Dear Sirs

Response to ED/2010/06 Revenue from contracts with customers

We welcome the opportunity to comment on the above exposure draft.

Revenue is a key indicator of performance of most entities and so the exposure draft is of central importance. We understand the need for consistency in revenue recognition in the financial reporting standards of the IASB and the FASB and welcome the joint approach to this issue. In particular we acknowledge that progress made in collating and simplifying the multiple sources of rules on revenue recognition currently contained in US GAAP.

Whilst the boards' should be commended for the progress thus far, we do believe the exposure draft has some significant, if not fundamental, flaws which must be addressed. The current standards, IAS 18 and IAS 11, are well understood and, in the main, consistently applied. Whilst there may be academic and philosophical attractions of developing a single set of requirements to be applied across all industries that purport to be based on principles consistent with other standards we urge the board to rigorously apply the tests that any new standard be superior to those it replaces and capable of consistent and understandable application. The quality of financial reporting standards must not be sacrificed in the name of achieving convergence, nor understandability sacrificed in the name of philosophical consistency.

We agree, in principle, with the five step approach for measuring and recognising revenue. However, we believe the current draft requires further development and re-wording. The explanations of each of the three key principles, price interdependence, distinctness of performance obligations and control, and associated guidance is currently inadequate.

In particular we would highlight that the principle of control has not been adequately developed and as a consequence it is unlikely to be consistently applied in practice. In addition the discussion of indicators of the transfer of control is not sufficiently explicit or clear to ensure consistency.
In our view, this is partly because the test of control is being applied to the wrong "asset". The approach concentrates on identifying when the customer has obtained control of the purchased good or service. Irrespective of the difficulties in (i) understanding what is meant by control of a service and (ii) applying this notion to a long term contract, this approach would only identify when the good or service should be de-recognised by the reporting entity.

Consideration should be given to the application of the concept of control to the receivable – i.e. the right to receive and retain consideration - as this is the asset the reporting entity will actually recognise. Whilst one would expect the moment the good or service is transferred to be the moment a receivable is recognisable, a test for the former is only a proxy for a test for the latter. A more easily understandable principle would be to recognise revenue as performance obligations are performed to the extent they have created a right to consideration.

We would urge the board to consider the requirements of Application Note G of the UK Accounting Standards Board’s FRS 5, which effectively applies a control test to the right for consideration. It may benefit from further development, but it would provide the basis for a notion of control that is consistent with a natural understanding of the term, consistent with other standards (in particular, the recognition of the receivable under IAS 39) and would lend itself to more straightforward application to service and long-term construction contracts.

Our detailed responses to the specific questions raised in the Exposure Draft are attached in an appendix.

Kind regards

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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 agree with the principle that two or more contracts should be combined and accounted for as a single contract where there is price interdependence between them. We also agree that a single contract be segmented to the extent some goods/services within the contract are priced independently of all goods/services provided under that contract.

However, paragraph 13, as currently drafted, is not helpful, especially when compared to paragraph 15. Paragraph 13 only defines price interdependence in a rather circular way, saying that price interdependence exists where the price of one good/service is dependent on the price of another. Paragraph 15 is clearer to the extent it states that price independence requires that the customer does not receive a significant discount by buying goods or services together. We believe this construct of the latter definition more explicitly reflects the key consideration.

Having said that, paragraph 15(b) might itself be considered unclear. It implies that all goods within a contract are priced interdependently if the customer has received a discount on any of the goods but the solution to Example 1 contradicts this. If this interpretation of paragraph 15 (b) was applied, an entity would not be able to segment good C from goods A&B, because the contract includes a discount on some of the goods. The solution given in example 1 is predicated on the pricing of C being independent of the pricing of A&B because the same discount on the latter goods could have been achieved without the additional purchase of C. We would advise the board to revisit the wording in both paragraphs 13 and 15 to ensure they are clear and consistent with each other and the application guidance.

We would also highlight shortcomings in the way indicators of price interdependence are described in paragraph 13. The implication of the current wording, being "Indicators ..... include the following", is that the characteristics described are individually indicative of price interdependence, but this is not true. The facts in 13 (a) and (c) (multiple contracts that have been "entered into at or near the same time" or "performed either concurrently or consecutively") are likely to apply when contracts have been interdependently priced but, in themselves, they do not indicate that this is the case. We would be concerned that in the absence of a clear definition of price interdependence in paragraph 13, the indicators may be taken to be individually definitive.

We note that these indicators are similar, though not identical, to the characteristics described in IAS 11, paragraph 9, but that standard requires the combining of contracts when all three characteristics apply. Whilst we would not advocate the use of a "bright line test" such as that in IAS 11, we would advise the board to reconsider the wording of paragraph 13 to clarify it is the existence and interaction of all the indicators that is important.

In our opinion, the proposed treatment of modifications in paragraphs 17 – 19 is too simplistic. In some cases the pricing of a modification may be dependent on the pricing of the original contract but it would still not be appropriate for the revised contract to be considered cumulatively. For example, a customer might agree to a change in price due to an unexpected rise in the entity's costs. If the new price does not reflect current market prices it will be seen as dependent on the previous prices. Applying the new proposals would lead to a cumulative spreading of the revenue which would not reflect the economic substance of the modification.
**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?

We agree there is a need to "unbundle" contracts with multiple goods and services and that a principle of distinctness is an appropriate basis for doing so.

However, the principle as set out in paragraph 23 is, in our opinion, not sufficiently clear nor properly developed. This view is, in part, supported by the inconsistencies between the paragraph and the application guidance example 11. Example 11 will be welcomed by those who fear that a construction contract could be segmented into infinitesimal obligations but, in our view, it is not supported by the principle as set out in paragraph 23.

Paragraph 23 (a) implies that the fact the entity or another entity sells a similar good/service is sufficient for identifying distinctness, and thereby its identification as a separate performance obligation. But in example 11, foundation development, structure erection, piping and wiring are not identified as distinct goods despite the explicit statement that the customer could contract separately with other entities for all of these tasks. On the face of it these two positions are irreconcilable.

The example introduces the notion of the tasks being integrated into a contract management service which, it is asserted, is not distinct without any reference to how this analysis refutes the assertion that, say, wiring is distinct as it meets the 23 (a) condition. It should be noted that in practice each of these services usually are distinct and are often provided by sub-contractors.

As well as the apparent conflict with the main body of the standard, the implied guidance in the example is insufficiently clear to promote consistent application, because:

- It is not at all clear why the limits of the contract management service should be taken to start with foundation development and to end before site finishing - in practice the management service may actually start at the design stage (and there are usually revisions to design during construction, both in response to client demands and practical difficulties encountered during construction) and would not end until the site has been fully landscaped
- No principle is set out that could clearly determine that, for example, foundation development is interrelated with structure erection but not with site preparation
- In practice, contract management services are distinct, in that they can be separately purchased from other entities, and often are with each step in construction being separately sub-contracted.

If example 11 properly reflects the board's intended principle then paragraph 23 should be amended

**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?

In our opinion, the proposed requirements (not guidance as described in the question) in paragraphs 25-31 and the related application guidance are not sufficiently clear nor well enough developed to facilitate consistent application of revenue recognition policies. When one compares the key recognition condition in paragraphs 25 – 27 with the indicators in paragraph 30 and Application Guidance examples, the lack of clarity is striking.

In our opinion, this is the result of a fundamental flaw in the proposed application of the concept of control. We recognise the centrality of the concept of control in financial reporting standards and accept it would be beneficial if that concept was also applied in revenue recognition. However, we believe the test is being applied to the wrong "asset", by which we mean we disagree with its application to the transfer of
control of the good/service, not least because the notion of obtaining control of a service is not easily understood.

Income is an increase in equity resulting from the recognition of a new asset or the reduction in a liability. With regards to revenue the new asset that increases equity is the consideration received or receivable. The transfer of control test should be applied directly to this asset not the transferred “asset”, be it a good or a service.

To identify when the customer has control of the good/service transferred, is to identify the moment when the entity should derecognise an asset, being any costs which have been deferred as, say, inventories. Obviously, we would normally expect the moment of derecognition of an item of inventory to also be the moment that we could recognise the receivable - but still the former is a proxy for the latter.

We would propose the following principle be considered instead:

Revenue should be recognised when the entity has performed its contractual obligations under a contract to the extent it has an enforceable right to consideration - i.e. it has control of an asset representing consideration.

It is worthy of note, that this principle is similar to the indicator in paragraph 30(a) being the customer has an unconditional obligation to pay. This indicates that the customer has gained control of the good, but only because it is proof that the entity has obtained control of the consideration received or receivable and, under normal commercial arrangements, one would expect the two to occur at the same time. It is our assertion that the right to have and retain consideration signals it is appropriate to recognise revenue.

Having said that, the wording of paragraph 30 (a) should be clarified. In particular, what is meant by “unconditional”? If subsequent failure to fulfil all contractual obligations could lead to the customer demanding a refund then an obligation to pay might never be “unconditional”. Whilst the entity may lose its right to consideration by failing to perform other obligations under the contract, the criteria should be that the customer cannot unilaterally avoid its obligations to pay for work already performed.

The relative benefits of our proposal include:

- The direct application of the concept of control consistent with its application in other standards – i.e. an asset is recognised when control over it is obtained, not when control of another asset is transferred to another party. In particular, it is consistent with the tests of recognition of the financial instrument, being the receivable, under IAS 39.
- It is more consistent with the common understanding of the term “control”.
- It does not require unnatural use of other terminology. For example, it is not remotely clear what, in normal terms, the transfer of control of a service means. Similarly, it would avoid the confusion arising from the idea of the continuing transfer of the control of a good constructed under a long term contract.

This proposal is not dissimilar to the revenue recognition criteria set out in the UK Accounting Standards Board’s Application Note G to FRS 5, which is generally considered to have improved financial reporting in the UK and to provide an appropriate framework for consistent application. We would urge the board to consider the contents therein.

If the board is not persuaded by the arguments for an alternative recognition principle, then we urge it to consider the explanation of their own principles carefully. If there is to be consistency across entities and industries in the recognition of revenue the criteria for recognising revenue must be clear and consistently applied. In our opinion the draft wording would not facilitate that.

Paragraphs 25 – 27 categorically state that there is a single test for the recognition of revenue; i.e. revenue is recognised when the customer has the ability to direct the use of, and receive benefit from the
good or service. Even if one does not agree that this is the most appropriate recognition criterion, as stated it is clear and understandable.

However, paragraphs 30 and 31 cloud the issue by listing a number of "indicators that the customer has obtained control of a good or service". In our opinion, these characteristics of a transaction sometimes coincidentally exist where control (as defined in paragraph 26) has been passed to a customer but do not indicate it has actually happened in any single transaction.

The fact there is only partial overlap of the situations where these characteristics exist and the situations where control is passed is made clear in paragraph 30 itself. 30 (b) makes clear in some cases transfer of legal title coincides with the transfer of control, but in some cases it does not. 30 (c) makes clear in some cases physical possession gives the customer control but in others it does not. 30 (d) refers to a characteristic (ability for customer to direct major design changes) that one would only expect an entity to permit if the customer was required to pay for the asset, or in other words where the characteristic in 30 (a) applies.

Whereas the criterion set out in paragraphs 25 – 27 is clear and distinct, a term used in a number of the application guidance examples appears to imply a broader assessment should be made. In both scenarios in example 15, and in examples 16 and 17, it states that "the terms of the contract and all the related facts and circumstances indicate" whether or not control has been passed. This term is not used in the main body of the draft standard and may be taken to imply that revenue is recognised when a judgemental analysis identifies the existence of some of the indicators, rather than if, and only if, there is clear direct evidence that the customer has the ability to direct the use of and receive the benefit from the good or service.

This blurring of the revenue recognition criteria, and the potential confusion this may cause in application, is most clearly seen in scenario 1 of example 15. The facts that the customer can specify and re-specify the design of the good (a paragraph 30 (d) indicator), must make regular non-refundable payments (paragraph 30 (a)) but legal title does not pass until the good is complete (absence of the paragraph 30 (b) indicator) are, in our opinion, all irrelevant. It is only the contractual right of the customer to terminate the contract early and take possession of the partly completed good that gives the customer the ability to direct the use of, and receive the benefit from, the good or service.

Nor is this clarified in scenario 2, where two of the facts have been changed but it is not made clear which of the changes is/are critical. In our view, it is not the absence of customer design specifications that bars revenue recognition (when applying the principle in paragraphs 25 – 27), but the inability of the customer to take control of the partly completed asset.

A similar critique can be made of example 16. It appears to us that control has been deemed to transfer continuously because the entity must share findings with the customer each month and the customer has the right to obtain any analysis prepared. Yet the conclusion implies that control is transferred on a continuous basis because of the unconditional obligation to pay and the customer specification of services. Both of these facts are irrelevant if the test for revenue recognition is the customer's ability to direct the use of, and receive the benefit from, the service.

We would advise the board to look carefully at the potential unintended consequences of giving undue prominence to the indicators in paragraph 30, as they are all irrelevant if the criteria in paragraphs 25 – 27 are not met. In particular, clear guidance is necessary on which combinations of indicators would provide conclusive evidence that control has been transferred and which would not.

**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 recognizing revenue when the transaction price is variable and why?

We agree that if the amount of consideration is variable, revenue should only be recognised where the transaction price can be reasonably estimated. However, we would disagree with the definition of transaction price. This is currently defined as "the amount of consideration that an entity receives or expects to receive...". In our opinion, a more appropriate definition would be the "the amount of consideration that is receivable under the contract or the entity expects to become receivable under the contract...". Such a definition would exclude the effects of the customer's credit risk which is considered further below.

**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?

We do not agree that the customer's credit risk should, as a matter of course, affect the measurement of revenue to recognise when an entity satisfies a performance obligation.

In the normal course of business most entities, with the possible exception of financial institutions, do not usually enter into contracts with a customer where it believes there is significant risk of that customer defaulting. Nor do non-financial institutions commonly make individual pricing decisions on the basis of any assessment of the customer's credit risk. We would assert that the management of credit risk and the recovery of amounts due from customers is seen by entities, accounts preparers and users as an administrative function and any bad debt expenses as administrative costs. Users of accounts can gain a detailed understanding of how such risk is managed from the disclosure requirements of IFRS 7.

By adjusting revenue for anticipated bad debt losses the information content of the primary statements and the ability to make important comparisons between companies are significantly impaired. Firstly, direct comparisons of entities' abilities to maximise the product of sales volume and sales prices are inhibited. Secondly, the efficiency of the company to convert direct input costs into sales at prices the market will accept is no longer separately encapsulated in the widely recognised and understood measure of gross profit. And thirdly, by not allowing such direct comparisons users would not be able to distinguish between an efficient operation with a poor credit control function and a less efficient operation with a good credit control function.

We realise that the definition of transaction price in the draft standard and its impact on the initial measurement of revenue and trade receivables is consistent with the proposed expected loss approach in the measurement of financial assets. However, we have the same concerns about the proposed expected loss approach if it was applied to the trade receivables of non-financial institutions that do not, and are generally not expected to, make individual pricing changes on the basis of individual assessments of credit risk.

However, if in the commercially unlikely event that at the time a performance obligation is satisfied the entity has significant doubt over the recoverability of the consideration receivable, then the standard should preclude the recognition of any revenue (as IAS 18 would) and require additional relevant disclosures. Entering into or continuing to perform a contract where there are significant doubts over recoverability are qualitatively and quantitatively different events to accepting a contract where there are no significant doubts and should be highlighted for users.

**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 that the measurement of revenue should reflect the time value of money where there is a material financing component, but only where the consideration is received after the performance of the entity’s obligations under the contract. This is because the entity is effectively providing an additional service, namely the provision of finance, and the income arising from that should be recognised over the period in which that service is provided. Furthermore, it is the deferral of the transfer of money that has value.

However, we do not agree that the measurement of revenue should reflect the time value of money when the consideration is received before the performance of obligations under the contract unless there is an explicit financing transaction. We would urge the board to clarify when a payment in advance should be seen as a financing transaction.

There may be a conceptual argument for demanding apparent symmetry in the accounting of payments in advance and payments in arrears but this has not been set out. Moreover, it is not consistent with a natural understanding of revenue for it to be measured at a greater amount than the cash received.

Secondly, the deferral of revenue recognition on the basis of whatever financial reporting principle is applied will not always reflect the physical and economic reality of the contract. By this we mean substantially all activities of the entity may have been completed and substantially all costs expensed, but revenue has not yet been recognised. In such cases, there will be no further cash flows and there is no money to have a time value.

Thirdly, the net effect of the proposed accounting treatment over the period from receipt of cash in advance and recognition of revenue will be:

Dr Interest expense  
Cr Revenue

In our view, these entries do not, when taken individually, meet the definitions of gains or losses in the Framework. The revenue does not represent an increase in an asset, as there are no additional inflows of economic benefit and the interest expense does not represent an increase in a liability as there are no additional outflows of economic benefit.

Finally, and most importantly, the entries will not be understandable to users of the financial statements. It would be inconsistent with any common sense understanding of revenue to recognise an amount which does not represent any inflow from customers, now or in the future, but is only supported by a corresponding expense. It is difficult to see how the recognition of total revenue in excess of the total cash received or receivable could ever be consistent with a common sense understanding of the term.

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?

Subject to concerns expressed elsewhere in our response we agree with the general principle of allocating the transaction price to performance obligations in proportion to the stand-alone selling prices.

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?
We think the requirements set out in paragraphs 57 – 63 are, in the main part, operational and sufficient though we do have some concerns over the accounting for costs incurred in obtaining a contract.

In some competitive bid situations, the customer promises to reimburse the successful bidder for costs incurred in putting together the bid. Both parties understand that this is not for future performance of the contract obligations but are in respect of past activities. Application guidance B27 – B30 would presumably result in the amounts received being accounted for as payments in advance for future performance obligations, similar to the proposed treatment of non-refundable upfront fees.

This would result in all bid costs being recognised before the contract commences, but the reimbursement of these costs being spread over the life of the contract as the performance obligations are satisfied. We do not believe this treatment would properly reflect the commercial substance of the explicit terms of the agreement between customer and contractor.

**Question 9:** Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing 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?

Subject to the concerns raised in our response to question 8, we agree with the costs specified in paragraph 58.

**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?

Whilst the proposed disclosure requirements will provide additional information on the amount, timing and uncertainty of revenue and cash flows arising from the contracts, we would urge the board to consider whether such extensive disclosures will actually improve understanding. There is a growing recognition in some quarters (for example the UK Financial Reporting Council) that extensive disclosure may actually detract from the usefulness of financial statements, by resulting in unnecessary complexity and clutter.

For example, we do not believe the disclosures required by paragraphs 82 and 83 will, in practice, be useful. These requirements will most likely lead to boiler plate descriptions of the methods applied and will add little value to users. At some level, users should be able and expected to rely on preparers of financial statements to choose appropriate methodologies and inputs and make appropriate.

Furthermore, for a multi-disciplinary, multi-product entity the disclosures would be alarmingly long. Whilst example 31 appears to be straightforward, this is only because it relates to one software upgrade as applied to two products.

**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?

We agree that information on remaining performance obligations an expected timing of their satisfaction would be useful to users of the financial statements. However, we would urge the board to carefully consider the context of such disclosures, given they:

- will require forward looking information in respect of transactions that may not yet have had any impact on the financial statements; and
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?

We agree that the disaggregation of revenue as described in paragraph 74 should be disclosed.

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 guidance 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.

Whilst we recognise that retrospective application will best preserve trend information, this will only be practicable if there is an extended lead time from publication of the standard to its effective date and if preparers are made sufficiently aware of the need to gather necessary information in this intervening period. The boards must take additional steps to publicise these changes to preparers.

We note the board's comments in the Basis of Conclusions that IAS 8 limits the extent of retrospective application if it is impracticable. An extended lead time before the effective date should help reduce the instances of such limitations.

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?

As discussed above, there are a number of instances where the application guidance appears to go beyond, or arguably contradict, the main body of the standard. There are further instances where the examples given do not sufficiently highlight the critical point. The guidance should be reviewed again to ensure such issues are properly resolved.

For example there are two differences highlighted between scenarios 1 and 2 in example 15 but, in our opinion, it is only the ability of the customer to take ownership part way through that is critical to the application of the principle.

We would also encourage the boards to reconsider the application guidance in respect of sales with a right to return (AG paragraphs B5 – B12) and the economically similar sales and repurchase agreements where the customer has the right to demand repurchase. In particular, we would not agree that the repurchase liability and right to receive asset are distinct items to be shown gross. We would question the implied assertion that the right to receive is an asset at all, in that the entity has no control over the returning of products, could not enforce it, nor restrict other entities from accessing the economic benefits inherent in the products once they have been sold.

We would urge the board to re-consider the treatment of non-refundable upfront fees in paragraph B28. If such a fee “relates to an activity that the entity is required to undertake at or near contract inception” then we see no reason to conclude that it must necessarily be “an advance payment for future goods or services”. Whilst it is the case that upfront fees will often create performance obligations for the recipient, we do not believe this will necessarily be the case in all circumstances. There should be some consideration of the economic substance in determining whether an upfront fee creates an obligation to provide future services.
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?

We do not agree with the proposed distinction as it would introduce unnecessary complexity and is likely to be applied inconsistently. For example, if items sold with a 12 months warranty are returned after 6 months it is impossible to determine if the loss of performance arose from a new defect that occurred after purchase or was a merely the manifestation of a defect that existed at the point of sale.

Furthermore, it is not at all clear why the indicators given in paragraph B18 should be considered in determining if the warranty is a separate performance obligation.

- B18 (b) – this is tautologous; if a warranty can not be sold separately it clearly is not a separate obligation, but paragraph 23 (b) of the draft standard does not appear to rely on any consideration other than a good’s distinct function and profit margin in determining if the entity could “sell the good .... separately”.
- B 18 (c) – the length of the period of the warranty is not a sufficiently clear indication to distinguish between two very different accounting treatments.

In our opinion, all warranties should be treated in the same way, namely as a separate performance obligation. Revenue in respect of this obligation should be recognised evenly over the warranty period.

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?

We agree that the pattern of revenue recognition should depend on whether the licence is exclusive and we agree with the patterns of revenue recognition proposed by the boards.

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?

We agree that the accounting for the gain or loss on sale of such non-financial assets should be consistent with the recognition and measurement principles in the finalised revenue recognition standard, be they consistent with those currently proposed or as re-drafted following the consultation on this Exposure Draft.