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International Accounting Standards Board
30 Cannon Street
LONDON
EC4M 6XH

Dear Sir/Madam,

Re: Exposure Draft - *Revenue from Contracts with Customers*

We welcome the invitation to comment on this Discussion Paper and write on behalf of Cobham plc, a UK based FTSE 100 and S&P Europe 350 company. We operate globally in the Aerospace and Defence sector.

Overall we are supportive of the desire to address some of the inconsistencies between current accounting standards on revenue recognition although we are surprised that the Board has issued an Exposure Draft that is fundamentally applying the same principles as those included in the Discussion Paper, given the amount of negative response received. We have also participated in discussion forums at which most participants were opposed to the proposed principles of revenue recognition.

We found the Exposure draft to be clear and well written in most areas and we found the numerous examples very helpful in understanding the proposals being made.

We disagree in principle with the Exposure Draft in the following areas:

- We believe that standard warranties are not performance obligations and any statistical estimate for remedial work should be treated as a cost accrual
- We disagree with the principle of recognising credit risk unless there are specific concerns about a customer with low credit rating. For a long term contract the assessment of a customer's credit risk at the commencement of the project is meaningless. Any concerns about recoverability of receivables should be accounted for as a bad debt provision.
- Some of the proposed disclosures will not, in our opinion, provide decision useful information for a diverse business without being very lengthy

We also have a number of concerns regarding the practical implications along with the effort and cost involved in implementing these proposals.

Please refer to our responses to each question for further details.

Please contact Stephen Morris or Paul Kemp if you need any further clarification in respect of these comments.

Yours faithfully,

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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 agree in principle to the Board's proposal. This does address the current inconsistencies seen between existing standards although does present some practical challenges. These are considered in more detail below.

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 appreciate the difficulty in setting criteria for the identification of performance obligations. It is noted that paragraph 23 (b) (ii) may require some judgement to determine whether the obligation has distinct risks which can be translated into a profit margin where a separate transaction price is not specified in the contract. However, we agree that this is inevitable in order to produce a definition that is sufficiently robust for diverse circumstances.

We do have some concerns regarding the application guidance of these principles. In particular Example 7 concludes that the upfront fee charged by a payroll provider to set up the payroll system is not a separate performance obligation and this revenue is therefore spread over the expected service period; paragraph B30 then appears to indicate that the costs incurred by the payroll provider might be expensed as incurred. Given that the upfront fee is charged to compensate for these costs we believe that it is inequitable not to match the costs and revenues associated with this activity.

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 agree that the guidance in paragraphs 25-31 provide reasonable indicators of the transfer of control to the customer.

We disagree with the position on standard warranties and would maintain our position presented in our response to the Discussion Paper that standard warranties are not performance obligations and should be treated as cost accruals rather than revenue items. Our position is based on the transfer of control to the customer.

Standard warranties are viewed primarily as part of the obligation to deliver a product in a condition and to a standard that makes it fit for purpose. They are therefore seen as part of quality assurance and we would therefore maintain that they are part of the performance obligation to deliver the product. We recognise that other situations such as extended

warranty options are different to the situation described above and would in substance be a separate performance obligation.

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?

Cobham operates in an industry which is highly specialised and a number of our contracts involve unique highly technical products. We are concerned that the criteria in paragraph 38 might be too restrictive in situations where a contract does not replicate previous contracts. We would prefer to remove this uncertainty and would suggest the insertion of 'or other relevant experience' after 'the entity has experience with similar types of contract'. We would also note that contingent consideration arising from business combinations is estimated using best estimate which is divergent from the proposed approach for recognising variable transaction prices.

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

The question provides two alternatives. Given this choice we agree that it is more appropriate for a customer's credit risk to reflect how much revenue is recognised rather than whether revenue is recognised. However, we believe that the inclusion of credit risk in the calculation of transaction price is over-complicated and will cause unnecessary demands on resource. It would also be highly judgemental. For short contracts the recoverability of the debt will become clear very quickly in most cases. For longer term contracts the credit risk of the customer could change dramatically over the life of the contract and therefore we would question the appropriateness of assessing this risk in advance of billing. We believe that doubtful debt provisions should be dealt with based on recoverability reviews of amounts invoiced and the valuation of any other assets held in the Statement of Financial Position.

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 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?

In general the stand alone market price is an appropriate basis to allocate the transaction price to each performance obligation. However, there will be instances in the aerospace and defence sector where market prices are not readily available. These will include some contracts with Government bodies which are priced on a cost plus basis in the absence of appropriate alternative products. In these situations the entity should have a good understanding of the risks of each performance obligation and the appropriate margins that should apply such that an appropriate allocation could be made. We consider that paragraphs 50 – 52 adequately cover our views on this matter.

Question 8:

Paragraph 57 proposes that if costs incurred in fulfilling a contract do to 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 agree that these proposed requirements are operational and sufficient.

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

We agree with the costs specified provided that they relate to costs which are incurred irrespective of whether the contract is won or not.

Question 10: The object 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 do not agree that the disclosure requirements proposed will meet the stated objective. For a diverse business a number of the disclosures would need to be so aggregated that, in our opinion, they would not provide any additional useful information to the users of the accounts. In our opinion, example 31 implies that the disclosures envisaged by the Board are too detailed for a complex and diverse business. Therefore we would disagree with these proposals.

Furthermore, some of the information required will be onerous to collect across a large number of businesses and may also contain information that is commercially sensitive. These concerns especially relate to the proposed disclosures in paragraphs 74, 77, 78 and 83.

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 and entity should disclose about its remaining performance obligations?

Consistent with our response to question 10 we are concerned about the effort required to collect the information required to satisfy the proposed disclosures and the ability to respect commercially sensitive information.

Question 12: Do you agree that an entity should disaggregate revenue into categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not why?

We do not agree with this proposal. In practice the satisfaction of this proposal will be highly judgemental for a business with a wide range of revenue streams. The reaction of revenue and cash flows to changes in economic factors could, in many cases, be contract specific which could make this categorisation of revenue very difficult to satisfy. Therefore the resulting information is unlikely to be aid comparison between different companies and possibly between different reporting periods in the same reporting entity.

Question 13: Do you agree that an entity should apply the proposed requirements retrospectively (i.e. 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 recognise that there is no viable alternative to some degree of retrospective application of these proposals. However, this is likely to result in significant effort and cost to implement and we would ask the Board to bear this in mind as they work through the transitional arrangements.

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 found the guidance helpful in understanding the principles proposed and therefore appropriate for inclusion in the guidance. However, they are generally quite simple and therefore, understandably, unlikely to be sufficient to make the proposals operational.

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 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 the 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?

Yes, although as noted above we believe that latent defect warranties should be treated as a cost accrual rather than a revenue recognition item.

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 that the proposed accounting treatment is appropriate assuming that the license agreement is straightforward. Where revenue is contingent or the substance of the payment schedule such that the agreement is satisfied in separate time periods then these principles would need to be reviewed for appropriateness.

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 believe that the principles contained in the various accounting standards covering the sale of non-financial assets are sufficient and there is no need for a revenue recognition standard to reach beyond its natural boundaries.