



Group Reporting

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BHP Billiton Limited
BHP Billiton Centre 180 Lonsdale Street
Melbourne Victoria 3000 Australia
GPO Box 86
Melbourne Victoria 3001 Australia
Tel +61 1300 55 47 57 Fax +61 3 9609 3015
bhpbilliton.com

Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor, 30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir David

Re: Invitation for Comment on Exposure Draft “Revenue from Contracts with Customers”

We welcome the opportunity to comment on Exposure Draft “Revenue from Contracts with Customers” issued by the IASB in June 2010.

On the whole, we believe that the requirements of financial statement users are better served by the revenue recognition principles encompassed in the current revenue standard. The current revenue recognition principles are easily understood, applied well in practice and relevant to all transaction types (not just transactions with customers). Although there may be some improvements necessary to finesse their application, we do not believe the wholesale changes proposed in this exposure draft provide a better platform for preparers to account for revenue and users understand the revenues reported.

In addition, the exposure draft appears to have been drafted as a hybrid of IFRS principles and US GAAP rules. We disagree with this approach as not only does it not accord with a principles based framework but it results in inconsistent outcomes between similar types of transactions depending upon whether they have been addressed specifically by a rule or left to be determined by the principle. We were of the understanding that US companies would be adopting a principles based IFRS in the future, not that the IASB would be redrafting IFRS as an amalgam of IFRS and USGAAP.

Whilst our responses to each of the questions raised in the Exposure Draft are outlined below, we would like to highlight our fundamental concerns with the exposure draft as follows.

Narrow scope

The model proposed in the exposure draft is limited to the recognition of revenue from contracts with customers, rather than dealing with the recognition of revenue for all transaction types which is achieved by the current standard. It is therefore unclear as to how the Boards expect entities to recognise revenue in respect of contracts for sale of goods and services which are not the output of the business' ordinary activities (e.g. contracts for the sale of a business) or passive income such as dividends, interest and royalties.

We believe that the Boards must endeavour to develop a revenue recognition model that can be applied to all transaction types, not simply contracts with customers.

Complexity

We believe that the proposals make measurement of revenue significantly more difficult than the current requirements. This is likely to have the following adverse impacts:

- the requirement to identify the performance obligations within every transaction will be significantly more time consuming for preparers to assess and measure,
- significant changes are likely to be required to accounting processes and computer systems,
- the complexity of the processes will result in a greater chance of error
- the recognition of revenue will be significantly more subjective and prone to manipulation
- financial report users are unlikely to understand the changes and therefore financial reports be of less relevance to users

Measurement inconsistencies

The exposure draft seeks to measure revenue at transaction price, defined as the "probability weighted amount of consideration that an entity expects to receive from the customer in exchange for transferring the goods or services". We question why the boards are seeking to introduce yet another measurement principle into the suite of IFRS standards in the absence of an explicit measurement principle being established in the Framework. This inconsistency is evidenced by the differing requirements between this exposure draft and other recent exposure drafts for provisions and insurance. Whilst all of these exposure drafts focus on unperformed obligations, each results in a different outcome. That is, the provisions standard requires unperformed obligations to be measured based on the cost of performing (which includes a margin) however, this exposure draft requires the unperformed obligation to be measured at an allocated transaction price which in most instances will differ to the cost of performance. This inconsistency is confusing for both preparers and users and results in a less meaningful financial report. We believe the development of measurement principles in the Framework is a critical task for the IASB to accomplish prior to creation of a new (and controversial) measurement basis in specific standards. Agreement across the IFRS community on an explicit measurement principle is necessary to ensure consistency of measurement techniques across all future IFRS.

Absence of pure recognition focus

The exposure draft has been drafted with a focus on recognising revenue when an entity has relieved itself of a performance obligation, rather than when the entity has actually performed (i.e. there is more of a focus on recognising revenue when the entity's liability is extinguished rather

than when the entity has created a right to be compensated for actually performing the transaction and exchanging rights of control). This is demonstrated by the focus on revenue being recognised when the customer obtains control of a good or service as opposed to the seller losing control (i.e. transfer of significant risks and rewards). We believe a revenue recognition model which is based on recognising rights acquired and exchanged by the reporting entity would be more intuitive than a model based on extinguishing obligations.

Application of scope exclusions

We appreciate that the Boards have introduced a scope exclusion “non-monetary exchanges between entities in the same line of business to facilitate sales to customers” to avoid the inappropriate ‘grossing up’ of revenue associated with certain product swaps. However we foresee two areas where the wording of this exclusion might have unintended consequences;

- It is not clear if the intention of this scope exclusion is for the proposed standard to apply to other exchanges of goods or services where there may also be a cash settlement. An example of this is where an entity and a joint venture partner contribute non-monetary assets in the formation of a joint venture. Such asset exchanges typically require cash equalisation payments when the fair value of the assets exchanged are not of equal value, but where the nature of the assets exchanged are nearly identical.
- The application of the scope exclusion will still result in the ‘grossing up’ of revenue associated with certain contracts. For example, in some instances both a sale and a purchase contract are put in place to affect a location swap of products, such contracts being settled in cash. The scope exclusion proposed would not apply to these contracts and as such, revenue would be recognised on both the sale to the ‘other supplier’ and the sale of the product to the final customer.

In this case, we believe that rather than a scope exclusion, this situation would be more adequately addressed by expanding the requirements for assessing whether to combine or segment contracts. Rather than such an assessment being based on price interdependence, we believe that the proposals should be expanded to encompass the current provisions of IAS 18 para. 13 which requires “the revenue recognition criteria to be applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole”. This clearly provides the correct outcome for contracts, which whilst settled in cash for their respective fair values, would not be entered into the absence of the other.

Introduction of inconsistent terminology with other exposure drafts

The Exposure Draft “Leases” indicates the derecognition approach (and therefore potential revenue recognition) must be based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset.

This differs to the revenue recognition principles in the revenue exposure draft which, although viewed as an asset derecognition model (para BC60), requires revenue to be recognised when the customer obtains control of that good or service. We believe that the principles for the recognition of revenue must be consistent throughout IFRS with revenue recognised either on the basis of the transfer of control of the good or service or the transfer of the significant risks and benefits of the underlying good or service.

We expand upon these comments and observations in the detailed responses to the questions below.

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 believe that the proposal for combining contracts is too narrow in focus and should be expanded to encompass the current provisions of IAS 18 para. 13 which requires “the revenue recognition criteria to be applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole”.

Segmentation of a contract, as opposed to separating out performance obligations, allows an entity to apply other IFRSs to segments of the contract and impacts the allocation of the transaction price. As noted previously, we believe that there should be a single revenue recognition model which would negate this perceived benefit. In the absence of a single revenue recognition model, we see merit in such segmentation, which ensures that variable transaction prices only impact relevant segments of a contract.

Further, the proposal for segmenting an individual contract requires an entity to assess whether an identical or similar good/service is sold separately and that the customer does not receive a significant discount. The term significant is used throughout IFRS, however, no guidance is provided on how significance should be measured or determined.

The proposals for the treatment of contract modifications are confusing. That is, it is difficult to see when a modification would be independent of the original contract. We believe the provisions of IAS 18 para. 13 as referenced above would be a better method of determining the treatment of a contract modification.

Finally, we note an inconsistency in terminology in this section, referring to consideration rather than transaction price.

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 principles are clear in their requirements; however, we envisage that difficulty will arise in application and due to the level of judgement necessary the requirements could be manipulated, leading to inconsistency and lack of comparability amongst market participants.

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?*

As written, the exposure draft could be interpreted as placing undue emphasis on the physical transfer of a good or service rather than on satisfaction of a performance obligation. This is inappropriate as physical transfer is not always required for control to pass. We would encourage the board to combine the first two sentences of paragraph 25 in order to remove this emphasis as follows:

“An entity shall recognise revenue when it satisfies a performance obligation identified in accordance with paragraphs 20 – 24 by transferring **control** of a promised good or service to a customer.”

In addition, the guidance provided for determining whether control has passed relates in the main to transfer of control of a physical good as opposed to a service. Based on the guidance provided, it would appear that revenue recognition in respect of Freight/Voyage Services (for example) would be prohibited prior to the arrival of the vessel at the port of destination on the basis that the customer has no control over the benefit from the service until completion of the voyage. We question if this is the intention of the boards or whether the boards consider the customer to be continuously receiving the right to control a benefit as the voyage progresses and the goods shift location.

Further, as noted in opening comments above, the Exposure Draft “Leases” indicates the derecognition approach (and therefore potential revenue recognition) must be based on whether the lessor retains exposure to significant risks or benefits associated with the underlying asset. This differs to the revenue recognition principles in this exposure draft which, although viewed as a derecognition model, require revenue to be recognised when the customer obtains control of that good or service. We believe that the principles for the recognition of revenue must be consistent throughout IFRS with revenue recognised either on the basis of the transfer of control or the retention or transfer of the significant risks and benefits of the underlying good or service.

Transfer of control based on the customers’ ability to receive *substantially all* of the potential cash flows from an asset differs to the current requirement for the transfer of the *significant risks and rewards of ownership*. However, the exposure draft, and IFRS in general, is silent as to the definition of ‘substantially all’ and ‘significant’. Whilst we do not support a rules based paradigm, guidance is required to ensure consistent application.

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 do not believe wholesale changes such as those specified in the measurement principles outlined in the exposure draft, which make the measurement of revenue significantly more difficult than the current requirements, are required. Overall, we believe that a transaction price derived from applying the principles and rules in the exposure draft will result in much less meaningful information which bears no relationship to the most likely outcome of a contract with a customer. We do not see this outcome as being informative for any users of the financial statements. We believe the inclusion of a principle requiring entities to measure the transaction price as the best estimate of the most likely outcome is a far more robust and meaningful measure, particularly when attempting to measure individual transactions.

Further, we question why the boards are seeking to introduce yet another measurement principle, when the focus has been to move towards a fair value regime. This implies that the boards consider transaction price to be different to fair value, in which case the exposure draft must be updated to address the treatment of any difference that arises due to a different measurement basis when a contract asset (measured at transaction price) becomes a financial asset (initially measured at fair value).

Finally, while the proposals in the revenue exposure draft and those concerning insurance and provisions all focus on unperformed obligations, each results in a different outcome. The proposals in the exposure draft requiring revenue (and any unperformed obligations under a contract with a customer) to be measured at the expected value of the consideration receivable, differ to the measurement of obligations in the provisions standard, which requires the measurement of unperformed obligations to be determined by comparing exit prices to the expected present value based on the cost of performing (which includes a margin). In most instances, the expected value of consideration receivable and the expected cost of performing will differ. Such an inconsistency should not be introduced within IFRS.

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?*

In principle, we do not disagree with credit risk affecting quantum rather than timing of revenue recognition as this would reflect the benefit that is expected to flow to an entity. However, we question the unit of account (e.g. individual contract) for the assessment of credit risk, being too granular if applied to individual contracts rather than using a portfolio approach. Further, the inclusion of an assessment of credit risk in determining the transaction price provides a complete lack of transparency as to how management is managing its debts (that is, the 'doubtful debt' becomes hidden in revenue).

Further, the Boards provide no guidance on the principles which must be applied in determining the impact of credit risk on the probability of payment or probability weighted amount of payment. This will contribute to subjectivity and the possibility of manipulation by management, compromising comparability between entities.

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 and believe that entities are fairly accustomed to the impact of the time value of money on measurement of revenue. However as the exposure draft requires the time value of money to be taken into consideration for contracts where consideration is due “significantly before or significantly after”, we believe that guidance should be provided for determining what constitutes ‘significant’.

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 disagree with the proposal. The allocation of the transaction price in proportion to stand alone selling price results in a consistent discount being allocated to each performance obligation which may not reflect the economic reality of the contract. We believe a management approach to the allocation of the transaction price would provide more decision-useful information to users and better represent the economics of transactions.

Further, we question whether the costs of implementing the proposals (e.g. system limitations) outweigh any perceived benefit.

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, an entity should recognise an asset only if those costs meet specific 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 question the relevance and appropriateness of such proposals in a revenue recognition exposure draft. We believe that the capitalisation of costs should be determinable by entities referencing the definition of an asset in the Framework and other IFRSs and should therefore be omitted from the exposure draft

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?

Refer to our response to Question 8 above.

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?

Overall we believe the disclosure requirements are too onerous, costly to implement, reflect information that is unlikely to be used by management in its decision making and will provide a level of disaggregation that will detract from, rather than enhance, the usefulness of the financial statements.

Further, while a reconciliation of opening to closing contract asset and contract liability balances is seen as good practice from a financial record management perspective we do not believe such reconciliations are a useful output of financial reporting. We believe the focus of financial reporting disclosures should be on the risks faced by the entity in deriving its revenue, which is not addressed by the proposed disclosure set.

Finally, the boards must consider potential conflicts between the disclosures proposed in the exposure draft and those required by IFRS 8 *Segments* (e.g. entity-wide disclosures as required by IFRS 8 para.'s 31 – 34).

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?

As noted in our response to Question 10 above, we believe the disclosure requirements are too onerous and costly to implement. Further, we believe that the disclosure proposed about remaining performance obligations and the expected timing of their satisfaction is unlikely to be useful to users of the financial report. This disclosure would only relate to existing recognised but unperformed contractual obligations, and for many entities is therefore likely to be a small subset of all performance obligations to be settled in the future. As such, it is difficult to see how a user could assess the ability of an entity to meet its future performance obligations with disclosure of only those that are presently contracted. Similarly, it is difficult to see how a user could assess the future revenue generating potential of an entity with such disclosure.

If these disclosure requirements were to be introduced, the Boards need to provide greater guidance with respect to the level of granularity required and level of aggregation permitted in order to achieve meaningful disclosures and comparability between market participants.

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?*

Subject to our concerns noted in above, we believe that a management approach to disaggregation is the most appropriate means of providing decision useful information to users of the financial statements. Requiring disaggregation based on prevailing economic factors is considered ambiguous, open to misinterpretation and manipulation and therefore will not provide users with a clear understanding of the amount, timing and uncertainty of revenue and

associated cashflows. We are also concerned that this disclosure conflicts with, rather than supports, the disaggregation of information required under segment reporting.

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 acknowledge that full retrospective application will ensure consistent application, allow for comparability between entities and therefore provide relevant information to financial statement users. However, such application will require a significant lead time between issuance and the effective date as entities may not have the appropriate systems in place to capture the required information. The cost of such system modifications may be excessive and difficult to implement.

Further, full retrospective application is of particular concern and potentially overly onerous for entities with existing long-term contracts, including long-term warranty obligations. An alternative transition method would be to make the requirements of the standard effective to contracts entered into after a specified date.

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 believe that any guidance provided must serve purely to aide the proper application of the principles. We struggled to understand the logic of the application guidance which infers rules of application rather than application of the principles.

Overall the application guidance provided does not provide clarity to clearly illustrate application of the principles of the proposed model (e.g. application of the proposed model to Scenarios one and two in Example 2 – Contract Modifications).

Further, some of the terminology used is inconsistent with the proposed model of recognising revenue upon transfer of control of a good or service. For example. paragraphs B33 and B34 refer to ‘control of substantially all the rights associated...’ as opposed to the customers’ ability to direct the use of and receive the benefit from a good or service.

Whilst specific, we have concerns regarding the application guidance for sales with a right of return. We believe that the right of return represents a separate performance obligation and should be accounted for as such. Prohibiting recognition of the associated revenue when the customer has clearly obtained control of the related good or service is considered inappropriate.

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?

As noted in our response to Question 14 above, we believe that the application guidance provided overlays rules on a principles based standard which we consider inappropriate. Any application guidance should aim to assist users in the identification of performance obligations, enabling entities to analyse contracts and determine the appropriate revenue recognition based on the principles espoused in the standard. As such, we believe that all product warranties should be taken into account when segmenting contracts into separate performance obligations and accounted for as such.

Where a warranty is considered to be a separate performance obligation (that is, is distinct), we disagree, as noted previously, with the introduction of yet another measurement of such a performance obligation. That is, the provisions standard requires unperformed obligations to be measured based on the cost of performing (which includes a margin). Conversely, this exposure draft requires the unperformed obligation to be measured at an allocated transaction price which in most instances will differ to the cost of performance. Such an inconsistency should not be tolerated within IFRS.

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;*
- (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?

As noted in our response to Question 15, we question the appropriateness of overlaying rules via the application guidance as opposed to such guidance clarifying application of the principles espoused in the standard.

Whilst we acknowledge that rights attached to licences of intellectual property vary and should affect the timing of revenue recognition, we question the introduction of the notion of exclusivity as a means of determining the appropriate revenue recognition for licences. As written, exclusivity could be difficult to determine and its application manipulated. As such, we believe

that the application guidance should serve only to provide clarity as to how performance obligations imposed by a licensing agreement would be identified and satisfied in accordance with the principles in the standard.

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?*

As noted previously, we believe that there should be one revenue recognition framework within IFRS and as such, the Boards must endeavour to develop a revenue recognition model that can be applied to all transaction types, not simply contracts with customers.

The model proposed in the exposure draft is limited to the recognition of revenue from contracts with customers, rather than dealing with the recognition of revenue for all transaction types which is achieved by the current standard. It is therefore unclear as to how the boards propose to recognise revenue in respect of contracts for sale of goods and services which are not the output of the business' ordinary activities (e.g. contracts for the sale of a business).

Further, it is unclear how the proposed model applies to situations where an entity and a joint venture partner contribute non-monetary assets in the formation of a joint venture. Such asset exchanges typically require cash equalisation payments when the fair value of the assets exchanged are not of equal value. Therefore, it would appear that the scope exclusion for non-monetary asset would not apply.

The IASB is silent on how the other aspects of revenue recognition will be addressed in IFRS, including passive income (e.g. dividends, interest and royalties which are currently specifically addressed by the revenue standard).

We would like to thank the IASB in providing the opportunity to comment on this important issue.

Yours sincerely,



Brett Rix

VP External Reporting and Governance