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Revenue from Contracts with Customers

ED /2010/6

Comments by the European Federation of Financial Analysts Societies (EFFAS) Financial Accounting Commission – FAC

Dear Madam, dear Sir,

The European Federation of Financial Analysts Societies is the European umbrella organization of national analysts' societies. It comprises 26 members representing more than 14,000 investment professionals in the areas of equity and bond research, asset management as well as investment advice. The European Federation of Financial Analysts' Societies through its Commission on Financial Accounting has reviewed the ED, *Revenue from Contracts with Customers*.

As revenues are the starting point for financial analysis they are of utmost concern for analysts. IASB eagerness to establish a standardized measure for revenue recognition and develop common standards with the US is an encouraging step towards accounting harmonization.

However, we do think that the ED fails short of meeting user's needs. We believe that to support the proposal an enhanced evaluation is needed to determine why it would lead to more useful information. Moreover, we would like to highlight that the complexity of the subject is compounded by a dense and bewildering wording. EDs written with a simple and uncomplicated language facilitate a direct and straightforward discussion of the subject.

To summarise we note here below which aspects, we believe, should in particular be further addressed:

- The definition of control. We are strongly in favour of the percentage of completion method which with the proposed definition of control can only be applied in special cases,
- The application of the recognition criteria to services, and;
- The consideration of comparability. We believe the proposed recognition of revenue which is based on the transfer of control of goods or services does not facilitate a comparison.

Moreover, we would like to note that the Commission supports the definition of revenue proposed by EFRAG. (i.e. that revenue is a measure of the establishment of an irrevocable right to consideration, subject to continued performance, that arises as the entity fulfils the contract with the customer).

Following several discussions the commission would like to present its comments to the ED questions, as follows:

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 that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

The Commission does not believe that the exposure of different components of a unique contract is useful for analysts.

We agree that the entity should recognise the cumulative effect of the contract modification in the period in which the revision occurs. However, what is meant by “interdependence” in paragraph 19 is not defined. The Commission believes this is a sort of grey area and would like to see more guidance on how the standard should be applied.

We also question how the right of return should be recognized (B5 and subsequent).

- The right to recover a returned asset is not an asset but a liability as the entity does not control the right. The asset and the obligation to accept the returned goods should be presented as a net amount;
- Expected expenses of replacing goods should not be presented as a reduction of revenues but as a cost;

- Costs related to returned goods are marketing costs that should not be recognized until the good is replaced and a provision for such costs should be recognized when a good is sold;
- A distinction should be made between:
 - i) a customer's right to have a good repaired or replaced; and
 - ii) a customer's right to receive a refund when a good is returned.

When the customer receives a refund for a returned good this represents a failed sale, however, when a good has been repaired or replaced the entity incurs a cost.

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?*

The Commission does not support the proposal. The identification of performance obligations is simple if applied to the retail sector but much more difficult when applied to the service and the goods markets. While a retail sale transaction is normally easily identifiable –representing the transfer of control and risk and reward-, in services markets things are not so clear.

The Commission view also differs from the model proposed in B49 as:

- When an entity assess whether revenue can be recognized, it has to consider how substantial is a seller's option to repurchase a good delivered to a customer. In many jurisdiction sellers incorporate a repurchase option to safeguard credit from customers. Applying the ED proposal would prevent recognition of revenues in many cases.
- If a seller has an option but not an obligation to repurchase a good, a sale should be recognised. However the value of the option should be considered when determining the sales price;
- If a seller has an option but not an obligation to repurchase a good, this should only be an indicator that a sale has not taken place. Therefore, it should not always lead to the conclusion that a sale has not taken place.

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?*

The Commission believes that the proposed application guidance has to be expanded to determine when control of a good or service has been transferred to a customer.

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?

The Commission supports the proposal. However, to avoid potential revenue manipulation the Commission would be in favour of including a specific disclosure about prior year's discrepancies in the notes to the financial statements, stating differences between estimated and actual transaction prices on each large contract.

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 experience of the Commission is that entities usually exclude a specific customer credit risk in the price of goods or services but include a global enterprise credit risk based on the past experiences. Entities that act in markets such as telecommunications, utilities, automotive, railways, etc...have fixed and public price lists. Moreover, they segment their customers (i.e. retail, large or top customers) and they manage these categories such as an open basket instead of considering customer credit risks individually.

In addition, the use of estimates based on credit risk assumptions for each entity reduces users' ability to understand and compare between financial statements issued by entities acting in the same market. The Commission doubts if a majority of companies have the capabilities to properly assess credit risks.

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 the proposal. Time and value of money should be reflected under the hypothesis that the company is playing the role of the bank. We would like to see a specific disclosure about the discount rate used by the entity and whether the same rate has been applied for every client, as risk might be different from one client to another.

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?*

As noted in answer 1, 2 & 3, the Commission does not support the proposal. To allocate the transaction price in proportion to the stand-alone selling price generates a mismatch between revenue and cash flow patterns whenever the contract-stated prices are not in proportion with the stand-alone selling price. An unstable market would imply high volatility and uncertainty in determining stand-alone selling prices.

Contract costs (paragraphs 57–63)

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?

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?

The Commission basically agrees. However, we are not in favour of combining goods or services produced for future sales to third parties with goods or services owned by the entity and utilized as a tool for the entity's production (see example 28).

The Commission would also prefer acquisition (contract) costs to be capitalised as in IAS 11. The proposal in the ED generates a discontinuity between costs and revenues from the same contract.

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?

The Commission agrees with the proposal.

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?

The Commission agrees with the proposal.

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?

The Commission agrees with the proposal but would like to see an additional line called *cash paid* to be added to paragraph 75. This line will be a key indicator about reimbursement made to customers and be able to reconcile the cash flows with the business activity.

Effective date and transition (paragraphs 84 and 85)

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.

The Commission is supportive of this proposal

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?*

The Commission would prefer more guidelines to be added coherently with our proposal and comments.

Question 15: *The boards propose that an entity should distinguish between the following types of product warranties:*

(a) *a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.*

(b) *a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.*

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

The warranty does not differentiate whether the deficiency is recurrent. The legal requirement generated by the warranty is, simply, to substitute or repair the product. Therefore, it is not relevant whether the deficiency is due to an existing or subsequent problem. The contracts subscribed by customers on voluntary basis to extend the period of warranty or to protect the product from fault of the owner are insurance and not a warranty.

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?

The Commission supports this proposal.

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?

The Commission is not supportive of a proposal to move from the current IAS 16 and 38 to the ED. We question whether it is necessary to change those other standards.

The Commission thinks that further discussions are necessary and would be willing to participate.

Yours sincerely,

Giampaolo Trasi
Chairman EFFAS

Javier de Frutos
Chair, Commission on
Financial Accounting

EFFAS Financial Accounting Commission

EFFAS was established in 1962 as an association for nationally-based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 26 member organisations representing more than 14,000 investment professionals. The Commission on Financial Accounting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint.

FAC members are Javier de Frutos (Chairman, Spain), Friedrich Spandl (Vice-Chairman, Austria), Jacques de Greling (SFAF, France), Henning Strom (NFF, Norway), Ivano Mattei (AIAF, Italy), Taras Koval (USFA, Ukraine), Jérôme Vial (SFAA, Switzerland) and Rolf Rundfelt (SFF, Sweden).
