

March 19, 2012

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

Re: Comments on IASB's Exposure Draft on Revenue from Contracts with Customers

I am pleased to provide comments on the IASB's November 2011 Exposure Draft *Revenue from Contracts with Customers* (ED). These comments have been developed by the IAASB's IASB Liaison Working Group (the Working Group), with a particular focus on auditability or verifiability, and reviewed by the IAASB Steering Committee.

Overall, the Working Group feels that the ED represents a significant improvement over the June 2010 exposure draft and is responsive to the IAASB's comments thereon. However, the core principles underlying the revenue recognition model would require preparers to make a number of important, and sometimes complex, judgments in determining the timing and amount of revenue to be recognized and related disclosures. Differences in the interpretation and application of the underlying principles would present challenges for auditors.

In that regard, the Working Group recommends that the IASB give further consideration to the following:

- Clarifying principles underlying the requirements, and modifying or further explaining key terms, to enhance the effective application of the proposed standard. For example, the Working Group believes that the IASB should consider clarifying whether a hierarchy exists regarding the phases containing the word "expect." In addition, the Working Group believes that the IASB reconsider the term "reasonably assured." For specific suggestions, please refer to items A - D in the Appendix.
- Clarifying what is expected regarding management's justification of its key judgments, including whether and, if so, what type of documentation is necessary to support such judgments. For specific suggestions, please refer to items E - G in the Appendix.

In addition, the Working Group found that the proposed approach to disclosures in the ED reinforces the need for a disclosure framework that would facilitate the application of the disclosure requirements and address matters such as how the concept of materiality should be applied to disclosures. Development of a robust disclosure framework would facilitate effective financial reporting and auditing. In this regard, the IAASB had, in its response to the *IASB Agenda Consultation 2011*,¹ recommended that the IASB give priority to developing a disclosure framework. Further explanation of the basis for the IAASB's

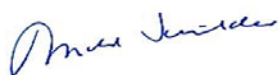
¹ See the IAASB's comment letter on the *IASB Agenda Consultation 2011*.

recommendation can be found in the IAASB's recently published Feedback Statement² to the Discussion Paper, *The Evolving Nature of Financial Reporting: Disclosure and its Audit Implications* (IAASB's DP). For the Working Group's specific suggestions, please refer to the Overall Comments in the Appendix.

Finally, the Working Group identified a number of other suggestions that may further strengthen the robustness of the proposed standard. For specific suggestions, please refer to items H - M in the Appendix.

I hope you will find the comments helpful. If you require any clarification or would like to discuss them further, please do not hesitate to contact me or Mr. Tomokazu Sekiguchi, the Chair of the Working Group (t.sekiguchi@iasb.org).

Yours sincerely,



Prof. Arnold Schilder
Chairman, IAASB

Cc. Mr. Prabhakar Kalavacherla, Member and Liaison Representative, IASB

² www.ifac.org/sites/default/files/publications/files/IAASB%20Feedback%20Statement-Nature%20of%20Financial%20Reporting.pdf

Appendix

IASB EXPOSURE DRAFT- REVENUE FROM CONTRACTS WITH CUSTOMERS Comments of the IAASB's Working Group

I. OVERALL COMMENTS

Importance of Clarity Regarding the Underlying Principles and Key Terms in the Standard both for Preparers and Auditors

The Working Group appreciates the principle-based nature of IFRS, as it recognizes that over-emphasis on rules may encourage preparers and auditors to take a technical compliance approach to meeting requirements rather than focusing on the substance of transactions. On the other hand, a financial reporting framework that is too open to differing interpretation, or allows too much latitude in application, could result in similar transactions being accounted for or disclosed in significantly different manners, thereby hindering comparability of financial statements. It is thus important to strike an appropriate balance by setting out clear and understandable principles that do not offer too much latitude in application while being flexible enough to accommodate various types of revenue transactions in a broad range of circumstances in different jurisdictions. In the same vein, the Working Group believes that clarity around key terms that potentially require significant judgments is critical.

These matters are particularly important for this proposed standard, as risks of material misstatement of the financial statements due to fraud are often significant relative to revenue recognition. The IAASB's International Standard on Auditing (ISA) 240³ specifically requires auditors to presume that there are risks of fraud in revenue recognition, as research has shown revenue recognition to be an area especially susceptible to fraudulent financial reporting due to the pressures on, or incentives for, management to meet performance targets or market expectations.

The Working Group has identified several areas where clarification of the underlying principles or key terms may help to promote a consistent understanding of the requirements by preparers of financial statements. This would in turn assist auditors in evaluating significant judgments that preparers will need to make in applying the requirements in the proposed standard. The Working Group believes that improvements could be made by: (i) modifying or clarifying certain requirements; (ii) providing more robust application guidance, which may include moving important explanations from the non-authoritative Basis for Conclusions (BC) into the standard; or (iii) a combination of these. The remainder of this letter provides more information on these important areas, as well as specific suggestions for the IASB's consideration.

Increased Use of Management's Judgment and Resulting Challenges on Auditing

The ED requires preparers to exercise judgment in determining when and to what extent revenue from customers should be recognized. Although use of judgment is a necessary element of applying principles-based standards, the trend towards increased use of significant judgments that are sometimes complex poses greater challenges to auditors in obtaining sufficient appropriate audit evidence. Often, auditors need to place more weight on management's representations, particularly in the absence of a specific requirement regarding what management needs to do to support its subjective judgments. Therefore, requirements for management to substantiate judgment (possibly by way of a documentation requirement) would be helpful, especially when the judgment process is complex or not well specified (for

³ ISA 240, *The Auditor's Responsibilities Relating to Fraud in An Audit of Financial Statements*, paragraph 26

example, judgments based on various indicators as opposed to a clear set of criteria), and its outcome may yield significantly different accounting treatments.

Also, the trend of increased use of judgment in applying accounting and disclosure requirements has led to demand from users of financial statements for more information from auditors regarding those areas of judgment. For example, some users have called for auditors to provide insights to external stakeholders on entity-specific matters, including accounting policies and other matters requiring management's significant judgments. The call for greater auditor involvement in these areas was among the key reasons for the IAASB to initiate its current project to revise its auditor reporting standards. It also underscores why collaboration between accounting and auditing standard setters is important.

Disclosure Framework to Facilitate Effective Financial Reporting and Auditing

The Working Group believes that the proposed approach to disclosure requirements in the ED highlights the need for a disclosure framework. The ED contains a substantial number of detailed requirements regarding disclosures of information relating to revenues (paragraphs 109–129 of the ED). At the same time, it requires preparers to consider the level of detail necessary to satisfy the disclosure objective, and how much emphasis to place on each of the various requirements (paragraph 110). Paragraph BC248 of the ED explains that a reason for not shortening the list of disclosure items is that "...an entity would not need to disclose information that is *immaterial*." [*Italics* and underlines are added hereafter, when emphasizing a particular word(s).]

In responding to IAASB's DP, many stakeholders representing a wide variety of groups expressed concern that a high volume of disclosures may hinder the effectiveness of financial reporting. An appropriate application of the concept of materiality should be helpful in this regard. However, it may not be as effective as it could be if there is uncertainty about how that concept should be applied in practice. For example, there may be uncertainty as to whether materiality should be judged in the context of the importance of the disclosure to the fair presentation of the financial statements as a whole, or in relation to a particular financial statement line item. Also, respondents to IAASB's DP thought there was insufficient guidance on how to take qualitative factors into account when making materiality judgments in relation to disclosures. Many respondents also indicated that there may be an implicit presumption that information must be disclosed unless the amount involved is clearly inconsequential.

For these reasons, the Working Group feels that, without the benefit of a disclosure framework, the reporting requirements may not be applied as intended by the IASB, resulting in information overload that may obscure readers' understanding of the entity's financial position and performance. A robust disclosure framework would help preparers and auditors in reaching common conclusions as to the appropriate level of an entity's disclosures, thereby helping to avoid unnecessary conflict in practice. For specific suggestions as to what should be addressed by the disclosure framework, please refer to the Annex to the letter.

II. SPECIFIC SUGGESTIONS TO IMPROVE THE CLARITY OF UNDERLYING PRINCIPLES AND KEY TERMS

A) QUESTION 1: PERFORMANCE OBLIGATIONS SATISFIED OVER TIME

Issue Description

An important judgment in determining when revenue should be recognized is whether the performance obligations are satisfied over time or at a point in time. As explained in paragraph 34 of the ED, an entity is required to determine at inception of the contract whether it satisfies the performance obligation over

time and, if not, whether it is considered to be satisfied at a point in time. Paragraphs 35 and 36 are particularly important in determining the timing of revenue recognition.

The Working Group found these paragraphs difficult to understand, especially without reading the relating BC section. In particular, the following concerns were raised:

- Whether the explanation of “alternative use” in paragraphs 35(b) and 36 is sufficiently clear for consistent application. In the Working Group’s view, wording such as “largely interchangeable,” “significant costs,” and “substantive terms” may be subject to different interpretations.
- In what circumstances a customer would be considered to simultaneously receive and consume the benefits of the entity’s performance as described in paragraph 35(b)(i), even when the goods or services are incomplete. The Working Group found paragraph BC96 helpful in explaining how this could occur.
- How an entity can demonstrate that another entity would not need to substantially re-perform the work the entity has completed to date as required by paragraph 35(b)(ii), when the goods or services are incomplete. The Working Group questions whether there needs to be a contractual arrangement between another entity and the customer, and felt that paragraph BC97 is essential to the understanding of this requirement.
- How preparers would be able to provide evidence that the entity has a right to receive payment for performance completed to date and expects to fulfill the contract as promised, when it would need to determine that its compensation will include a “reasonable profit margin.” Should this concept be explicit in contracts (considering the particular importance of the requirement) or would it be sufficient for such an arrangement to be implicit or customary? In the Working Group’s view, unless the entity breaches the contract, it would often be customary for an entity to receive a certain (but not necessarily the entire) amount of compensation. However, the level of specificity of the conditions in contracts may vary significantly and significant judgment may be required. At a minimum, it would be helpful to clarify the notion of “reasonable profit margin.”

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB:

- Provide guidance regarding when and how paragraph 35(b) can be applied, including the term “reasonable profit margin” in paragraph 35(b)(iii); and
- Consider moving relevant explanations in paragraphs BC96-97 to the standard, whether in the requirements or in the application guidance, to enhance the understanding, and provide for more consistent application, of paragraphs 35(b) (i)-(ii).

B) QUESTION 3: MEASUREMENT OF REVENUE FOR VARIABLE CONSIDERATION

Issue Description

Paragraph 81 of the ED establishes a maximum threshold for revenue recognition when the amount of consideration to which the entity expects to be entitled is variable. The cumulative amount of revenue an entity recognizes to date cannot exceed the amount to which the entity is reasonably assured to be entitled.

Clarification of Phrases Containing the Word “Expect”

The ED states, as its core principle, that an entity shall recognize revenue to depict the transfer of the promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This requires the use of judgment when recognizing and measuring revenue with customers. Drawing on this principle throughout the ED, many of the proposed requirements make reference to the entity’s “expectations.”

The Working Group wonders if requirements using the word “expect” may be interpreted by some as being forward-looking, in the sense of “what the entity ultimately expects to receive.” In the overall context of the ED, this does not seem to be the IASB’s intention. Therefore, when reference is made to, for example, the consideration to which the entity expects to be entitled, the Working Group assumes that it is the consideration to be received under the terms of the contract. The Working Group believes there is merit in clarifying this throughout the proposed standard.

The Working Group also observed that the ED uses different wording in various places when referring to “expectations.” For example:

- An entity may apply this [draft] IFRS to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the result of doing so would not differ materially from the result of applying this [draft] IFRS to the individual contracts (or performance obligations) (paragraph 6);
- If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall apply this [draft] IFRS to the modified contract when the entity has an expectation that the price of the modification will be approved (paragraph 19);
- Performance obligations include promises that are implied by an entity’s customary business practices, published policies or specific statements if those promises create a valid expectation of the customer that the entity will transfer a good or service (paragraph 24);
- In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation (paragraph 48);
- For a performance obligation that an entity satisfies over time and that the entity expects at contract inception to satisfy over a period of time greater than one year, an entity shall recognise a liability and a corresponding expense if the performance obligation is onerous (paragraph 86); and
- An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs, subject to the practical expedient in paragraph 97 (paragraph 94).

In the Working Group’s view, it would be helpful to understand whether the IASB believes the various phrases containing the word “expect” have different meanings (for example, whether a hierarchy exists for these terms). Clarification of this matter would be welcomed before final approval of the proposed standard.

Use of the Term “Reasonably Assured”

Paragraph 83 of the ED states: “The presence of any one of the indicators in paragraph 82 does not necessarily mean that the entity is not reasonably assured to be entitled to an amount of consideration.” Paragraph BC201 explains that the “reasonably assured” threshold is intended to be a qualitative

threshold (as opposed to quantitative threshold). The Working Group is concerned that the requirement in paragraph 83 is not sufficiently clear for consistent application in practice. The Working Group believes that making the threshold one that can be demonstrated based on reliable evidence would be beneficial.

Moreover, in auditing literature the term “reasonable assurance” is often characterized as “a high, but not absolute, level of assurance” (without defining whether it is a qualitative or quantitative notion), which contrasts with the explanation in paragraph 81 of the ED. To avoid misinterpretation or confusion in practice regarding the meaning of “reasonable assurance,” the Working Group believes it would be advisable for the accounting standard to use a different term. Although the term “reasonable assurance” is already used in one of the IASB’s standards⁴, its use in the proposed standard may significantly increase the potential for misinterpretation or confusion, because of its broad application.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that, throughout the proposed standard, the IASB use wording that makes it clear that the expectation is based on the contractual terms rather than a forward-looking expectation of what management believes it will ultimately receive. For example, a phrase such as “*expects to be received under the terms of the contract*” could be considered.

In addition, the Working Group recommends that the IASB clarify whether it intends that there be a ‘hierarchy’ among the phrases containing the word “expect,” depending on the different contexts in which the term is used throughout the proposed standard. For example, it would be helpful to know whether and how “reasonable expectation” differs from mere “expectation” or “valid expectation.” If there is no difference, it would be appropriate to use consistent terminology throughout the proposed standard.

Further, the Working Group recommends that the IASB consider wording other than “reasonably assured” in paragraph 81 to avoid undue confusion with the use of the same term in the auditing literature. Alternative wording might be “...the cumulative amount of revenue an entity recognizes to date shall not exceed the amount that *the entity [validly] expects to be entitled to receive under the terms of the contract, supported by reliable evidence.*”

C) APPLICATION OF PRACTICAL EXPEDIENTS TO A PORTFOLIO OF CONTRACTS

Issue Description

As a practical expedient, paragraph 6 of the ED permits an entity to apply the proposed standard to a portfolio of contracts (or performance obligations) with similar characteristics *if the entity reasonably expects that the result of doing so would not differ materially* from the result of applying it to the individual contracts (or performance obligations). The Working Group questions if the practical expedient would work as intended.

For example, it is not clear how preparers would be able to substantiate and how auditors would audit the presumption that application of the proposed standard on a portfolio basis would not be materially different from doing so on an individual contract basis. In the Working Group’s view, this might eventually require quantifying the difference. In addition, the Working Group questions whether this practical expedient would be in compliance with the proposed standard in one year (when a higher materiality threshold is used), where it could be viewed as a misstatement in another year (when a lower materiality threshold is used) and implications to its effect on the consistent application of accounting policies.

⁴ IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB consider simplifying the sentence as follows: "... as a practical expedient, an entity may apply this IFRS to a portfolio of contracts (or performance obligations) if they share substantially similar characteristics."

D) METHOD USED IN ESTIMATING STAND-ALONE SELLING PRICES

Issue Description

As a part of allocating a transaction price to separate performance obligations, paragraph 73 of the ED requires an entity to estimate a stand-alone selling price when it is not directly observable, while providing three approaches for estimation (that is, adjusted market assessment approach, expected cost plus a margin approach, and residual approach). However, there is little guidance about which approach is appropriate in what circumstances, except that a residual approach is applicable when the stand-alone selling price is highly variable or uncertain.

Clarification as to which approach is applicable to specific situations and how management can support its judgment would be helpful for both preparers and auditors to properly understand the intent.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB provide further explanation as to which of the three approaches is appropriate in a given circumstance.

III. SPECIFIC SUGGESTIONS RELATING TO JUSTIFICATION OF MANAGEMENT'S JUDGMENTS

E) ORAL APPROVAL OF CONTRACTS

Issue Description

Paragraph 14 of the ED requires an entity to apply the proposed standard to a contract with a customer when four conditions are met. Subparagraph (b) of the paragraph states as one of the criteria that "the parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations."

Although legally enforceable contracts can be written, oral or implied by an entity's customary business practices, the Working Group is not sure whether, and if so, how management would be able to provide evidence to support contracts approved orally, in particular for complex transactions. The Working Group also questions whether auditors can obtain sufficient appropriate audit evidence about the completeness of revenue amounts, including whether undisclosed side agreements exist, if there is no documentation available.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB provide guidance about how an entity could demonstrate that a contract meets the relevant conditions and is legally enforceable, when the documentation is not available.

F) RELATED PARTY OF THE CUSTOMER

Issue Description

Paragraph 17 of the ED requires an entity to combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contract as a single contract if

certain conditions are met. Paragraph BC54 explains that “...the boards acknowledged that in some situations, contracts with related parties (as defined in IAS 24 Related Party Disclosure and ASC Topic 850 on related party disclosures) need to be combined...”

The Working Group does not believe it is practicable for management to identify the customer’s related parties as defined in IAS 24, and for the auditor to obtain evidence supporting such identification. This approach would encompass a very broad range of stakeholders including, among others, family of key management personnel of the customer entity.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB consider using a different term or specify the scope of related parties to be identified in the context of this paragraph.

G) DISCLOSURE OF FORWARD-LOOKING INFORMATION

Issue Description

Paragraph 119 of the ED requires certain information to be disclosed when the entity expects to recognize that amount as revenue for contracts with an original expected duration of more than one year.

The Working Group feels that the requirement may pose significant challenges to auditors with respect to verifying the completeness of an entity’s disclosure, as it may relate to information about the backlog of orders not recognized in the financial statements. Moreover, if the paragraph intends to capture situations where timing of transfer of control is not predetermined in a contract and such timing is susceptible to future actions by management or third parties (for example, long-term construction contracts), it would be very difficult for management to substantiate their expectations so that auditors would be able to obtain sufficient appropriate evidence. The Working Group, therefore, believes that this approach has the potential to pose significant challenges to both management and auditors.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB clarify or reconsider the requirement, in the light of the above-mentioned issues. The IASB may wish to work with securities regulators to determine if such information might better be presented in a section of annual reports rather than in the audited financial statements. If the IASB decides that such information should be disclosed in financial statements, an accompanying disclosure requirement to explain the uncertainty associated with this information may be necessary for the readers to properly understand the context of the information.

IV. OTHER COMMENTS

H) CRITERIA TO DETERMINE IF A GOOD OR SERVICE IS DISTINCT

Issue Description

Paragraph 28 of the ED specifies criteria for an entity to use in determining if a good or service is distinct. In particular, its subparagraph (b) states as a condition that “the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.”

This requirement is consistent with the core principle of the proposed standard as specified in paragraph 3. It is the Working Group’s understanding that the intention behind the criterion is to describe the circumstances when a good or service is capable of being used, and to reflect the understanding of the entity based on the nature of its products or services and typical business relationship with its customers.

However, the Working Group finds it troublesome to draft the criterion from the perspective of the customer. Interpreted literally, it would seem to require the entity to account for its transactions based on what its customer does or is able to do.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB redraft paragraph 28(b), so that the focus is not on actions of the customer, but rather on when control has passed to the customer. Alternative wording might be: *“The good or service is capable of being used either on its own or together with other resources that are readily available.”*

As an alternative, the IASB might provide guidance to clarify that an entity is not required to undertake an unlimited search to determine whether the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. Alternative wording might be:

“An entity need not undertake an exhaustive search of all possible situations to identify whether the criteria in paragraph 28 are met, but shall take into account all information that is reasonably [or readily] available. In the absence of evidence to the contrary, the entity can assume that the customer cannot benefit from the good or service either on its own or together with other resources that are readily available to the customer, if the entity and its major competitors do not regularly sell the goods or service separately.”

I) TIMING OF TRANSFER OF A PROMISED GOOD OR SERVICE

Issue Description

Paragraph 31 of the ED requires an entity to recognize revenue when *the customer obtains control* of a promised good or service. As noted in H) above, the Working Group suggests that IASB consider wording the requirement differently to avoid any misinterpretation that it should be applied from the perspective of the customer.

Actions that IASB May Wish to Consider in Addressing the Issue:

In line with the Working Group’s suggestion in H), possible wording for paragraph 31 might be: *“...An asset is transferred when control of that asset has passed from the entity to the customer.”*

Alternatively, the IASB might provide the guidance worded as follows:

“An entity need not undertake an exhaustive search of all possible situations to determine whether a customer obtains control of a promised good or service, but shall take into account all information that is reasonably [or readily] available. In the absence of evidence to the contrary, the entity can assume that the customer obtains control when the entity determines that it transfers control to the customer.”

J) REASONABLE MEASUREMENT OF PROGRESS

Issue Description

Paragraph 47 requires an entity to recognize revenue for a performance obligation satisfied over time only if the entity can *reasonably measure* its progress towards complete satisfaction of the performance obligation, while explaining that an entity would not be able to reasonably measure its progress towards

complete satisfaction of a performance obligation if it lacks *reliable information* that would be required to apply an appropriate method of measuring progress.

Although “reasonable estimation” is an essential part of the preparation of financial statements,⁵ the Working Group is unclear why an entity is not required to develop a reliable measurement, when it has reliable information to support the measurement. The Working Group is concerned that referring to “reasonable measurement” could be misinterpreted as setting too low a threshold, and could result in estimates that are too imprecise to be a fair representation.

Actions that IASB May Wish to Consider in Addressing the Issue:

Considering the increased use of judgment in preparing financial reporting, the Working Group recommends that the IASB use the term “*reliably measure*” rather than “reasonably measure.” The Working Group believes that it would be important, as a part of the recognition of elements of financial statements, for the financial reporting framework to require “reliable measurement” of the progress, to promote that audited financial statements provide reliable information.

K) FINANCING COMPONENT

Issue Description

Paragraph 58 of the ED requires an entity to adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract. The Working Group found that the explanation in paragraph 58 and the factors for consideration in paragraph 59 are somewhat duplicative and potentially inconsistent. For example, paragraph 58 explains that “if the promised amount of consideration differs from the cash selling price of the promised goods or services, the contract also has a financing component that may be significant to the contract.” Paragraph 59(b), on the other hand, states “whether the amount of consideration would differ substantially...” as one of factors in assessing whether the financing component is significant to contracts.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB streamline and clarify paragraphs 58-60 considering the above-mentioned issues when finalizing the standard.

L) ONEROUS PERFORMANCE OBLIGATIONS

Issue Description

Paragraph 86 requires an entity to recognize a liability and corresponding expense if a performance obligation that an entity satisfies over time is onerous. However, that paragraph limits the scope to the situation where an entity *expects* at contract inception to satisfy the obligation *over a period of time greater than one year*.

The Working Group believes that establishing a threshold that contains the word “expects” to record losses under the onerous performance obligation is unclear as to what is necessary to support management’s judgment, and might set the bar too low. Past experience has shown that this has been an area where the risk of abuse is often significant, and the Working Group wonders if the proposed requirement might not lead to earnings management. Lack of robust criteria may pose challenges to auditors, as they would find it difficult to obtain sufficient appropriate evidence, especially when information involves judgment of forward-looking estimation.

⁵ The IASB *Conceptual Framework*, paragraph 4.41

There is also a risk of inconsistent interpretation regarding whether and how renewals of the contracts should be taken into account in determining the length of a contract, especially when such renewals are made orally or are implied through customary business practices. As a contract is usually concluded through a bilateral agreement, the length of a contract could be artificially altered in the absence of robust guidance in the proposed standard.

Actions that IASB May Wish to Consider in Addressing the Issue:

In light of alleviating the risk of potential abuse, the Working Group recommends that the IASB modify the paragraph to require an entity to recognize losses in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*⁶ when it [validly] expects to incur losses under a contract based on the information that are reasonably available at the reporting date. Alternatively, the entire content dealing with losses expected under the terms of the contract might be placed in IAS 37.

M) OTHER MATTERS

The Working Group feels that the following matters warrant the IASB's further consideration.

- The proposed standard does not follow the order of the “five steps” as explained in paragraph IN10 of the ED. In our view, these steps are key to describe what is intended by the core principle. Considering that the proposed standard will be read by stakeholders in different industries in various jurisdictions, it may be helpful if the requirements are written in the sequence of these steps.
- It does not seem appropriate to set an expectation for an entity to look at “*all* facts and circumstances,” because taken literally it would require an unlimited and thorough search. The wording could be amended to “all facts and circumstances reasonably obtainable (or available) in the relevant circumstances” (paragraphs 5 and 83, and BC34).
- BC139 to BC142 could be moved to immediately after BC197, as they relate primarily to paragraph 78.

⁶ IAS 37, paragraphs 66-69

ANNEX

SPECIFIC SUGGESTIONS FOR THE DEVELOPMENT OF DISCLOSURE FRAMEWORK

As stated in the covering letter and overall comments, the Working Group believes that the ED underscores a strong case for development of a robust disclosure framework. In particular, the Working Group believes the framework might address following issues:

- Whether and, if so, when disclosure requirements containing the phrase ‘as a minimum’ is appropriate (the phrase ‘as a minimum’ is used in some disclosure requirements including IFRS 12 *Disclosure of Interests in Other Entities*, while the ED does not set out requirements containing such phrase.);
- How the concept of materiality should be applied to disclosure items (materiality of an item because of its inherent nature vs. materiality of an item given the entity’s particular circumstances);
- Whether and, if so, how the term ‘material’ differs from the term ‘significant’;
- Whether the extent of disclosures sufficient to meet users’ needs should be different in annual vs. interim reporting, and if so, what the differences should be (including whether, and if so, how a reporting deadline may affect that consideration);
- Whether preparers have flexibility as to the format of information to be presented (in other words, not using a format required by the standard would be deemed to result in a material misstatement). For example, when a standard requires presentation of specific information in a *tabular format*, whether there would be a material misstatement if an entity present specific information (such as a reconciliation of assets or liabilities from the beginning of the year to the year-end) in a narrative manner; and
- How to split the financial reporting information into a financial statement (often subject to audit requirements by legislative or regulatory requirements) and other information that is part of financial reporting (often required by securities regulations and not within the scope of audit of financial statements).

In its comment letter to the *IASB Agenda Consultation 2011*, the IAASB expressed its willingness to collaborate with the IASB and other key stakeholders in working towards addressing these matters.