IAASB INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

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November 15, 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David,

Re: Comments on IASB's Exposure Draft, *Revenue from Contracts with Customers* (ED/2010/6)

As you are aware, we have established working groups to monitor the development of IASB projects of particular interest to the IAASB. The focus of the working groups is to identify significant aspects of proposals by the IASB which could pose difficulty in an auditing context and therefore where the IAASB members' expertise can add value to the IASB's deliberations – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate. Among the working groups is one established to monitor the IASB's project on revenue from contracts with customers.

The Working Group has considered the IASB's Exposure Draft ED/2010/6: *Revenue from Contracts with Customers* (ED) and supports the IASB's objective to establish principles for recognising revenue that would provide clearer and more consistent guidance. A single, contract-based revenue recognition model should help achieve that goal, as long as it is practicable to apply. We anticipate, however, that there will be a number of situations where the proposed concepts in the ED may be difficult to apply and could be problematic from a verifiability and/or auditability perspective. These include proposals in the ED relating to: (i) recognition of revenue, particularly the identification of separate performance obligations, (ii) determination of point of transfer of "control," (iii) measurement of revenue, particularly the determination of the transaction price, (iv) determination of stand-alone selling prices for individual performance obligations, and (v) measurement of the effect of credit risk on revenue. These areas are discussed further in the Appendix to this letter.

In general, the Working Group feels that some important guidance and explanatory material is currently contained only in the Basis of Conclusions on the ED. The Working Group encourages the IASB to explicitly incorporate some of this guidance and explanatory material into the proposed IFRS. The Appendix to this letter points out some specific examples.

The Working Group also suggests that the IASB consider whether the examples and illustrations fully convey the nature of the judgments that may be needed in applying the proposed IFRS in practice. The Working Group finds that a number of the examples and illustrations provided in the ED are based on quite simple fact patterns. As a result, they may not always demonstrate the judgments necessary to apply the requirements in more complex situations.

I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize the proposed IFRS.

Yours sincerely,

Prof. Arnold Schilder

Chairman, IAASB

Appendix

IASB EXPOSURE DRAFT (ED/2010/6) — REVENUE FROM CONTRACTS WITH CUSTOMERS

Comments of the IAASB Working Group

OVERALL COMMENT

Revenue recognition and measurement has been a challenging area in financial reporting. There are many complex judgments involved in determining when revenue should be recognised and how it should be measured to reflect the economic realities of the underlying situation. Because of the complexity and the risk of bias in making those judgements and susceptibility of fraud, the International Standards on Auditing (ISAs) require auditors to assess the risks associated with revenue as significant risks.[1] Notably, ISA 240[2] states that when identifying and assessing the risks of material misstatements due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue recognition or assertions give rise to such risks. It is against this backdrop that auditors need to exercise professional judgment in designing and performing audit procedures to assess the risks of material misstatement of revenues, and appropriately respond to the assessed risks.

RECOGNITION OF REVENUE

Identifying the Contract

Paragraph 9 of the ED states that (emphasis-added), "[c]ontracts can be *written, oral or implied* by the entity's customary business practice." This seems to conflict with paragraph 10(b) which states (emphasis-added), "[a contact exists only if] the parties to the contract have *approved* the contract and are committed to satisfying their respective obligation." It is anticipated that it will be difficult to verify, for example, the parties' approval of an oral contract and their commitment to satisfying their respective obligations after the fact, and even more difficult to verify in the case of a implied practice.

In this regard, the Working Group feels that since the proposed IFRS is based on recognizing revenue when separate performance obligations are being satisfied, it may be more appropriate to focus on the determination of the existence of performance obligations, the evidence of which might be found in a written contract, or through the history of the entity's customary business practices.

Combining, Segmenting and Modifying Contracts

Paragraph 13 of the ED sets out helpful indicators of whether two or more contracts have interdependent prices. However, the Working Group feels that a definition or explanation of "interdependent prices" would provide further clarity. Also, guidance for financial statement preparers on the nature and extent of steps they would be expected to take to establish that prices are interdependent would be particularly

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1 This presumption may be rebutted.

2 ISA 240, *The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements*, paragraph 26

useful. The Working Group feels that by comparison, the corresponding criteria in IAS 11[3] are clearer and more precise.

The Working Group also feels that the guidance and illustrative examples relating to contract modifications is difficult to understand. In particular, it found Example 2 to be confusing. The Working Group is of the view that it may be helpful to provide some examples to illustrate when changes to the economics of the original contract result in modification to the original contract which should be recognized in accordance with the proposed IFRS.

Determining Separate Performance Obligations

The Working Group feels that it may be difficult to determine all of the separate performance obligations in a contract, and whether or not they are distinct, as required by paragraph 20 of the ED. The indicators proposed in paragraph 23 of the ED are helpful, but may not be sufficiently complete to ensure consistent application in practice. For example, there seems to be a need to strengthen and clarify the references to "distinct profit margin" and "distinct risks." In addition, it is unclear how far preparers are expected to look to identify comparable goods or services. Paragraph 23 refers to not only similar goods or services sold by the entity, but also "another entity." The Working Group also questions whether the preparer would be expected to consider the goods or services offered by other entities locally or more broadly (for example, globally). Accordingly, the Working Group recommends the inclusion of further guidance in these areas to enhance the clarity of the proposed IFRS.

In addition, the Working Group feels that it would be useful to clarify whether the judgment regarding the existence of a performance obligation should be considered from the perspective of the vendor or customer, and whether all of the indicators should be considered collectively. It seems unlikely that any single indicator on its own would be sufficient. The Basis for Conclusions on the ED includes some useful guidance in understanding when performance obligations are distinct. Inclusion in the IFRS of guidance such as that in paragraphs BC50 and BC53–BC56 would be particularly helpful.

It appears that the IASB intends performance obligations to be identified at the outset (paragraph 20 of the ED). This is followed by the determination of whether each obligation is distinct and, therefore, whether it should be accounted for separately or aggregated to form a bundle of goods or services that would be recognized as a single performance obligation. The Working Group feels that this progression may be difficult to implement in practice and that it may be more effective and efficient to approach the task by disaggregating a contract into distinct performance obligations.

Determining Transfer of "Control"

The Working Group agrees with the principle set out in paragraph 25 of the ED that revenue results from the satisfaction of performance obligations. It anticipates, however, that it may not always be easy to determine the point at which "control" is transferred from one party to another—particularly in the case where services are bought and sold. The Working Group is concerned that without further guidance, the proposals could result in significant divergence in practice. In the view of the Working Group, there is also a risk that, in light of the ISA requirements for the need to obtain persuasive evidence regarding revenue recognition there may be undue focus on legal title or physical possession. To promote consistent application in practice, the Working Group feels that the proposed IFRS should set out either

[3] International Accounting Standard (IAS) 11, *Construction Contracts*

indicators of the types of factors that would evidence the transfer of control, particularly for services, or more specific guidance on the practical application of the concept of control.

The Working Group further anticipates that it will be difficult to determine when "control" has passed in cases where there is "work in progress." In some of these cases, both the seller and buyer may not have unfettered action that might be associated with the concept of "control" as anticipated in paragraph 26 of the ED. The Working Group suggests that the provision of more complex examples that demonstrate the judgments involved and disclosures necessary would be particularly useful.

Overall, in view of the probability for bias in decision-making and susceptibility of fraud in the area of revenue recognition due to managements' incentives, the Working Group feels that more guidance to support the proper and consistent application of paragraphs 25–31 of the ED is particularly important.

MEASUREMENT OF REVENUE

Determining Transaction Price

The Working Group supports the proposal in paragraph 38 of the ED that revenue should be recognized only when the transaction price can be reasonably estimated. However, this is likely to be an area of significant debate between auditors and preparers because of the judgments that would be involved. Further guidance on how to apply this principle, in particular to situations involving variable consideration, would be particularly useful.S

Measuring the Effect of Credit Risk on Revenue

The Working Group is of the view that the collectability of amounts from customers described in paragraph 43 of the ED is difficult to understand and, therefore, likely to pose difficulty in practice. For example, it is unclear what the minimum threshold is for collectability in order for the related revenue to be recognized. Further, it is unclear how this is distinct, if at all, from paragraph 38 of the ED which states that revenue should be recognized only when the transaction price can be reasonably estimated, taking into account the *probability-weighted* amount of consideration that the entity expects to receive (paragraph 35 of the ED). The Working Group recommends that the IASB consider clarifying what is intended by these paragraphs. Also, guidance on the nature and extent of the steps that preparers would be expected to undertake to assess the collectability of revenues would be particularly useful.

Allocating Transaction Price to Separate Performance Obligations

The Working Group agrees with the principle of allocating the transaction price to the separate performance obligations in proportion to their stand-alone selling prices, as this would provide a verifiable basis for the allocation. Notwithstanding this, the Working Group anticipates that there may be circumstances where it is difficult to determine the stand-alone selling prices, or where they are not available at all. Paragraphs BC122–BC125 in the Basis for Conclusions on the ED explains that the IASB concluded that the residual method should not be used as an alternative methodology. In some circumstances, however, this might be an acceptable basis for estimating the stand-alone price. The Working Group feels that providing further guidance in this regard would bring about greater clarity thereby enhancing consistency in the application of the proposed IFRS in practice.

DISCLOSURES

The ED contains detailed requirements for disclosures of information relating to revenues (paragraphs 69–83 of the ED). The Working Group agrees with the IASB regarding the need for the reporting entity to disclose this information to users of financial statements. However, the disclosure requirements leave a lot of scope for preparers in determining the level of detail, the extent to which certain matters should be emphasized and the level of aggregation or disaggregation of information (paragraph 70 of the ED).

Whilst not disagreeing with the IASB's aim, the Working Group is concerned that preparers and auditors will be met with the challenge of having to determine the adequacy of the disclosures but without a suitable framework for forming such judgments (that is, a disclosure framework).[4] It can be difficult to assess the adequacy of disclosures absent an established framework to guide those judgments.

Accordingly, the Working Group encourages the IASB to consider developing an overarching framework on disclosures that addresses matters such as the objectives of disclosures in financial statements and what information to disclose and how much to disclose (that is, adequacy of disclosures). The Working Group notes that accounting standard setters such as the European Financial Reporting Advisory Group and the US Financial Accounting Standards Board have projects underway to develop such disclosure frameworks. In the view of the Working Group, such frameworks are necessary to make the judgment-based disclosure requirements proposed in the proposed IFRS workable.

OTHER REMARKS

Finally, the Working Group observed that certain requirements in the Exposure Draft deal with liability recognition. The Working Group recognizes that the IASB is also progressing work on the proposed IFRS on *Liabilities*.[5] It encourages the IASB in finalizing this IFRS to ensure that where relevant, the proposals are consistent with the principles under consideration in the proposed IFRS on Liabilities for example, product warranties and product liabilities.

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4 For example, paragraph 71 of the ED states, "[if] the disclosures provided in accordance with this [draft] IFRS and other IFRSs do not meet the objective in paragraph 69, an entity shall disclose whatever additional information is necessary to meet that objective."

5 Exposure Draft ED/2010/1: Measurement of Liabilities in International Accounting Standard (IAS) 37, *Provisions, Contingent Liabilities and Contingent Assets*