separate legal documents signed at the same time.

We believe that price interdependence is an appropriate factor to consider when combining contracts. However, we are concerned that the approach proposed in the ED may be unnecessarily complex to apply in practice, because it is possible to argue that many contracts entered into with a customer are, to some extent, price interdependent with earlier contracts. For example, if a customer purchases a core product, it is possible that any discounts given on subsequent purchases of associated products or services could be considered price interdependent with the original purchase, potentially over a very long period. Under the ED's proposals, this could mean keeping the accounting for the original contract open, and subject to revision, for a very long time – perhaps decades – which may be a significant burden in terms of record keeping.

We assume that this concern led the boards to include paragraph 14 of the ED. However, the wording of paragraph 14 is very vague, such that its intended interaction with the core principle in paragraph 13 is unclear. We are concerned that paragraph 14 may undermine the principle in paragraph 13 in some cases. For example, if an entity agrees to sell two items to a customer, it could artificially separate them into two contracts, with the first being priced too high and the second, correspondingly, too low. It seems clear to us that, in this scenario, the contracts should be combined – but it would seem possible instead to invoke paragraph 14, arguing that the customer has received a discount under the second contract as a result of an existing customer relationship arising from the first contract. We do not believe the boards would intend this result, but it illustrates that the wording of paragraph 14 is not sufficiently precise.

We are also concerned that the guidance may result in some contracts being combined inappropriately. For example, in some industries a core product is sold at a standard price as a loss-leader, with a much higher margin being made on any subsequent supply of associated goods and services, also at a standard price. A customer buying the core product is likely to purchase associated goods and services later, but is under no contractual obligation to do so. Under present accounting guidance, we do not believe those subsequent sales would be combined with the original contract. However, there is clearly a sense in which the standard prices set for the core product and subsequent goods and services are interdependent. It might, therefore, be possible to argue under the proposed guidance that the contracts should be combined. The effect of this might be to trigger additional revenue and profit on the first contract when the customer enters into a subsequent contract, even before any subsequent goods or services have been provided. We do not believe this would be appropriate, and we doubt that this was the boards' intention. We suggest that the guidance on interdependence should be clarified to avoid this misinterpretation.

It appears that the ED does not permit adoption of the approach currently required by IFRIC 13 Customer Loyalty Programmes, but that approach (which does not remeasure the amount allocated from the original contract to future deliverables) might be significantly easier to apply in some cases. Therefore, in order to address the practical difficulties of combining contracts over a very long period, and having to revise the original contract accounting throughout that period, we suggest the boards consider an alternative approach where there is genuine customer 'optionality'. This would be to retain the ED approach of combining contracts only to the extent that, at the point of entering into an initial contract, it is reasonably certain that a customer will, as a consequence, enter into a subsequent related contract – i.e. there is no realistic likelihood that the customer will choose not to enter into the subsequent contract. In contrast, where an initial contract would permit a customer to enter into subsequent contracts but there is a real possibility that the customer might not choose to do so, the contracts would not be combined. Instead, an appropriate amount of revenue from the first contract would be deferred, corresponding to the value of the customer's option to enter into subsequent contracts. That amount of revenue would be amortised on an appropriate basis over any subsequent contracts, but the amount attributed to the option would not be remeasured. This approach would be consistent with that currently required by IFRIC 13. It would have the advantage that it would not be necessary to keep open the accounting for the original contract.

Segmenting contracts

We believe that the guidance on segmenting contracts will be confusing for many readers. It is already necessary to divide a contract into its separate performance obligations, which calls into question the need for an additional segmentation step. It appears to us that the only purpose of such a step is that it can affect precisely how revenue is allocated between performance obligations using the methodology set out in the ED. However, as explained in our response to question 7 below, we favour a less mechanistic approach to the allocation of the transaction price between performance obligations. If the boards were to adopt this less mechanistic approach to allocation, it would be possible to delete the requirements relating to segmentation of contracts. We believe this would increase the understandability of the proposals.

If the boards decide to retain the requirements on segmentation, we encourage them to explain better the interaction with the identification of performance obligations, and to make it clear that the only purpose of the segmentation step is as part of the methodology for allocating the transaction price. This should help to reduce confusion on the part of users.

Contract modification

We do not support the ED's proposals on contract modification. We believe that they are very confusingly expressed, and that they will lead to inappropriate accounting in some cases.

The ED proposes that, where a contract is modified such that the new price to be charged prospectively is a market price, it is not necessary to make any retrospective adjustment to revenues. We agree with this aspect of the proposals.

However, in all other cases, the ED appears to propose that any modification to contract pricing should be applied retrospectively, giving rise to a cumulative effect in the period of modification. We do not believe this is appropriate as a blanket approach. For example, contract pricing may be amended prospectively as a consequence of a significant change in market prices part way through a contract. It is entirely possible that contract negotiations in such cases will not result in a revised price that is 'on market' – precisely because the existence of the original contract will strengthen the bargaining position of whichever party was benefitting from the change in market prices. To illustrate, if the market price of the good or service increases significantly, the customer may accept that the seller is no longer able to cover costs and may accept a price increase – but there is no reason why the seller should give away all of the benefit of the existing fixed-price arrangement. In these cases, it seems to us that any higher price to be charged should be recognised by the seller only from the point at which market prices increased, not from the start of the contract. Applying the revised pricing retrospectively will lead to too much revenue being recognised on a cumulative basis, with a marked distortion in the year of change, and will understate revenues in subsequent years.

In our view, rather than apply a blanket rule, the accounting for contract modifications should be a matter of judgement, with the objective of properly depicting the economic substance of the modification. We therefore encourage the boards to provide more guidance on the different circumstances that can cause contracts to be modified and the appropriate accounting in each case.

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 broadly agree with the approach proposed by the ED, subject to our detailed comments below.

It seems to us that, although they are drafted differently, the ED's proposals will have much the same effect as existing UK GAAP in that two contract elements will be accounted for separately if one of them can be seen as an 'optional extra' or, alternatively, could be purchased separately. It might be helpful to readers for the final standard to clarify that this is the effect, as the drafting of this part of the ED is otherwise very theoretical.

We note that in some cases, particularly for multi-stage construction contracts, it would in theory be possible to separate a contract into a very large number of performance obligations. It would be helpful for the guidance to emphasise that it is not necessary further to segment contracts, particularly those involving the continuous transfer of control, if that further segmentation would not materially alter the profile of revenue recognition. For example, where a construction contract involves the continuous transfer of control, it should only be necessary to separate out those stages that might be expected to

have different margins from each other. (It may be helpful to draw an analogy with component depreciation. It is not necessary to analyse property, plant and equipment into all possible components; rather, that analysis is only required to the extent that it may be expected to have a material effect on the overall profile of depreciation expense.)

We find the guidance in paragraph 23(b)(ii) unclear, and we find Example 11 unclear and unconvincing in illustrating how it might be applied. In our view paragraph 23(b)(ii) is unnecessary and should be deleted. If instead the boards choose to retain it, it seems likely that this will lead to significant diversity in how it is applied unless the associated explanatory material is greatly improved.

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? No, we think both that the underlying control concept is insufficiently well developed and that the guidance is drafted in language that will be opaque to the majority of readers. In our view, the combination of these two factors is a fundamental flaw. Unless the guidance is considerably improved, it is likely to lead to significant diversity in practice. We note that the guidance in the ED is particularly difficult to interpret and apply in the context of services.

Part of the confusion arises from the use of the term 'control', which can be inherently difficult to apply in the context of a contract between buyer and seller. In such scenarios, neither party has the kind of unfettered freedom of action widely associated with 'control' as a concept – instead, each party is likely to have some, but not all, of the powers associated with the concept. Unless the underlying concepts are much better explained, there is considerable risk that users will reach an inappropriate view when focusing on the question of who 'controls' work in progress for an ongoing contract. In our view, the question might be better expressed as 'whose asset is the work in progress'?

At present, the principle set out in the ED is very difficult to understand, and the indicators are neither fully fleshed out nor adequately tied back to the underlying principle. As a consequence, readers will not properly understand the approach that the ED takes, and instead are likely to regard the indicators as a checklist (e.g. 'two out of four demonstrates customer control'). This will not lead to consistency of application of the proposals.

In our view, it is essential to develop and then better explain the core principle. Currently, it is unclear (1) whether customer needs to have ability to take 'work in progress' from the seller (in our view, this should not be required) and (2) whether it is necessary that any 'work in progress' could be completed by someone other than seller (again, in our view this should not be required).

We then believe the indicators should be developed, and better explained in the context of the core principle. In particular:

- At the moment, there is insufficient explanation of what is meant by a customer's 'unconditional obligation to pay'. In our view, this should not mean that the customer must pay in all circumstances, irrespective of any breach of contract or non-performance by the seller. Instead, it should mean that the customer cannot, through its own actions, avoid paying for any work that has been done to date (e.g. by seeking to terminate the contract). The assessment of this should be based not just on the contract itself but also on the likely consequences of any breach of contract. For example, the contract may not explicitly allow for cancellation by the customer, but if the customer cancelled anyway and was in breach of contract, would a court award more than nominal damages to the supplier? If not, the customer does not have an unconditional obligation to pay.
- The test of whether goods or services are 'customer-specific' should focus on whether it would be feasible to recover the value of any 'work in progress' by using it for another customer if the

contract was cancelled and, if so, whether this would involve significant additional costs. If this would be possible, with only minor modifications, then the work in progress is not customerspecific; if it would be impossible, or would involve significant additional costs, then the work in progress is customer-specific.

If the indicators were better explained then it should be possible to give more guidance on which combinations will be sufficient to demonstrate customer control. For example, in our view, where a customer has an unconditional obligation to pay for customer-specific goods (as explained above), this demonstrates that the customer has control. This follows from the second sentence of paragraph 26 in the ED, which states that control 'includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service'. Where a customer contracts to receive goods that are customer-specific (in the sense explained above), it is in effect preventing the seller from using them for the benefit of other customers. We encourage the boards to be more specific as to which combinations of indicators are sufficient to demonstrate customer control, and which are not, as this will reduce the risk of the guidance being incorrectly applied.

Finally, once the underlying principle and indicators have been properly developed, we believe it is important that they are expressed in language that is as 'user-friendly' as possible. The terms used in the exposure draft have some meaning for standard-setters and technical accountants (though even the latter have struggled with some of the drafting); however, the proposed Standard will need to be applied by a very wide variety of entities in a very wide variety of circumstances. If that is to be successful, clear and unambiguous communication is essential, and this will be best achieved through the use of terminology that is meaningful for users. Accordingly, once the boards have properly developed these concepts, we urge them to re-express the guidance in the language of 'goods' and 'services'. It is counter-intuitive and confusing to think in terms of transferring control of a part-complete service. Readers will find it far easier to apply guidance that explains when to account for a supply as being of goods and when as being of services.

Questions 4 to 7: 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 believe that the kind of weighted average approach proposed by the boards can give acceptable answers on a portfolio basis, i.e. for a large population of similar but independent items. However, we do not support its use in other cases, such as where an item is a 'one off' and subject to a binary outcome. In such cases, the methodology could base revenue on an amount that could never be achieved. An example might be a success fee of £1 million for assisting a company to list on an exchange. The amount receivable will either be nil or £1 million – it will never be a weighted average of the two. In our view, it would be better to apply an approach that recognises revenue at the highest amount that is more likely than not to be received. We note that, for large populations, this will produce similar outcomes to those under the ED, but it avoids the problem described above.

At present, the ED does not appear to exclude from revenue amounts that the customer can choose not to pay (in the sense that an obligating event has not yet occurred). A common example is additional royalties that become payable each time a customer makes an onward sale; the customer's obligation in respect of such royalties arises only when it makes a sale. In our view, the ED should make clear that such amounts are not factored into variable consideration until an obligating event has occurred. It would be inappropriate for the seller to recognise as a receivable an amount that is not yet a liability of the customer.

Finally, there needs to be more clarity on the scope of the proposed guidance and its interaction with the Standards on financial instruments. Once a seller has fully performed its obligations, any amounts receivable (which might include variable consideration) will meet the definition of a financial instrument. However, where the variability of consideration has not yet been resolved, the measurement proposed by the ED will be different from (and lower than) the measurement that would apply for initial recognition under the financial instruments Standards (i.e. fair value). It is unclear whether the ED continues to apply to such a receivable until the consideration is no longer variable, or whether it ceases to apply once performance is complete. If the latter, it is unclear how to account for any difference of measurement at the point of transition between the Standards.

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 agree, subject to ensuring consistency with the requirements of the Standards dealing with financial instruments.

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.

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?

We agree that the starting point for the allocation should be the stand-alone selling price of the performance obligations, but we disagree with this rule-based approach. Although it may produce acceptable results in the majority of circumstances, it will produce inappropriate results in a significant minority of cases. The main problem will arise when high and low margin items are sold as a package and a large discount is given on the high-margin items. A common example is where a high-margin software licence is sold together with subsequent lower-margin services. It is not uncommon for significant discounts to be given on such a licence, but the ED's methodology will spread the discount across all items in the package. This will result in too much revenue and profit being recognised on delivery of the licence, and in an extreme case may reduce the revenue attributable to the remaining services to such an extent that they become loss-making.

Accordingly, in our view it is inappropriate for a final Standard to mandate a single methodology that must be used by all entities in all circumstances for allocating discounts. We would be happy for the approach proposed by the ED to be a default methodology, but entities should be permitted to adopt a different methodology where the default methodology would not properly reflect the underlying contract economics, as in the example above. In such cases, the entity should identify any overall discount by comparing the total of stand-alone selling prices to the transaction price. It should then devise a methodology for allocating that discount against the stand-alone selling prices of the goods and services being supplied, so as to properly reflect the underlying economics (in our example, it is likely that most or all of the discount would be allocated against the licence). The methodology should take into account any ongoing discounts that will be available to the customer for goods and services included in the contract. The entity should apply that methodology consistently to all similar transactions, and should explain in the financial statements:

the methodology being applied;

- the class of transactions to which it is applied; and
- why it is judged better to reflect the underlying economics of the transaction.

We would also propose one additional related disclosure, which is that where a contract is profitable overall, but the methodology adopted allocates discounts in such a way as to make one or more performance obligations loss-making, that fact should be disclosed and an explanation provided of why this is judged appropriate.

Questions 8 and 9: Contract costs (paragraphs 57 – 63) Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 380; 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?

We agree with this proposal.

To avoid confusion, it would be helpful to clarify that, when paragraph 59(a) states that 'bid and proposal' costs must be expensed, this does not apply to costs meeting the criteria in paragraph 57, such as designs that will be used if the contract is won.

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 with the costs specified. However, we disagree strongly with the proposal that provision should be made for onerous performance obligations. In our view, it is appropriate to assess the need for a provision at the level of a contract, as at present, and not at the level of a single performance obligation. Entities do not take on individual performance obligations; they enter into contracts. When an entity enters into a contract that is profitable overall, it is better off – even if one of the performance obligations will be loss-making. In our view it is inappropriate to recognise a loss at the point of entering into a profitable contract, as this does not properly depict the economic effects of the event that has occurred.

Questions 10 to 12: 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 agree that there is a need to improve the quality of disclosures associated with revenue, but we have some concerns as explained below.

Overall, it is very hard to gauge the extent of disclosures that will be required. Paragraph 70 explains that this must be a matter of judgement, and we agree. Nevertheless, it would be very helpful to set out a realistic example of disclosures, to give entities more of a flavour of the level and extent of detail that might be intended.

The reconciliation required by paragraph 75 gives the appearance of having been devised with a particular type of entity in mind – specifically, an entity that has only a relatively small number of contracts, which typically run over several periods. Such entities may be able to produce the reconciliation without incurring excessive expense. However some other entities, particularly those with a very large number of small value contracts, may find it very difficult and expensive to produce. In particular, the information required by (a)(ii) is unlikely to be readily available and may require system changes to obtain. We do not believe the boards have as yet made the case for why this disclosure should apply to all types of entity, or why it is important enough to warrant significant additional costs.

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

We do not believe this disclosure should be required within IFRS financial statements. Many entities will find it difficult to produce, and it will be even more difficult to audit. In reality, a forecast of when performance obligations are expected to be satisfied is unlikely to prove accurate, not least because of factors outside the seller's control. Moreover, as this is in essence a forecast of future revenues, its inclusion may expose both preparers and auditors to inappropriate risks.

We note that there is also insufficient guidance on how to apply the requirement in the context of contracts that can be cancelled by the customer on short notice and at little expense (should they all be excluded, or all included, or should an estimate be made of the level of cancellations?) and contracts that include a significant level of discretionary spend by the customer (should this be forecast and included or excluded?).

If the boards believe it is useful to provide information of this type, we suggest that they encourage its disclosure outside the IFRS financial statements, e.g. in the business review.

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. In order to minimise duplication of information, and to aid clarity, we encourage the boards to align these proposals as much as possible with the requirements of IFRS 8 *Operating Segments*. Paragraph 72 could be strengthened in this regard.

Question 13: 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 period 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.

We believe many entities will find retrospective application difficult and expensive. However, we do not see a way of requiring prospective application that will result in sufficient comparability between entities. In particular, it does not seem appropriate to apply the requirements only to contract entered into after a specified date because some existing contracts will continue to run for years or even decades.

Accordingly, we are reluctantly in favour of retrospective application. But in order to avoid entities incurring disproportionate expense, we encourage the boards explicitly to allow the use of estimates where it would otherwise be very costly to reconstruct data. Disclosure and explanation should be required where it has been necessary for an entity to make significant estimates.

Although the boards have not asked in this document for comments on an appropriate effective date, we do not believe adoption should be mandated before 2014 at the earliest.

Questions 14 to 16: 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?

Although the application guidance is already extensive, we agree that it is appropriate to have extensive guidance attached to a Standard on revenue recognition. The nature of the subject is such that the guidance must be applied in a very wide range of circumstances, and it is helpful to provide guidance on the specific issues that can arise in particular circumstances.

Many of our comments above would have a consequential effect on the application guidance; we do not repeat them here.

We note, in particular, that there is insufficient application guidance on professional and other services. We would welcome further examples, particularly those dealing with cases where the most significant activity does not involve physical delivery to a customer. Examples might include health tests for an individual, where samples are analysed in a laboratory, or an advertising agency devising, filming and arranging for broadcast of an advertisement, without the customer ever taking 'physical delivery'.

Some of the examples use fact patterns that are unrealistic – e.g. Scenario 1 in Example 15 states that the customer 'has the ability to take possession of the equipment during manufacturing and engage another entity to complete the manufacturing'. In our experience, this would be a very unusual contractual term. It would be much more helpful for the examples to include fact patterns that are realistic and, where this then requires greater application of judgement, to say so. (For the reasons set out in our response to question 3 above, we believe the quoted sentence from Example 15 could be deleted without altering the answer.)

Further to our response to question 4, we disagree with the accounting proposed in Example 14 when applied to a single item rather than a portfolio of similar items. We do not believe it is meaningful to recognise half an asset and a liability to repay half the consideration received when the only possible outcomes are to refund none or all of the consideration. We are also sceptical that it would be possible to estimate reliably the probability of the asset being returned in such a scenario.

We disagree with the analysis in Example 23. Where an entity sells goods as a principal, we do not believe slotting fees involve a service to the supplier. This is because product placement increases the sales of the entity / principal, not the sales of the supplier. Although greater sales by the entity may cause it to place further orders with the supplier, the benefit of that to the supplier is captured entirely by the net amount the supplier receives from the entity. Therefore, we believe that slotting fees should be treated as a deduction from the cost of goods purchased by the entity, not as revenue.

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?

We broadly agree with the accounting proposed by the ED, although we think some of the drafting is confusing. We suggest that the drafting should be revisited and simplified.

We are aware of considerable concern that entities will find it too difficult to distinguish between latent and other defects. However, notwithstanding the statements to the contrary in question 15(a) and in paragraph B14, it seems to us that the ED does in fact treat the subsequent repair of an item for a latent defect as a separate performance obligation. (This is because the final sentence of paragraph B15 defers revenue only for the repair, not for the item as a whole – which can only be consistent with the ED's model if the repair is a separate performance obligation. We support this approach.)

Therefore, we believe the ED can be simplified so as to treat all outstanding work under warranty as separate performance obligations.

The only impact of the difference between latent and other defects is likely to be in the area of measurement. Often, there will be an observable price for the type of warranty described in (b) above, because a customer can often choose whether or not to purchase an 'extended warranty'. In contrast, it will usually be necessary to estimate a stand-alone selling price for the types of warranty described in (a), and we suggest that this should be estimated on the basis of direct costs (including labour etc.) plus an appropriate margin.

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 terms 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 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 disagree with this analysis. In our view, whether or not a licence is exclusive has no effect on whether the seller has outstanding performance obligations.

It seems to us that the analysis above is inconsistent with the ED's focus on control. Irrespective of exclusivity, either a customer has been granted a right to use intellectual property for a period, or it has not. If it has not been granted that right, no revenue should be recognised. If it has been granted that right, which will typically be under the terms of a contract, there is no sense in which the seller has an ongoing obligation to allow the customer to use the intellectual property – rather, it has already given up its ability to prevent the customer from using the intellectual property.

In our view, in these cases, revenue should be deferred only where a seller has real outstanding performance obligations.

Question 17: 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?

We agree, but subject to the comments made and concerns raised throughout this letter. In particular, our concerns around variable consideration will often be relevant for sales of intangible assets and property, plant and equipment.

We trust you find our comments helpful in the consultation process and please do not hesitate to contact our Chairman, Brian Creighton on +44 (0) 207 7893 3415 if you wish to discuss any of our comments further.

Yours faithfully

Brian Creighton

Brian Creighton.

LSCA Technical Committee Chairman