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October 22, 2010

International Accounting Standards Board
30 Cannon Street, 1st Floor
London EC4M 6XH
United Kingdom

Technical Director,
Financial Accounting Standards Board,
401 Merritt 7, PO Box 5116,
Norwalk, CT 06856-5116

Dear Sirs:

**Re: Exposure Draft, Revenue from Contracts with Customers
IASB Reference ED 2010/6, FASB Reference 1820-100**

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the Exposure Draft, *Revenue from Contracts with Customers*, issued jointly by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (together "the Boards"), on June 24, 2010.

The AcSB has consulted with a broad spectrum of Canadian preparers, practitioners and users. Responses to the questions posed in the Exposure Draft reflect comments gathered from these constituents as well as the views of AcSB members.

The AcSB commends the Boards for their efforts to produce a common single standard for revenue recognition. We agree that a standard based on one over-arching principle applied to all types of contracts with customers is desirable. Developing the principle from the conceptual framework definitions of assets and liabilities is consistent with a principles-based set of standards and should be preferable to the existing less precise notions of transfer of risks and rewards.

Our major concern with the proposals is the specification of this over-arching principle. We think that the transfer of control of the goods or services to the customer is not sufficiently robust to result in appropriate revenue recognition in some circumstances. In our view, this is evidenced by the difficulty the Boards encountered in trying to make this principle apply to long-term construction contracts. This is the part of the proposals that has caused the most confusion among our constituents and, consequently, has resulted in the most frequent requests for more guidance.

Financial statement users tell us that they need information about the reporting entity's cash flows during the reporting period, about the progress of long-term contracts and the sustainability of the activities that will generate future cash flows. We are concerned that revenue from long-term construction contracts may not be readily determinable on the basis of transfer of control as defined and described in the Exposure Draft in a manner that faithfully represents the substance of each transaction and meets the information needs of users. We think that, in the absence of extensive additional guidance, the judgments that would be required to apply the transfer of control concept to long-term contracts will make the model difficult to apply consistently. We also think that the results will be difficult to interpret.

As an alternative, we propose that revenue should be recognized when the entity has an unconditional right to consideration for the provision of goods or services in accordance with a contract with a customer. We agree with the Boards that when there is a "complete" transfer of control, such as in a straightforward sale of goods, transfer of control is a sufficient condition for revenue recognition. However, we do not think that a complete transfer of control should be a necessary condition for revenue recognition. The proposed indicators are not sufficiently clear when control is partially shared between the vendor and the customer, such as in some long-term contracts, to result in consistent and appropriate application of the "transfer of control" concept. For example, it is not clear whether revenue should be recognized while an asset specifically designed for a customer is under construction when the customer can refuse acceptance if the asset's performance fails to meet specifications.

Like the Exposure Draft proposals, our proposed approach is based on the identification of assets and liabilities arising from contracts with customers in accordance with the *Framework*. However, we think it would have the following advantages over the Exposure Draft proposals:

- An unconditional right to payment is a criterion that can be applied to all types of contracts. Constituents struggle to apply the transfer of control notion to contracts for services in addition to the long-term construction contracts discussed above.
- It identifies the relevant assets and liabilities from the perspective of the entity rather than the customer. We think that the recognition of revenue should depend on the entity's rights and obligations rather than those of the customer.

Given that we propose that transfer of control would be considered a sufficient condition for revenue recognition, we think that much of the currently proposed material would continue to be relevant and useful.

Should the Boards not agree with our recommendation to reconsider the main principle the proposals are based on, we nevertheless urge them to complete the project. We think that the proposals are a significant improvement over both Boards' existing revenue recognition guidance. For example, the AcSB thinks that the proposals would improve revenue reporting for contracts with multiple deliverables.

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One approach to responding to the concerns about consistent application of the proposals to long-term construction contracts might be to incorporate more of the guidance from IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*. At the same time, some of the guidance from IFRIC 15 that has been incorporated into the proposals was developed to identify construction contracts to which a different model of revenue recognition applied. This guidance does not seem appropriate when all the requirements for revenue recognition are set out in a single standard and should be reconsidered.

Another approach would be to develop a different principle for revenue recognition that would be applied to long-term construction contracts. If a different principle is to be applied to long-term contracts, then perhaps a second standard that describes this principle and its scope and application may be a better option. We recognize that the Boards' objective was to develop a single standard. However, it is possible that these contracts have sufficiently different characteristics that they warrant separate treatment. We think having two clear principle-based standards with comprehensive guidance would still be a major improvement to both sets of standards.

We have included in the Appendix our responses to the questions set out in the Exposure Draft.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email peter.martin@cica.ca) or Kate Ward, Principal, Accounting Standards (+1 416 204-3437 or email kate.ward@cica.ca).

On behalf of the Board



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APPENDIX

Question 1:

The AcSB agrees with the proposed principle of price interdependence. However, more guidance is necessary to explain the difference between segmenting a contract based on independent pricing and dividing it into separate performance obligations based on distinct profit margins. The difference between independent pricing and distinct profit margin is not clear and stakeholders find the similarity between paragraphs 15(a) and 23(a) confusing.

We are particularly concerned about possible inconsistencies in the application of the guidance to construction projects. In our view, there should be a rebuttable presumption that separate contracts for different phases of a single project to build a discrete asset or interrelated group of assets should be considered interdependent. This should be the case even when the contracts are not negotiated as a single package and there are observable prices for the goods and services in the separate contracts.

We note that the guidance in paragraph 19 would need to be modified if the proposed over-arching principle proposed in our covering letter were adopted. An entity could not have an unconditional right to consideration prior to becoming a party to a new or revised contract. Depending on the new contract terms, the entity may obtain that right immediately or in the future. We are advised by the surety industry, which is a significant user of contractors' financial statements, that the accounting for changes in contracts can frustrate their risk assessment of contractors. Accordingly, we think that the standard should require disclosure of information necessary to permit a financial statement user to understand the implications of a contract modification.

Question 2:

The AcSB agrees that performance obligations in a contract should be recognized separately on the basis of whether they are distinct. However, the requirement in subparagraph 23(b)(ii) that a good or service have a distinct profit margin will fail to identify some performance obligations that should otherwise be considered distinct. We think that many contracts are priced to achieve a constant profit margin across a number of deliverables that have distinct function and risks. Therefore, we disagree with the assumption that a distinct profit margin necessarily follows from distinct risks and the ability to identify the resources required to deliver the good or service. We think paragraph 23(b) should require all of the following criteria to be met:

- The product or service has a distinct function;
- The product or service has distinct risks; and
- The resources to create or deliver the product or service should be identifiable.

This change should help preparers identify distinct performance obligations in a more consistent manner. It should also help resolve the ambiguity between segmenting contracts and identifying separate performance obligations.

Consistent with our views on segmenting contracts in response to Question 1, we think that it is not helpful to break construction projects into discrete performance obligations. There are many phases of a construction project that might meet the criteria to be considered distinct, and, therefore, to be treated as individual performance obligations. This is particularly true when the services are provided by a sub-contractor. Stakeholders are confused about whether revenue from construction contracts would be recognized on a completed contract basis, on the basis of satisfaction of individual performance obligations, or on a continuous transfer basis. The discrete performance obligation approach and the transfer of control of work-in-progress do not appear to be suitable models for achieving consistent, decision-useful reporting for construction contracts. Users of contractor financial statements tell us they need information about the overall progress of a construction project and the realization of cash flows. They stress that a percentage of completion model best serves their needs.

Except for construction contracts, the AcSB agrees with the proposed principle for identifying individual contract deliverables subject to the modification to paragraph 23 suggested above.

Question 3:

The AcSB thinks that the proposed guidance in paragraphs 25 – 31 is confusing because it is attempting to determine whether the entity has satisfied a performance obligation by assessing the customer's rights. The indicators are not sufficiently clear to produce consistent and appropriate application of the "transfer of control" concept when control is partially shared between the vendor and customer, as might occur in the case of some long-term contracts. This could occur, for example, if the good is specifically designed and so satisfies paragraph 30(d) but the customer can refuse acceptance if the good's performance fails to meet specifications as required by paragraph B72.

As discussed in our covering letter, we think that revenue recognition should be based on the broader principle of recognizing the economic benefits from satisfying obligations to provide goods or services to a customer. We think that the entity has fully or partially satisfied a performance obligation when it has an unconditional right to payment. Although an enhancement of assets occurs throughout a manufacturing or construction process, the recognition of that value added should occur only when the entity has the right and ability to realize it. In many cases, the right to receive payment occurs when control of an asset transfers. Control is an important indicator that an entity has satisfied an obligation to provide a good to a customer and, therefore, should be a sufficient condition for recognizing revenue.

We agree with the discussion in paragraphs 28 and 30 that legal title and physical possession are not necessarily indicative of control. These paragraphs might be more helpful if they were presented in the context of an illustrative example in Appendix B. We also agree with the proposed guidance for

repurchase agreements, rights of return and bill-and-hold arrangements as they relate to title and possession.

We think that the pattern of revenue recognized on a construction contract should not be based on the assessment of the transfer of control of a good or service. The Exposure Draft proposals could be modified such that there is no question that an asset constructed on the customer's land is always in the customer's control by distinguishing control of the work in progress from control of the construction site. However, this would not resolve uncertainty about the transfer of control of an asset constructed on the vendor's property. Further, in such circumstances a conclusion that transfer of control is continuous is unlikely to be feasible when implicit or explicit customer acceptance conditions have not been met.

We note that the criterion of customer-specific design (paragraph 30(d)) was developed in IFRIC 15 as a factor in determining whether the contract is a construction contract or a contract for the provision of an asset. This was necessary in deciding which standard applies in existing IFRS. However, we do not think it is an indicator of whether control of an asset transfers from the vendor to the purchaser. Rather, as discussed in paragraph 30(d), we think in such circumstances the vendor will require payment as the work is completed. Consequently, this indicator adds nothing to paragraph 30(a).

Uncertainty about the application of the transfer of control notion will result in inconsistent treatment of comparable construction contracts. Stakeholders argue that information will be lost if construction contracts are reported on a completed contract basis. Users want information about the stage of completion of a project including costs incurred and amounts invoiced to date, as well as updated estimates of the cost to complete the project. They think that revenue should be recognized on the basis of engineer's certificates or similar milestones that validate the entity's progress. Recognizing revenue on the basis of the entity's right to receive payment aligns with a percentage of completion revenue recognition model.

Question 4

The AcSB agrees that if the amount of the consideration is variable, revenue should be based on estimated transaction prices when reasonably estimable. We also agree that the guidance in paragraph 38 is appropriate. However, preparers and auditors have expressed concerns with their ability to implement this aspect of the proposal consistently due to uncertainty about applying the relevant experience requirements in paragraph 38 and the possible subjectivity of the estimates. Some stakeholders are uncomfortable with measurements based on probability-weighted estimates and question the usefulness of replacing recognition uncertainty with measurement uncertainty. We understand some of those concerns. Nonetheless, we agree with the Boards' proposal to address uncertainty about the amount of consideration in the measurement rather than imposing recognition criteria. We think that additional illustrative examples would be helpful, including examples of how revenue should be recognized when all or any component of the transaction price cannot be reasonably estimated.

Question 5:

The AcSB does not agree that the effects of customer credit risk should be reflected in reported revenue. Users have consistently advised us that the effects of customer credit risk should be reported separately from other line items. Management of credit risk is a separate business activity from selling goods or services. Users are interested in determining the quality of the entity's customers, the level of customer credit problems, the entity's collections experience and changes from previous periods. These metrics are unavailable under the measurement approach proposed in paragraph 43 unless additional disclosures are provided.

We would also object to the replacement of the proposal in paragraph 43 with the assessment of customer credit risk as a hurdle for the recognition of revenue. As discussed on our response to the Amortised Cost and Impairment Exposure Draft, we think that impairment of financial assets, including customer accounts receivable, should be reported in a separate line, on an incurred loss basis with no probability of loss threshold or requirement for objective evidence of impairment. We agree that, when estimable, an immediate provision for credit losses might be recognized concurrently with accounts receivable relating to a group of sales.

Question 6:

The AcSB agrees that material financing components of contracts should be reported separately. Stakeholders think that more guidance is necessary, particularly as regards discount rates and interpretation of "significantly before or significantly after the transfer". We agree that further guidance would be helpful because we think that it would be unusual for an entity to undertake "separate financing transactions" with customers when its business involves selling goods or providing services other than financing and because determining appropriate discount rates has been widely debated.

Question 7:

The AcSB agrees that the transaction price should be allocated to individual performance obligations on the basis of their relative stand-alone selling prices. However, we are concerned that the wording of paragraph BC 125 appears to provide application guidance on the ability to use the residual method to estimate a stand-alone price for a performance obligation in some circumstances. Application guidance should be included in the standard and the circumstances in which the residual method might be appropriate should be clarified. For example, can it be used when there are more than two performance obligations?

Question 8:

The AcSB agrees with the proposed requirements on accounting for contract costs.

Question 9:

The AcSB agrees with the costs specified but thinks that, consistent with IAS 37, all outstanding performance obligations under an individual contract should be assessed collectively. The requirement should be to recognize a loss on an onerous contract, rather than on an onerous obligation. It is inappropriate to assess individual performance obligations because the requirements for allocating the transaction price will distribute any discount and measurement uncertainty proportionately across all performance obligations, reducing the margin that would otherwise be earned on each deliverable. The allocation of revisions to estimated selling prices could inappropriately cause an individual performance obligation to be considered onerous because negative revisions to estimates would reduce the margin on all performance obligations without necessarily causing a loss on the total contract. This could occur, for example, when the discount really related to a particularly profitable performance obligation but was allocated across all of them.

Question 10:

The AcSB strongly supports the guidance in paragraph 70 that an entity should use judgment in complying with the disclosure requirements. We hope that the Boards' direction to focus on the need to provide information that is useful will help to alleviate the current tendency to treat disclosure as a 'check the box' exercise. Also see the answers to the more detailed questions below.

Question 11:

The AcSB agrees with the proposed disclosure requirements but thinks that more information should be required about outstanding performance obligations. Financial statement users tell us that the proposed requirements will not provide sufficient information about order backlogs or the progress of long-term contracts. They are not convinced that paragraph 77(a) will provide adequate information about contracts that have been signed but are awaiting permits or other approvals prior to work commencing. They also need information about revisions to estimates of project costs.

Constituents also noted that the general principle in paragraph 69 is stated differently from comparable requirements in the Defined Benefit Plans and Leases Exposure Drafts. While this does not necessarily affect the detailed disclosure requirements, it is helpful for disclosure principles to be consistent. We suggest that paragraph 69 be conformed with the other two proposals.

Question 12:

The AcSB agrees that disaggregated information should be provided. Preparers generally agreed with the requirement to disaggregate revenue but questioned why the level of disaggregation in IFRS 8 was not replicated in this proposal. The requirements of these two standards should be the same unless there is a particular reason for a difference. If so, this reason should be explained. Preparers were also

concerned about whether the requirements might infringe on proprietary information for some entities. They suggested that an exemption similar to that in IAS 37.92 should be added.

Question 13:

The AcSB disagrees that the requirements should be applied retrospectively. We think that it would be difficult to apply the requirements retrospectively without using hindsight in many cases to combine or segment contracts, to identify performance obligations and to develop the significant estimates required.

In addition, applying the requirements to all contracts in existence during any reporting periods presented would require entities with quarterly reporting requirements to review virtually all completed contracts for comparative periods to determine if the new requirements would alter the timing of revenue recognition between quarters. We do not think this meets a reasonable cost-benefit test. The Boards could solve this problem by specifying that in applying the requirements retrospectively an entity does not have to reconsider the accounting for contracts begun and completed in the same annual period.

However, because of our concerns about the inability to apply the requirements retrospectively without the use of hindsight, we recommend that the Boards consider providing entities with a choice between the following alternatives:

- At the beginning of the first comparative period presented, the entity assesses all contracts in existence on that date in accordance with the new requirements to determine remaining performance obligations, etc. Revenue previously recognized is not adjusted. The remaining consideration to which the entity is entitled under the contract is allocated to the performance obligations still to be satisfied.
- The entity designates any date before the effective date and applies the new requirements to all contracts with customers in existence on or after that date.

Question 14:

As previously noted, many stakeholders are having difficulty envisioning the difference between segmenting a contract and identifying separate performance obligations within a contract or segment. Examples 1 and 2 are useful but do not illustrate the distinction between the two or the rationale for segmenting contracts. Stakeholders do not agree that Example 2 is effective in illustrating price interdependence. It would be helpful to move Examples 9 and 10 to the third and fourth example spots and describe in each of the first four examples the change in terms that would result in either segmenting the contract or identifying separate performance obligations. As noted earlier, we think that the concept of distinct profit margin should be replaced. An example illustrating the application of these criteria would be helpful.

Many of the examples would need to be revised to conform to the over-arching principle recommended in our covering letter. Example 11 would be deleted or modified because construction contract revenue would always be recognized on the basis of obtaining an unconditional right to consideration. However, if the Boards retain transfer of control as the main principle, several changes to the examples will still be necessary. Example 15 should be modified to illustrate how the scenario meets the criteria to be accounted for as a continuous transfer of control. We also think that example 17 works better in the context of IFRIC 15.

The guidance on customer acceptance in paragraphs B69 through B73 is confusing. These paragraphs do not specify whether customer acceptance is a necessary or sufficient condition to a transfer of control. Removing the multiple negatives from paragraph B72 suggests that customer acceptance is a necessary condition. We think that any necessary criteria should be included in the main part of the standard.

Question 15:

The AcSB thinks that the accounting for all forms of warranties should be the same. In principle they are all insurance contracts. We think both kinds of warranties give rise to a separate performance obligation to repair or replace defective goods and both are contingent on the product being defective. From a practical viewpoint, we do not think the proposal will produce relevant information. Representatives of many businesses think that it is not possible to identify reliably whether a product fails because of a latent defect or because of use. Others disagree with the proposed treatment because they think that reducing revenue for expected returns results in a loss of information about trends in returns. Conceptually, we do not understand how the entity can assert that it has retained control of the inventory it reports as a result of accounting for 'latent defect' warranties as 'failed sales'.

Further, consultations with stakeholders reveal that the accounting treatment of warranties that would be considered a performance obligation is not clearly understood; many think that these warranty obligations are recognized as an expense in the period of the sale as opposed to a deferral of revenue. More guidance or illustrative examples are needed.

Question 16:

The AcSB is concerned that the guidance on rights to use intellectual property is inconsistent with that proposed for lessor accounting for rights to use tangible property. These transactions are similar in substance and should be treated in the same way. Stakeholders think that applying the requirements in paragraph B33 to determine whether substantially all of the rights are transferred and those in paragraph B37 to determine whether the rights to use are exclusive will be difficult and result in inconsistent treatment of similar transactions. We agree with their concerns.

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Question 17:

The AcSB is not convinced that the proposals will result in appropriate treatment of some transactions. Of particular concern are farm-out arrangements common in the extractive industries. We think the Boards should undertake additional consultation and consideration of this aspect of the proposals.