

AC-2-1-18

15 October 2010

Sir David Tweedie Chairman The International Accounting Standards Board 30 Cannon Street London EC4M 6XH UNITED KINGDOM

Dear David

ED 2010/6 REVENUE FROM CONTRACTS WITH CUSTOMERS

Thank you for the opportunity to comment on this exposure draft (ED). The New Zealand Treasury is pleased to submit its comments below.

The Treasury supports the objectives of this proposal and the development of a single revenue recognition model. However, we have the following concerns with the proposals in the ED:

- The ED is insufficiently clear for services. The ED's focus on the transfer of control works well for goods but in our view doesn't translate well for services.
 We think that services are performed rather than transferred. As such, we recommend that the boards:
 - Provide separate guidance on services that avoids the current conflation of ideas regarding satisfying, transferring, obtaining and benefiting from services
 - Add further examples of common service transactions to illustrate their application.

Further discussion of our concerns and recommendations are provided in our answer to question three.

- We disagree with the proposal that revenue is adjusted for customer credit risk for the following reasons:
 - o Blending the consequences of a lending transaction with revenue recognition under the one net revenue line in the operating statement is unhelpful to users. Relevant and useful information about two separate and important business activities is 'lost' on the main statement.
 - o Entities could take either a conservative or aggressive view regarding the collectability of receivables. The resulting diversity in initial revenues 3724

Wellington New Zealand and subsequent gains/losses in collection may not provide comparable information between entities.

We recommend the initial and subsequent assessments of credit risk be treated as an expense (rather than offsetting the initial credit risk against revenue), because it provides the users with relevant business information.

- The proposal might capture grant income where a grantor as a customer purchases goods or services from the entity, for the benefit of a third party. We recommend the boards explicitly state if the proposal is intended to cover grants or not. There are two main issues if grants are captured:
 - There are inconsistencies between this ED and IAS 20 Accounting for Government Grants. Under IAS 20 grant income can be recognised when related expenses are incurred. However, this revenue ED only permits recognition when a performance obligation is satisfied. This could lead to different treatment depending on whether you consider you receive a government grant or perform a contract for services.
 - The concept of transfer of control of goods or services is difficult to apply in cases where the grantor has the ability to direct the use of the good or service, but the benefit might go to a third party.
- The ED requires an entity to recognise a liability and corresponding expense if a performance obligation is onerous. We think that the onerous contract requirements should not apply where a not-for-profit entity intentionally provides goods and services at less than cost for social benefit objectives. Particularly as sometimes the entity receives a government grant to fund the revenue shortfall. Further details are given on the last page of this submission.
- We consider the proposed disclosure requirements onerous, with the costs of compliance outweighing the benefits to users. In particular we question the comparability of the information on remaining performance obligations greater than one year, where uncertainties exist as to the duration of the contract and timing and amount of future price increases. Further details are given in questions 10 and 11.

Our other detailed comments on questions raised in the ED are set out in Appendix One.

Yours sincerely

Hugh Packer

for Secretary to the Treasury

Appendix One

Recognition

Question 1:

Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether: (a) to combine two or more contracts and account for them as a single contract; (b) to segment a single contract and account for it as two or more contracts; and (c) to account for a contract modification as a separate contract or as part of the original contract. Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

The Treasury notes that contracts need to be segmented where there are distinct performance obligations. However, we believe that further (or initial) segmenting on the basis of price interdependence is not warranted or helpful.

Our concerns are:

- That interdependence is an arbitrary notion, and the required judgements will lead to inconsistent treatments. We could for example foresee different judgements being reached regarding loss leaders in similar circumstances, with the ensuing debates being harmful for business as the costs do not exceed the benefits. We consider this may pose risks for the IFRS brand.
- That application of the independence principle produces results that are misleading. In scenario 2 of example 2, the substance of the renegotiation as stated in the example is that the price for the four years following the renegotiation is \$280,000, and if the services are delivered equally, the revenue should be \$70,000 per annum. The proposed "interdependence" principle has confused the reporting and in producing a \$40,000, \$80,000, \$80,000 has produced a result at odds with the economic substance.
- We also note that clearer wording is needed in <u>scenario 1 of example 2</u>. In this example, the facts given are that the entity agrees to reduce the price for the third year of services to \$80,000 and "*in addition* (emphasis added) the customer agrees to pay an additional \$220,000 for an extension of the contract for three years. Therefore we consider that the revenue should be: Year 1 \$100,000, Year 2 \$100,000, Year 3 \$80,000 (\$100,000 originally paid less \$20,000 refundable under renegotiation) Year 4-6 \$73,333 (\$220,000/3). From the following discussion it becomes clear that what is intended is the \$20,000 reduction in price is included in, rather than additional to the subsequent 3-year \$220,000 agreement.

The Treasury considers that the rights established under a contract with customers can and should be associated with the performance obligations. Where there are distinct performance risks and different timings of performance delivery under a contract, then segmentation is required, otherwise it is not.

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?

Paragraph 23 specifies a good or service as distinct if either: "the entity, or another entity, sells an identical or similar good or service separately; or the entity could sell the good or service separately because the good or service ... has a distinct function... and it has a distinct profit margin."

The Treasury considers that if there are distinct goods or services, with different performance risks then the revenue probably should be allocated to them separately (as per question 1).

We consider that there is not a distinct good or service if the item is a component that does not represent a performance obligation in itself (with a distinct performance risk). Therefore the profit should apply to the whole rather than the parts.

Question 3:

Do you think that the proposed guidance in paragraphs 25–31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

The Treasury considers the proposed guidance in paragraphs 25-31 does not provide sufficient clear guidance that will lead to comparable accounting for revenue from services. While the guidance is appropriate for the sale of goods, the same terminology and ideas do not translate well to services.

Paraphrasing paragraphs 25 and following as regards to services, the guidance in the proposed exposure draft states:

"An entity shall recognise revenue when it satisfies a performance obligation ... by transferring a promised service to a customer. A ... service is transferred when the customer obtains control of that ... service. A customer obtains control of a ... service when the customer has the ability to direct the use of, and receive the benefit from ... the service."

There are essentially four ideas here, which the boards are combining as a single recognition point.

- "satisfying the performance obligation"
- "transferring a promised service"
- "obtaining control of that service"
- "ability to direct the use of, and receive the benefit from the service"

We note that the boards have provided a relatively simplistic example 16 on consulting services. However, the Treasury invites the boards to consider a number of common

service transactions, and to consider the confusion their proposed guidance will generate.

- Audit services are delivered in accordance with an audit engagement letter, and involve the forming of an opinion or judgement that relies on the collection and analysis of audit evidence. The performance obligation is met as the professional procedures to support an audit opinion are carried out. At the end of this process an opinion and other reports are provided to the management of the customer, who are able to receive some benefit from the opinion, by including it in their financial statements. The opinion itself is not ever transferred to management; if the opinion became management's opinion, it would lose value because it would no longer be an independent opinion.
- An architectural firm may be engaged to provide professional architectural services to an entity. These services require significant input from the customer, who may be considered to be in control of that service throughout the process through their ability, and need, to give ongoing direction to the architect throughout the contract. The architect may however withhold or restrict the use of their drawings until reimbursed, thus not allowing the customer to benefit until payment is made.
- A consulting firm is employed to conduct a survey and report on the results to
 the entity. The customer specifies the questions that are asks and specifies the
 population base that will be sampled, and the timing of the survey. The contract
 entitles the customer the results of all the survey information thus establishing
 an (executive) right at the start of the contract. The survey is conducted over a
 three month period, at which time the consulting firm is satisfying the
 performance obligation, although the survey results are not transferred until the
 end of the three month period.

In each of the above cases, the services are performed rather than transferred. The item that is transferred (i.e. the audit opinion, the drawings, the survey results) may not in fact be considered services, despite the fact that the transfer generally reflects a significant event in the life of the transaction, and is an important empowering event for the customer.

The guidance in the proposed standard is further confused by paragraph 30 (a) which states that an indicator that the customer has obtained control of a good or service is that the customer has an unconditional obligation to pay. While fair bargaining is likely to lead to a set of payment obligations which reasonably closely matches the performance obligations, Treasury notes that depending on the contract, this obligation could arise ahead of services being transferred to the customer, in the case of prefunding or after the services being transferred to the customer, when there is training or implementation or further customer development of the services required.

Treasury considers that the guidance that the boards have adopted for the sale of goods (where a physical transfer of the asset takes place), needs to be adapted in the case of services that are performed rather than transferred. We consider that the thinking in the proposed standard defaults too readily to guidance that will be appropriate for goods but not services. Treasury recommends that the boards provide separate guidance on services that avoids the current conflation of ideas regarding satisfying, transferring, obtaining, and benefiting from services, and adds examples to illustrate their application.

Question 4:

The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price. Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

Paragraph 38 proposes the following criteria: "(a) the entity has experience with similar types of contracts....; and (b) the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances."

The Treasury considers the two mandatory criteria for making a reasonable estimate too restrictive. Lack of experience may not of itself prevent an entity from making a reasonable estimate based on other relevant facts and circumstances relevant to the transaction. Particularly where there may be little likelihood of the customer failing to pay the agreed transaction price.

The Treasury recommends a more principles-based approach using the conceptual framework. We believe it's sufficient to state that the price should be "relevant" to the contract and "faithfully represent" the contracts consideration. However, the criteria in paragraph 38 could be provided as guidance indicators.

Question 5:

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognises when it satisfies a performance obligation rather than *whether* the entity recognises revenue? If not, why?

The Treasury disagrees with the factoring of a customer's credit risk into the measurement of revenue for the following reasons:

 To be useful and relevant, financial reporting should reflect how businesses transact and manage credit expenses associated with contracts with customers. We believe the most useful and relevant presentation is to show credit losses as separate expenses and not offset them against revenue on the face of the operating statement.

Generally, if credit terms are being offered to customers, credit checks are carried out at the start of a contract. This analysis is used to decide upfront whether to proceed with the sale or not. Typically organisations credit checks and subsequent collection activities are carried out by separate personnel to salespeople, for well understood and accepted business reasons.

Invariably, there will be some credit losses when an entity lends by advancing credit to customers. Assessment of potential credit losses due to lending decisions is important information to readers. However, by blending the consequences of a lending transaction with revenue recognition under the sales contract, relevant information about two separate and important business

activities (sales and the cost of lending) becomes lost to the reader because of the complexity of a single netted amount in the operating statement.

 If a particular entity takes a conservative view regarding collectability of receivables, it may recognise relatively small amounts of revenue initially, and large "gains" from subsequent collection efforts. Conversely, if another entity takes a more aggressive position, it may record more revenue up-front, and have large reversals in subsequent periods.

The resulting diversity in practice would defeat the board's objective to "improve comparability of revenue recognition practises across entities, industries, jurisdictions and capital markets."

We recommend that the initial and subsequent assessments of credit risk is treated as an expense, rather than offsetting the initial credit risk against revenue while treating subsequent changes separately from revenue.

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?

The Treasury agrees with the above, as it reflects the economic substance of a transaction and is consistent with other standards.

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?

The Treasury agrees with the above, subject to the issues raised in questions 1, 2 and 3.

Question 8:

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 *Intangible Assets* or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria. Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

Question 9:

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for

an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

The Treasury thinks that the proposals could conflict with IAS 38 Intangible Assets. IAS 38 prohibits the capitalisation of internally generated intangible assets. Paragraph 57 of the ED however may allow the capitalisation of some internally generated assets.

We would like the boards to address this inconsistency in the final standard.

Question 10:

The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

The Treasury disagrees with the proposed disclosure requirements. We consider they are substantially more detailed than the existing ones in IAS 18, however are not any more useful. In particular:

- Disclosing reconciliations of contract balances in paragraphs 75 and 76 is excessive. While this information might be useful to an entity's auditors in supporting the contract balances in the balance sheet, it is not clear what the usefulness of such information is in the entity's notes to the accounts.
- Disclosing judgements made in paragraph 81 potentially duplicates the
 disclosures required by IAS 1 Presentation of Financial Statements. In
 particular regarding the judgements made in the process of applying the entities
 accounting policies and information about sources of estimation uncertainty.

In future work-plans, we recommend the boards develop a principles-based disclosure framework. We think that the absence of such a framework has resulted in the development of ad-hoc disclosure requirements.

Question 11:

The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

The Treasury disagrees with the proposals.

We consider the proposed disclosure may not be comparable with other entities disclosures and may be incomplete due to the nature of the business. As an example, consider an electricity supplier, where there is uncertainty as to the duration of the contract (customer can terminate with no penalty) and the timing and amount of future price increases. Even within the same industry, it would be hard to compare and see the value of this disclosure.

We consider the existing disclosure requirements to be sufficient. In IAS 1 Presentation of Financial Statements, entities are already required to disclose the portion of assets and liabilities expected to be recovered or settled: (i) no more than twelve months after the reporting period; and (ii) more than twelve months after the reporting period. We think that the existing classification provides users with appropriate and useful information.

Question 12:

Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

The Treasury agrees with the above.

Question 13:

Do you agree that an entity should apply the proposed requirements retrospectively (i.e. as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

The Treasury agrees with the proposal for full retrospective application. In particular, we agree with the assertion in BC231 that retrospective application would provide useful trend information.

We do however recommend preparers are widely consulted as to an appropriate timeframe from the issuance of the new standard to its effective date, to allay implementation concerns particularly where entities have many long-term contracts.

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 noted in question 3, more common type service examples are required.

Question 15:

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

- (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.
- (b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract. Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product

warranty? If not, how do you think an entity should account for product warranties and why?

The Treasury disagrees with the proposed distinction between the types of product warranties. We would argue that most product defects result from deficiencies in manufacture and merely take differing time periods to emerge. The timing of the emergence of the defect should not drive differences in accounting.

The Treasury also does not agree with the rights of return proposal. We consider an entity should recognise revenue for the full transaction amount because:

- the performance obligation to transfer the product to the customer is satisfied and control of the product passes to the customer; and
- as discussed in question 5, we consider the gross revenue amount to be useful information.

Question 16:

The boards propose the following if a licence is not considered to be a sale of intellectual property: (a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and (b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence. Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

The Treasury disagrees with the proposed distinction between exclusive and non-exclusive licenses. We consider the ED creates an unnecessary distinction, akin to the operating and financing lease distinction that the boards are currently attempting to eliminate. This is because whether the license is exclusive or non-exclusive:

- the right to use does not differ from the customer's viewpoint
- the licensor would retain control of the licensed intellectual property because it could sell the underlying property, regardless of any encumbrance with an exclusive license agreement

Question 17:

The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

The Treasury agrees with the proposals. The accounting for revenue or similar items should be consistent across all standards as far as possible.

Other Issues:

Grants

The ED defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations" and defines a customer as "a party that has contracted with an entity to obtain goods and services that are an output of the entity's ordinary activities."

The Treasury considers that these definitions might capture government grants where a grantor as a customer purchases goods or services from the entity, for the benefit of a third party. The Treasury recommends the boards explicitly state if the proposal is intended to cover grants or not.

If grants are captured, the following issues need to be clarified:

- A government grant to a for-profit entity falls under the recognition requirements in IAS 20 Accounting for Government Grants and Disclosure of Government Assistance, which is inconsistent with those in the ED. Under IAS 20 grant income can be recognised when related expenses are incurred, whereas the ED would only permit recognition when a performance obligation is satisfied. The timing of each may be different, leading to different treatment for similar transactions depending on whether the entity considers they receive a government grant or performs a contract for services. We recommend that IAS 20 is integrated using the same principles as the ED.
- The concept of transfer of control of goods or services is difficult to apply in cases where the grantor has the ability to direct the use of the good or service, but the benefit might go to a third party.

Onerous performance obligations

Paragraph 54 of the ED requires an entity to recognise a liability and a corresponding expense if a performance obligation is onerous.

The Treasury thinks these requirements should be scoped out for not-for-profit entity's, which intentionally provide goods or services at less than cost for social benefit objectives. In a lot of cases a not-for-profit entity will receive a government grant to fund the revenue shortfall. If the customer and government grants were considered together, the entity's costs would not exceed its revenues.

Consider an example of a railway entity that only recovers 60% of its costs from its customers and the remaining 40% from Government grants. The ED would view both the customer contract and government grant as onerous, as neither party pays for the full cost of the railway services. Therefore the railway would be required to recognise an expense and a liability for each, even though on a total contract basis there is no loss on the services it provides. This does not appear to be a sensible outcome when considering all the facts and circumstances of the transaction.

The Treasury therefore recommends that the ED scopes out onerous social benefits.