

June 2010

Exposure Draft ED/2010/6

Revenue from Contracts with Customers

Comments to be received by 22 October 2010



International
Accounting Standards
Board®

COMMENTS BY L.VENKATESAN CHARTERED ACCOUNTANT

NEW NO 23 OLD NO 13 28TH CROSS INDIRA NAGAR CHENNAI 600 020 INDIA

MOBILE 91 98400 13020

Withdrawal of other IFRSs

This [draft] IFRS supersedes the following IFRSs:

- (a) IAS 11 Construction Contracts;
- (b) IAS 18 Revenue;
- (c) IFRIC 13 Customer Loyalty Programmes;
- (d) IFRIC 15 Agreements for the Construction of Real Estate;
- (e) IFRIC 18 Transfers of Assets from Customers; and
- (f) SIC-31 Revenue – Barter Transactions Involving Advertising Services.

COMMENTS

The proposed exposure draft tries to replace the above six documents.

It is better to have a separate standards for construction contract and revenue items. The proposed draft does not specifically address use of resources of the entity like, interest, loyalty and dividend. Reason for the same is not clear. Further, IFRIC 18 and SIC-31 does not seem to have been included in the proposed draft.

QUESTION WISE COMMENTS

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?

-2-

ANSWER

The word profit margin in the existing standards has been replaced with single commercial objective (paragraph 13B). Single commercial objective has not been defined.

Application guidance does not contain an example to explain paragraph C. An example will be useful.

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?

Answer

An example with and without profit margin for identification of goods and services will be useful.

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?

Answer

ED proposed to recognize revenue when a goods and services is transferred and when the customer obtains control of the goods and services as against the present practice of substantial transfer of risk and reward.

Para 31 says "Not one of the preceding indicators determines by itself whether the customer has obtained control of the good or service. Moreover, some indicators may not be relevant to a particular contract (for example, physical possession and legal title would not be relevant to services)". Para 31 can be reworded into a positive manner.

QUESTION 4

The boards propose that if the amount of consideration is variable, an entity should recognize 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 recognize 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?

Answer

We agree with the above proposal but however, when transaction prices are varying, the accounting should be done on a to-date basis. This principle seem to have not been included in paragraph 34 to 42.

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 recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

Answer

Customer credit should not affect the transaction price.

If the word "if material" should be added as given below: -

Para 43 - Collectability refers to the customer's credit risk – the customer's ability to pay the amount of promised consideration. In determining the transaction price, an entity shall reduce the amount of promised consideration to reflect the customer's credit risk, If material.

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?

Answer

When advance is received, it is proposed to suitably adjust the time value of money. Such adjustments will not enhance the presentation of financial statement. The pricing would have already taken into account such advance payment. US GAAP specifically provides consideration of such adjustments if it is more than one year. Such time limit as may be decided by the management, should be taken into account instead of adjusting the time value of money in all contrast.

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?

Answer

Para 51 states - The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately. A contractually stated price or a list price for a good or service shall not be presumed to represent the stand-alone selling price of that good or service. If a stand-alone selling price is not directly observable, an entity shall estimate it.

It may not be correct to say that what is stated in the contract does not represent standalone selling price. Instead of placing reliance on standalone selling price, more reliance should be placed on what is stated in the contract.

-5-

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 recognize 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?

Answer

Para 57B states - generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (i.e the costs relate to future performance).

An example to explain the above will be useful.

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 recognized for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

Answer

Para 58 does not talk about liability recognized for an onerous performance obligation.

Para 54 talks of - An entity shall recognize a liability and a corresponding expense if a performance obligation is onerous.

As per the existing IAS 11, an entity has to recognize expense if the contract is likely to incur a loss. No such provision appears either in para 54 or in para 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?

Answer

These are all only disclosures may not help to understand the amount, timing, uncertainty of the revenue and cash flows from those contracts. Too many disclosures are being proposed, which may not help an ordinary investor.

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?

Answer

Para 77 states - An entity shall disclose information about its performance obligations in contracts with customers, including a description of:

- (a) the goods or services the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (ie if the entity is acting as an agent);*
- (b) when the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered or upon completion of service);*
- (c) the significant payment terms (for example, whether the consideration amount is variable and whether the contract has a material financing component);*
- (d) obligations for returns, refunds and other similar obligations; and*
- (e) types of warranties and related obligations.*

-7-

The disclosures proposed in para 77 are too onerous and may involve disclosure of commercial consideration. A typical example in a manufacturing, servicing, trading organizations may be discussed before finalizing the disclosure requirement.

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?

Answer

Disaggregation of revenue should be left to the management or as per the local laws. The proposed disaggregation may not achieve the objective of depicting the amount, timing and uncertainty of revenue and cash flows arising out of economic factors.

QUESTION 13

Do you agree that an entity should apply the proposed requirements retrospectively (ie 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.

Answer

As per para 81, this will be treated as change in accounting policies in line with IAS-8 and accounted accordingly.

-8-

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?

Answer

Presentation and disclosure requirement are too many and the cost of preparation and presentation may not justifies.

A proper study should be made with the help of various industry organization before coming to a conclusion.

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?

Answer

The proposed ED suggest that product warranties should not be accounted as revenue.

In a running business, both opening and closing product warranties will either match or will become immaterial. Hence, there is no necessity to distinguish between product warranty and performance obligation. Both can be treated as performance obligation to reduce the complexities in accounting.

QUESTION 16

The boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license 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 license; and
- (b) if an entity grants a customer a non-exclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

Answer

The pattern of revenue recognition should not depend whether the license is exclusive or not (para B31 to B38). Further, the chapter on licensing and right to use is given in application guidance only and not in the exposure draft.

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?

Answer

The same principle should be applied in other IFRS also.

-10-

QUESTION 18

[FASB only]: Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Answer

The principle of recognition of revenue should not differ between entities. However disclosure requirement should be restricted for non-public entities (private companies and not-for-profit organizations).

OTHER ISSUES

- It is not correct to combine all revenue standards into one single standard.
- Principle of Barter Transaction not discussed in the proposed ED.
- Use of resources of the company not dealt in the proposed ED.
- Para 37 - If any entity receives consideration from the customer and expects refund some or all that consideration, such consideration would be accounted using a discounted cash flow. This is not specified in para 37.
- Customer specific credit risk should not affect revenue recognition.
- Para 46 does not talk of fair value of the asset / financial instrument transferred.
- Para 48 & 49 should consider normal credit period extended to customer and it should not be presumed.
- Para 61 - asset may either be amortized or it can be sold also. This para should cover all situations.

BC44 - The boards concluded that all goods or services provided to a customer as a result of a contract give rise to performance obligations in that contract because they are part of the negotiated exchange between the entity and its customer. Although the entity might characterize those goods or services as marketing incentives, they are goods or services provided in the contract for which the customer pays. In contrast, marketing incentives are incurred independently of the contract that they are designed to secure. The boards also noted that even if a conceptual justification could be found to distinguish goods or services that are marketing incentives from those that give rise to performance obligations, it would be difficult to develop criteria to make that distinction in practice.

Comment

Such item should be left to the management discretion.

-11-

BC65 - The boards did not intend that revenue should be recognized only upon contract completion. Nonetheless, the intention was that an entity would recognize revenue only when the customer receives promised goods or services and not necessarily as the entity undertakes activities to fulfill the contract. In the case of a construction contract, the customer receives the promised goods or services during construction only if the customer controls the work in progress. In contrast, if the customer does not receive the goods or services until the work is completed, the entity would not recognize revenue until then.

Comment

This will affect Indian construction industry.

