

21 October 2010

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft: Revenue from Contracts with Customers

We are responding to the invitation of the IASB/FASB ('the boards') to comment on the Exposure Draft, ('the ED') on behalf of The Capita Group Plc.

We welcome the opportunity to comment on the ED. We agree with the boards' objectives in attempting to clarify the principles for recognising revenue and seeking to develop a common revenue standard that removes weaknesses and inconsistencies in existing standards; provides a more robust framework for dealing with revenue recognition issues; improves comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets; and attempts to simplify the preparation of financial statements by reducing the number of requirements to which entities must refer.

We welcome and acknowledge the considerable effort the boards have put into achieving these objectives and in attempting to devise a robust conceptual framework to deal with revenue recognition which can be applied across the board but feel that the proposed model in the ED is not appropriate for certain types of economic activity and contracts. We feel that, although the model would work reasonably well for the majority of contracts, it is unlikely to result in fair revenue recognition in the specific cases of construction-type contracts where control of the asset is not transferred to the customer on a continuous basis or for certain types of contracts for the delivery of services where such delivery (and transfer of control) is not continuous.

As set out in our detailed response to the questions posed by the boards in Appendix 1, we feel that the ED's control-based model would mean that revenue and profit recognition (for entities with such contracts) would be deferred possibly for significant periods until it was clearly established that control had passed to their customers for separately identified performance obligations within these contracts. Consequently, revenue recognition within such entities could become considerably 'lumpier' than at present where revenue (subject to certain conditions) can be recognised on a consistent basis as activity on the contract progresses.

This would also not be conducive to fostering comparability between such entities. Consider two entities working in the same construction related industry and having the same level of economic activity and profitability. The only difference being that their contracts have different timing profiles such that one entity completes more performance obligations (as defined within the ED) within its contracts than the other entity in a reporting period but their level of activity has been exactly the same. Under the existing standards, the two entities would produce comparable financial results

but under the proposals, one entity would report more revenue and profit than its counterpart. This does not seem to result in useful information for users of the financial statements.

It was precisely to recognise the special nature of such contracts that UK GAAP developed SSAP 9 Stocks and Long-Term Contracts and FRS 5 Application Note G Revenue Recognition. Under existing IFRS, these same principles are well established (and understood) within IAS 11 Construction Contracts and IAS 18 Revenue.

As stated in Appendix 1, we are in broad agreement with the alternative, contract-based activity model set out by the European Financial Reporting Advisory Group (EFRAG) in appendix 3 of its draft comment letter to the ED. We feel that this alternative model would lead to more decision-useful information for the users of the financial statements.

There is much in the ED which we support as noted in Appendix 1 but our other main concerns are:

- We do not think that the credit risk of customers should be reflected within revenue.
- We do not think an entity should recognise a liability where a performance obligation in isolation is onerous but the contract overall is profitable.
- We do not agree that all costs incurred relating to securing a contract should be expensed as incurred. We consider that certain costs incurred in securing a contract, such as sales commissions and similar costs, which are incremental, directly related and necessary to secure the contract should be capitalised and amortised over the life of the contract. These costs represent cash flows directly related to the contract and thus should be accounted for as part of that contract. This would be consistent with current practice in accordance with paragraph 21 of IAS 11. In our view, the proposal to expense such costs would not result in more decision-useful information than the current standard.

In addition, we have concerns about the extensive disclosure requirements. Whilst we recognise that these would provide useful information to informed users of the financial statements who have an in-depth understanding of accounting standards, we have concerns about the practicalities and costs of gathering the data and information. The requirements will also add to the length and complexity of financial statements at a time when there are growing calls for a reduction in the complexity of annual reports.

Our answers to the specific questions raised in the ED provide more detail on the views expressed above and are attached in Appendix 1.

If you would like to discuss these comments further or have any questions, please do not hesitate to contact Simon Mayall (simon.mayall@capita.co.uk) or Ray Byrne (ray.byrne@capita.co.uk).

Yours faithfully

The Capita Group Plc

Appendix 1

Responses to questions posed in the exposure draft

Recognition of revenue

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?

We support the principle proposed for combining and segmenting contracts but feel that the guidance and paragraphs setting out the basis for doing this should be clarified as, in the ED, they are not well defined and may lead to considerable divergence in practice among preparers of financial statements. In particular, the definition of 'interdependence' as applied in the ED should be clarified. From paragraph 13 it is clear that two contracts are priced interdependently when the price the customer pays for one is discounted in exchange for agreeing to pay a premium in another contract. In addition, paragraph 14 states that the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount in the new contract as a result of an existing customer relationship from previous contracts. Between these two extremes the guidance is less helpful. A contract may be priced based on a discounted rate on that adopted in recently entered contracts in cases where it is difficult to say whether this is due to genuine price interdependence or as a consequence of established relationships.

We support the principle for dealing with contract modifications but again feel the concept of interdependence which underpins it needs to be further clarified. The guidance given here in example 2 in paragraph B3 is not particularly illuminating as the two examples, which lead to differing outcomes, appear to have little in genuine substance to distinguish them. In both cases the customer seeks an extension of a contract for a further three years with a reduction in the standalone selling price for years three to six. This example needs to be replaced with guidance which clearly explains how to distinguish between those circumstances giving rise to accounting for a contract modification together with the existing contract and those which do not. In this regard, it may be useful to include in the guidance, a quantitative test on similar lines to the '10% test' contained in paragraph AG62 of IAS 39 Financial Instruments: Recognition and Measurement.

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 support the principle proposed in the ED for determining when a good or service is distinct and welcome the extensive guidance examples provided on this in paragraphs B4-B43. However, there seems to be a tension between paragraph 20 and paragraph 23. Paragraph 20 states that an entity shall evaluate the terms of the contract and *its customary business practice* to identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation. However, paragraph 23 (a) requires the entity to consider the *practice of other entities*. This wording could generate confusion as to whether the test is based on the entity's own business practices or based on the practices of the wider market.

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?

We are unable to fully support the control model for revenue recognition as set out in the ED. We appreciate the attempt of the boards to devise a robust conceptual framework to deal with revenue recognition which can be applied across the board but feel that this model is not appropriate for certain types of economic activity and contracts. The model would work reasonably well for the majority of contracts but we feel that it is not likely to lead to fair revenue recognition in the case of construction-type contracts where control of the asset is not transferred to the customer on a continuous basis or for certain types of contracts for the delivery of services where such delivery (and transfer of control) is not continuous.

The boards acknowledge that many respondents to its Discussion Paper (DP) on Revenue Recognition expressed similar concerns about how the model would apply to existing construction-type contracts and had asked the boards to retain existing requirements for those types of contracts – paragraph BC21. The boards concluded that this response was partly attributable to a misperception that the proposed model would require completed contract accounting for all contracts currently within the scope of IAS 11 Construction Contracts (or ASC Subtopic 605-35) and pointed out that this would not be the case. We agree with the boards that this would not be the case for all such contracts but our reading of the ED is that revenue recognition for many of these contracts would be significantly different from that which would be reported under current standards. In many cases, revenue and profit recognition would be deferred possibly for significant periods until it was clearly established that control had passed to their customers for separately identified performance obligations within these contracts.

Revenue recognition within such entities could become considerably 'lumpier' than at present where revenue (subject to certain conditions) can be recognised on a consistent basis as activity on the contract progressed. It was precisely to recognise the special nature of such contracts that UK GAAP developed SSAP 9 – Stocks and Long-Term Contracts and FRS 5 Application Note G – Revenue Recognition. Under existing IFRS, these same principles are well established within IAS 11 Construction Contracts and IAS 18 Revenue.

One of the aims of the boards is to increase comparability between the financial statements of entities but the proposals in some respects would make this more difficult. Consider two entities which in all respects are similar. They work in the same construction related industry and have the same level of economic activity and profitability. The only difference is that their contracts have different timing profiles such that one entity completes more performance obligations (as defined

within the ED) within its contracts than the other in a reporting period but their level of activity was exactly the same. Under the existing standards, the two entities would produce comparable (in our example – identical) financial results. Under the proposals, one entity would report more revenue and profit than its counterpart. This does not seem to result in useful information for users.

We are in broad agreement with the alternative model set out by the European Financial Reporting Advisory Group (EFRAG) in appendix 3 of its draft comment letter to the ED dated xx October 2010 (sic). It is not considered appropriate to set out the full model here (please refer to EFRAG's draft comment letter for the full details) but the key elements are contained in paragraph 4:

'Under this alternative model, revenue should reflect the activity carried out by an entity pursuant to a contract with a customer. That is, revenue should be recognised as an entity progresses towards the fulfilment of a performance obligation. However, the following conditions should exist before revenue is recognised:

- a) A contract with a customer must be concluded, and the entity must have performed pursuant to that contract, ie made progress in fulfilling its performance obligations under the contract;*
- b) The contract must be such that the entity, as it progresses towards fulfilling its performance obligation, holds an irrevocable right to consideration subject to continued performance. This right may be stipulated in the contract itself, stem from law or from law enforcement practices. In other words, the customer must be obliged, in one way or another, to pay for any work completed to date, as long as the entity performs under the contract.'*

In our view, such a model would provide more decision-useful information for users of the financial statements than the boards' proposed model would for these types of contract activity. As noted earlier, the boards' model would be satisfactory for most types of contracts but its attempted 'one-size fits all' control-based model would not satisfactorily fit these construction-related and similar contracts. As EFRAG in paragraph 12 of appendix 3 of its draft comment letter notes:

'Information provided to users would ... not be limited to depicting transfers of control of assets between suppliers and customers. The income statement would convey supplementary information – ie how the activity of the entity throughout the period generates revenue and profit pursuant to contracts with customers. This information would prove to be more useful to users in determining sustainable streams of future cash flows. Also, the statement of financial position would show inventory for which no irrevocable right to receive payment contingent on continuous performance separately from inventory (work in progress) for which such a right exists.'

In paragraphs BC33-BC34 of the Basis for Conclusions on the Exposure Draft, the boards express concerns with an activities-based model as follows:

BC33 (a) Revenue recognition would not be based on accounting for the contract – in an activities model, revenue arises from increases in the entity's assets, such as inventory or work in progress, rather than from the contract. Therefore, conceptually, an activities model does not require a contract with a customer for revenue recognition, although revenue recognition could

be deferred until a contract exists. However, that would result in revenue being recognised at contract inception for any activities completed to that point

We disagree, an activities model as proposed by EFRAG would require a contract to be concluded and revenue would reflect activity carried out pursuant to that contract with the customer. No revenue would be recognised at inception – revenue would only be recognised as the entity actually progresses towards fulfilling its performance obligations under that contract.

BC33 (b) It would be counter-intuitive to many users of financial statements – an entity would recognise consideration as revenue when the customer has not received any promised goods or services in exchange.

We disagree, as noted above – no revenue would be recognised at inception of the contract. Revenue would only be recognised as the entity actually undertakes activity in performance of its service obligations under the contract in circumstances where it holds the irrevocable right to consideration subject to continued performance.

BC33 (c) There would be potential for abuse – an entity could accelerate revenue recognition by increasing its activities (for example, production of inventory) at the end of the reporting period.

The potential for abuse would be unchanged from the existing standards and indeed would be no different from that afforded by the ED in cases where control is deemed to be transferred on a continuous basis.

BC33 (d) It would result in a significant change to existing standards and practices.

We disagree, in our view the proposed EFRAG contract-based activities model results in an outcome which is more in line with existing standards and practices. As mentioned earlier, this revenue recognition practice is well established and well understood and is clearly sanctioned by IAS11 and IAS18 within IFRS and SSAP 9 and FRS 5 Application Note G within UK GAAP. Our view is that it is the ED's proposed control model which would result in a significant change to existing standards and practices.

We now turn to the specific question posed as to whether we think that the proposed guidance in paragraphs 25-30 of the ED and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer. Given that the ED's model is based on this concept of control, we feel that the guidance on this issue is not sufficiently robust. The ED provides four basic 'indicators' for determining whether control has passed to the customer, however none of these is individually determinative and some may not be relevant in all cases.

We have noted that some commentators on the ED have expressed concern that all factors must be considered equally but that this might not be fair in cases where a highly specialised asset is being constructed. In the latter case, this in itself could mean that control is continuously transferred

regardless of any other factor. However, the ED states in paragraph 31 that 'not one of the preceding indicators determines by itself whether the customer has obtained control of the good or service'.

In our view, the application of this test will place considerable reliance on preparers of financial statements in exercising their judgement. This is likely to lead to highly subjective assessments which may lead to differing judgements made by entities in similar circumstances. It is not clear that this will contribute to greater comparability.

We are also concerned that the concept of control is more difficult to apply in the case of services and feel that more substantial guidance is needed in this area. It is also problematic, in our view, that the entity itself has to make this judgement based not on its own perspective but that of its customer.

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 agree with the proposal that an entity should only recognise income if the transaction price can be reasonably estimated and with the proposed criteria for establishing that in paragraph 38.

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 do not agree with the proposal that a customer's credit risk should affect the amount of revenue the entity recognises. The amount of revenue recorded in the financial statements is a useful number for users in giving an indicator of the level of activity undertaken by the entity in the reporting period be that sales of goods or services or both. To adjust this figure with estimates of perceived credit risk which may fluctuate until the entity has the unconditional right to consideration would not be helpful and may undermine the usefulness of this activity measure. In our view credit risk should be treated consistently across all accounting standards and should not disturb the well understood revenue line.

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 with this proposal.

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 transaction price should be allocated to the separate performance obligations in a contract in proportion to their individual stand-alone selling prices at contract inception. However, after contract inception, we think that allocation of any changes in the transaction price should be allocated based on the facts and circumstances at that time and not by default based on the proportion of stand-alone selling prices at inception. The latter method which is proposed in paragraph 53 of the ED may be suitable in the majority of cases but there may be circumstances where this would not be appropriate and the ED should cater for these. For example if an entity performs the bulk of its performance obligations on time and satisfactorily but experiences delays in the delivery of certain of its later performance obligations such that the customer requests and receives a reduction in the transaction price to compensate for the delays in delivery of the later obligations, we think the reduction in the transaction price should only be allocated to the performance obligations subject to delay and yet to be performed. We do not think it would be appropriate to allocate the reduction over all of the performance obligations including those already performed.

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?

We broadly support these proposals and think they are operational and sufficient. However, we do not agree with the proposal in paragraph 59 that all costs incurred relating to obtaining the contract should be expensed as incurred. We feel that certain costs incurred in securing a contract, such as sales commissions and similar costs, which are incremental, directly related and necessary to secure the contract should be capitalised and amortised over the life of the contract.

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 proposal for capitalising direct costs as set out in paragraph 58 but as noted above we also believe it should be permissible to capitalise the costs of securing a contract in certain circumstances. We also believe these direct costs criteria are appropriate for determining a liability for an onerous contract. However, we disagree with paragraphs 54 and 55. We feel that a liability should only be recognised if the contract as a whole is onerous. We do not think a liability should be recorded where a performance obligation in isolation is onerous or loss-making but the contract as a

whole is profitable. The losses on individual performance obligations (where this is the case) should only be recognised as incurred. We also disagree with the probability-weighted approach for determining this liability – we feel it should be calculated on the best most likely estimated basis, subject to re-assessment at each subsequent reporting date. We object to the probability-weighted method unless it is restricted to cases where there is a large population of items. Thus the liability should be estimated based on the best forecast for the specific circumstances subject to re-measurement.

Disclosure

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?

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?

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 with the boards' objectives regarding disclosure and agree that the proposed disclosures would provide useful information to informed users of the financial statements who have an in-depth understanding of accounting standards. However, we have serious concerns about the practicalities and costs of gathering the data and information. The proposed disclosures are extensive and will add considerably to the task of preparing the financial statements. It is inevitable that the proposed requirements will require significant adjustments to existing internal data gathering processes and may have implications for entities' IT systems to ensure they are able to compile and report the required information and data. This will be a particularly difficult task for entities with decentralised operations.

Obviously, this is a question of weighing up the costs and benefits and the answer will differ according to the respondent's perspective. The proposed disclosure would indubitably add to the length and complexity of financial statements. This at a time when there is growing disquiet in some quarters that financial statements are becoming so voluminous and complex that fewer users are able to fully understand them. There is a growing movement to try and redress this problem as evidenced by the 'Louder Than Words' discussion paper issued by the UK's Financial Reporting Council in June 2009, and more recently in the UK's Financial Reporting Review Panel's Annual Report which encourages preparers of financial statements to 'cut the clutter' by ensuring that over-disclosure is not prevalent. The disclosure requirements of the proposed standard will add to rather than ease concerns on this point.

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.

We agree that the proposed requirements should be applied retrospectively. If applied prospectively to new contracts only, this would give rise to a mixture of revenue recognition criteria being applied and, depending upon the unexpired duration of contracts at transition, this could continue for several reporting periods.

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?

We feel that standards should be written in a clear, non-ambiguous manner setting out succinctly clear principles which are capable of being applied without any further guidance being necessary. We appreciate that this is often easier said than done especially when dealing with complex conceptual matters. There are elements of the proposed standard, for example the guidance for determining when control of a promised good or service has been transferred to a customer, which we feel could be significantly improved. In many areas, we consider that more guidance and explanation of the principles is necessary. It would also be useful if there were more detailed and comprehensive illustrative examples showing how the disclosure requirements could be presented.

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 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 agree with the proposals.

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 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 agree with the proposals.

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 with the proposals.