



22 October 2010

Sir David Tweedie
Chairman
The International Accounting Standards Board
30 Cannon Street
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Dear David

EXPOSURE DRAFT ED/2010/6 *Revenue from Contracts with Customers*

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*.

Broadly speaking, the FRSB supports the overall approach in the Exposure Draft. However, the FRSB has a number of key concerns that we believe must be addressed before the proposed standard is finalised, in order for the final standard to be an improvement over existing standards. We explain these key concerns below.

In addition, at a conceptual level, we believe that there are some important issues that should be addressed once the Conceptual Framework project has made further progress. We understand the practical reasons for measuring performance obligations based on an allocation of the transaction price, and agree with those reasons and hence agree with using this approach at this point in time. However, we note that it adds to the variety of different measurement methods used in IFRS to measure liabilities. Accordingly, the measurement phase of the Conceptual Framework project should consider the range of measurement methods currently used in IFRS, the objectives of those methods, and the conceptual basis for choosing between them when developing accounting standards. We also believe that the conceptual definition of revenue, including whether and how to distinguish revenues from gains, should be considered in the Conceptual Framework project.

Key concerns

The FRSB's primary concerns with the Exposure Draft are as follows:

- There is potential for the concept of control to be misunderstood as implying transfer upon physical delivery of goods. In the case of a contract involving services, or a combination of goods and services, transfer of control, as described, is difficult to understand and apply.
- The proposed approach to accounting for rights of returns and warranties.
- The proposed approach to measurement uncertainty.
- Some inconsistency between the proposed standard and the application guidance, and the extent of mandatory application guidance proposed for a principles-based standard.
- The degree of complexity that the Exposure Draft might introduce.
- The onerous amount of disclosures proposed.

Revenue recognition based on physical transfer of goods or services

The ED focuses on the transfer of control of goods or services as the key determinant of the recognition of revenue. The FRSB is concerned that there is potential for the concept of control to be misunderstood as implying transfer upon physical delivery of goods. In the case of contracts involving services, or a combination of goods and services, transfer of control, as described, is difficult to understand and apply. The FRSB is particularly concerned that this could result in inappropriate timing of revenue recognition under long-term contracts. The proposals in the Exposure Draft seem to particularly affect construction contract accounting in a way that could unnecessarily delay revenue recognition.

The model involves (a) identifying performance obligations and (b) determining when those obligations are satisfied. The performance obligations involve the provision of goods or services to customers, which leads to a focus on (a) identifying the goods or services to be provided and (b) determining when those goods/services are provided to the customer. But since an individual good is provided at a single point in time whereas services are often provided over a period of time, it can make a difference whether one considers the performance obligation to involve the provision of a good or a service. So with construction contracts (and some other contracts involving a mixture of goods/services), one ends up trying to determine whether the performance obligation involves the provision of a good (the constructed asset) or a service (the constructing of the asset) - or a combination of the two. In addition, some of the language in the Exposure Draft may lead to more of a focus on goods rather than services (words like "transfer" and even "control" are more easily applied to goods rather than services).

We believe that the problem stems from the difficulty of applying the control concept, as described, to contracts that involve combining goods and services, as any attempt to identify the goods and services separately or determine when control of any particular good or service passes to the customer leads to a focus on the physical output from the construction process, since that is more easily identified than the transfer of goods/services during the construction process. However, the objective is to determine when a performance obligation has been satisfied and much of that performance obligation relates to the provision of construction services. The physical delivery of the constructed asset is only one step in the construction process.

The FRSB considers that what is needed is an acknowledgement that the performance obligations in a particular contract sometimes can be analysed in different ways, therefore it may be necessary to assess the nature of the performance obligations and when they are satisfied. This is where considering the rights and obligations can be helpful. For example, the guidance in paragraph 30(d), (based on IFRIC 15 *Agreements for the Construction of Real Estate*), discusses the customer's obligation to pay for the work completed to date and whether or not the customer has the right to specify major changes to the design of the asset being constructed. More generally, it would help to state that, in some cases, one would need to consider together the guidance on (a) identifying performance obligations and (b) determining when those obligations have been satisfied, as they can be two related issues, rather than two distinct issues. For example, in the case of a construction contract, if the customer has an obligation to pay for the work as and when the asset is being constructed, that suggests both (a) the performance obligation is satisfied over a period of time and (b) the performance obligation involves the provision of construction services rather than the provision of a constructed asset.

In particular the FRSB has concerns with the following paragraphs of the Exposure Draft:

- Paragraph 21(g) suggests that a contractor provides a good or service as the contractor performs contractually agreed tasks (arguably, every step in a contract could be a contractually agreed task and therefore give rise to recognition of revenue). However, paragraph 22 then restricts revenue recognition by referring to criteria unrelated to the rights and obligations under the contract i.e. criteria for identifying goods and services that are physically distinct.
- Paragraph 30 includes a list of indicators that control of goods or services has transferred to a customer. In our view, the indicators are more focused on the creation of rights and satisfaction of obligations, which we believe is more helpful, compared with other paragraphs discussed above. If a principle that focuses on rights and obligations was established, it would then provide an appropriate foundation for the use of these indicators.
- Paragraphs 25 – 27 appear to be focused on the physical delivery of goods rather than to the rights and obligations arising under the contract. We have already discussed construction contracts above. But there are also other examples where the focus on physical delivery could result in inappropriate outcomes. Take the example of an audit. Assume that an audit firm provides its client with an annual audit report and the audit firm conducts its audit through two visits to its client: (i) an interim visit part way through the year; and (ii) a final visit shortly after financial year-end. Under the proposals in the Exposure Draft, if we consider the goods or

services transferred to the customer to be the delivery of the audit report, the audit firm would be permitted to recognise revenue only once the audit report has been delivered to its client. This is because the client obtains 'control' of the asset only upon physical delivery at completion of the audit. On the other hand, if we consider the contract with the client to be a contract for the provision of assurance services over the period during which the audit is conducted, the audit firm would be permitted to recognise revenue as the audit progresses. This is because the audit firm will have a contractual right to be paid for the services performed. We suggest that the audit firm should recognise revenue as the audit progresses regardless of whether an audit is considered to be the delivery of a good (i.e. the audit report) or the delivery of an audit service, because this is when rights are created and performance obligations to the customer are satisfied.

Proposed approach to accounting for warranties and rights of return

The FRSB considers the distinction between warranties for latent defects and warranties for subsequent faults to be appropriate if the IASB is intending that statutory-type warranties covering defects are the former and extended warranties sold separately are the latter. This is because the former is failure of a sale, at least in part, and the latter is a separate sale. However, the FRSB is concerned about the practicality of this distinction where, for example, an entity does not sell separately the warranty for faults or where there is a significant lapse of time between sale and a warranty claim (as may be the case with a vehicle manufacturer recalling vehicles for repairs some years after initial sale).

The FRSB is also concerned about presentation in the statement of financial position (grossing up an executory contract, being the put option held by the customer). We understand that the objective of the proposed approach is to ensure that revenue is not overstated at the time of the original sale (reporting revenue when there is a significant risk that the goods will be returned). To meet this objective while addressing our concern about the presentation in the statement of financial position, the FRSB recommends reporting a net presentation in the balance sheet (so that only a liability is reported, measured based on net future cash outflows) and gross presentation in the statement of comprehensive income. For example, if the original sale of the good expected to be returned (via a right of return or warranty obligation) was \$100 and cost of goods sold was \$40, the entry would be debit revenue for \$100, credit cost of goods sold for \$40 and credit a returns or warranty liability for \$60 (being \$100 less \$40). Since there is no conceptual basis for determining when a gross versus net presentation should be adopted in the statement of comprehensive income, and current practice is that transactions involving the sale of goods and services are usually reported gross in the statement of comprehensive income, the gross presentation in the statement of comprehensive income is reasonable, while reporting on a net basis in the statement of financial position ensures an entity does not report inventory as an asset when it has no control over the goods to be returned. Also, this provides a better reflection of an entity's financial position, as the \$100 refund to the customer will only occur if the \$40 goods are returned at the same time, so the entity has a net \$60 obligation (subject to further comments below on measurement).

In addition, the FRSB supports measurement based on the 'most likely outcome' approach, for example, if an entity sells 10 items and the most likely level of returns would be 1 item, then the return obligation is measured based on the 1 item likely to be returned. This would include considering if the item is likely to be sold again for at least its cost amount (especially in the case of goods expected to be returned under warranty claims). If the entity expects the item to be resold at below cost, this would be taken into account when measuring the return obligation. For example, using the amounts set out in the previous paragraph, if the entity estimates that the most likely outcome (based on the entity's historical experience with returned goods) is that the returned good would be resold for \$30, then the return obligation would be measured at \$70 (being \$100 less \$30). Then, following the presentation approach set out above, revenue would be debited for the transaction price of that 1 item, and cost of sales credited for the cost of that item (or net realisable value, if the item is expected to be resold below cost) whilst the statement of financial position would be credited for the net of these two amounts. While there may be issues with this approach at a conceptual level, the FRSB considered this approach to be a reasonable compromise of practical considerations that would provide useful and understandable information to users.

Approach to measurement uncertainty and prescriptive criteria

The FRSB agrees that there should be a reliability threshold; revenue should not be recognised if the outcome is too uncertain. However, an appropriate balance is needed: the thresholds must not result in reporting that is too conservative especially since there are no thresholds for recognition of expenses.

The FRSB considers the proposals regarding the circumstances in which an entity has the necessary experience to be able to estimate reasonably the transaction price and therefore recognise revenue, to be inconsistent with the IASB's approach to measurement uncertainty elsewhere and could create an inappropriate accounting outcome. The proposals in paragraphs 38 and 39 of the Exposure Draft could give rise to a situation where an entity, having met a milestone in a contract, is still unable to recognise revenue because the entity does not know what the ultimate contract revenue will be. The entity would not recognise revenue but would continue to recognise a liability for any consideration received even though it may be clear that the performance obligation has been satisfied.

The FRSB recommends revisiting what should be the appropriate unit of account in this area of the proposals. Paragraph 38 states that an entity can only recognise revenue on satisfaction of a performance obligation if the transaction price (which is a whole of contract notion) can be reasonably estimated. The contingent element of the transaction price may only relate to some or one of the performance obligations. The FRSB considers that uncertainty over some performance obligations should not affect an entity's ability to recognise revenue for satisfying other performance obligations for which the stand alone selling price is reasonably certain. The FRSB recommends that the reliability threshold be applied at the performance obligation level, rather than at a contract level.

In addition, the FRSB considers the following paragraphs to be too prescriptive for what is intended to be a principles-based standard:

- Paragraphs 38 and 39 regarding the circumstances in which an entity's experience is relevant in estimating the transaction price.
- Paragraphs 48 and 49 regarding consideration payable to the customer.

Inconsistent application guidance and amount of mandatory application guidance

In some instances, the examples accompanying the Exposure Draft seem to conflict with the principles in the Exposure Draft. Part of the concern with IAS 18 *Revenue* is that the accompanying illustrative examples are inconsistent with the principles in IAS 18. If the IASB proceeds with the Exposure Draft and related application guidance it will perpetuate the same concern. In our response to question 14 of the IASB's questions for respondents set out in the appendix to this letter, we explain our concerns with particular illustrative examples in the proposed application guidance.

Also, the FRSB questions whether a proposed standard supplemented by up to 50 pages of mandatory application guidance is indeed a principles-based standard.

Degree of complexity that the Exposure Draft may introduce

Including a customer's credit risk in measurement of revenue

The FRSB is concerned about the proposal to factor a customer's credit risk into the measurement of revenue. In a retail environment, often the same prices are charged for cash sales and credit sales. And even when an entity takes credit risk into account when setting prices to be charged, this does not mean that revenue is recognised in advance or is overstated. An entity's pricing strategy affects how much revenue it generates, whereas impairment losses represent a cost of generating that revenue. We believe there is both a conceptual issue and a practical issue. It is not appropriate to offset expenses (i.e. the impairment expense) against revenues, in this case the revenue from goods or services. As noted in IAS 1 *Presentation of Financial Statements*, offsetting of revenues and expenses reduces the ability of users of financial statements to understand the transactions and other events that have occurred and to assess the entity's future cash flows. In addition, the FRSB considers that the proposed approach would be very difficult and costly to apply. The proposed approach would be very complex and would require a significant number of subjective estimates to be made. We comment further on this in our comments below on example 20.

Use of probability-weighted estimates

The FRSB considers that it may be extremely complex and costly to measure amounts using detailed probability-weighted averages of all possible outcomes. As such, the proposed approach to dealing with measurement uncertainty would create: (i) considerable compliance costs; (ii) overly complex reported amounts (that do not equate to actual or expected outcomes); and (iii) tension between reporting entities and their auditors. Measurement at the most likely amount is preferred and provides users with the most relevant and useful information.

The onerous amount of disclosure proposed

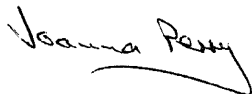
The FRSB considers that the disclosures proposed by the Exposure Draft could provide too much detailed information and preparers would find providing such disclosures to be onerous. In our response to questions 10, 11 and 12 of the IASB's questions for respondents, set out in the appendix to this letter, we explain our concerns with particular disclosures proposed.

Responses to questions for respondents

The FRSB's responses to the specific questions for respondents to the Exposure Draft are provided in the appendix to this letter.

If you have any queries or require clarification of any matters in this submission, please contact me.

Yours sincerely



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Appendix – FRSB’s responses to specific questions for respondents raised in the Exposure Draft

Recognition of revenue (paragraphs 8-33 of the Exposure Draft)

Question 1

Paragraph 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?

1. The FRSB does not agree with the outcome of the proposals as illustrated in scenario 2 of example 2 in the proposed application guidance. In our view, it is not consistent with the principles in the Exposure Draft.
2. In scenario 2 of example 2, it is concluded that the price negotiated for a further 3 years of service is dependent upon the price agreed for the first 3 years of service. Consequently, the entity is required to account for the agreement for a further 3 years service together with the original contract for the first 3 years of service. The entity therefore is required to recognise the cumulative effect of the contract modification as a reduction to revenue in year 3 and, for the further 3 years of service, recognise revenue at the stand-alone selling price that would otherwise be charged for those services.
3. Using the principles in the Exposure Draft, the entity should recognise revenue of CU70,000 per year for the remaining year of the first contract and the 3 years of the next contract i.e. CU100,000 plus CU180,000 divided by 4 years service. This is based on using the stand-alone selling price of CU80,000 multiplied by 4 years of services equaling CU320,000 and then allocating this to each year. The solution proposed in scenario 2 of example 2 is based on using actual stand-alone selling prices, rather than an allocation of the transaction consideration based on those prices, which is inconsistent with the proposals in the Exposure Draft.

Question 2

The boards propose that an entity should identify the performance obligation 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?

4. The FRSB does not agree with the proposals. Refer to the covering letter for the FRSB's comments in regards to these proposals and particularly in relation to recognition of revenue under long-term contracts.
5. If the IASB proceeds with its proposals in the Exposure Draft, the FRSB recommends that the IASB clarify what makes a good or service distinct. In the Exposure Draft (paragraphs 22 – 23), it is proposed that if an entity promises to transfer more than one good or service it is required to account for each separately only if the goods or services are distinct. To determine whether the goods or services are distinct, an entity is required to consider whether the goods are services could be sold separately and whether the goods or services have a distinct function and a distinct profit margin. However, it is stated in the basis for conclusions (paragraph BC53) that the IASB's view is that an entity would have a sufficient basis for estimating a selling price only if the good or service is subject to distinct risks.

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?

6. The FRSB believes that the guidance is unclear and may lead to inappropriate outcomes. The FRSB is also concerned at the potential for inconsistent application of the proposals in practice. Refer to the covering letter for the FRSB's detailed comments in this regard.

Measurement of revenue (paragraphs 34-53 of the Exposure Draft)

Question 4

The boards proposed 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 proposed 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?

7. The FRSB is concerned with certain aspects of the proposals in the Exposure Draft. Refer to the covering letter for the FRSB's detailed comments in this regard.

Question 5

Paragraph 43 proposed 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?

8. The FRSB disagrees with the proposal to factor a customer's credit risk into the measurement of revenue. Refer to our comments in the covering letter.

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?

9. The FRSB agrees that, where the effect is material, the amount of promised consideration should be adjusted to reflect the time value of money.

Question 7

Paragraph 50 proposed 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?

10. In general, the FRSB agrees that the transaction price should be allocated to performance obligations identified within a contract on the basis of the entity's selling price (estimated if necessary) of the individual goods or services underlying those performance obligations. However, refer to our covering letter for a discussion of our concerns on applying this approach to construction contracts and other contracts involving services or a combination of goods/services.

Contract costs (paragraphs 57-63 of the Exposure Draft)

Question 8

Paragraph 57 proposed 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, IAS 16 or IAS 38), 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 [specifies] the costs that related 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 liabilities recognised for an onerous performance obligation.

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

11. The FRSB agrees with the proposals. The costs related directly to a contract are in the nature of work in progress and should be considered for capitalisation.

Disclosure (paragraphs 69-83 of the Exposure Draft)

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 that the proposed disclosure requirements will meet that objective? If not, why?

12. The FRSB considers that the disclosures proposed by the Exposure Draft could provide too much detailed information and preparers would find providing such disclosures to be onerous. In particular the FRSB is concerned with the following proposed disclosure requirements:

- Disclosure of detailed reconciliations of contract balances may require disclosure of too much detail (paragraphs 75-76 of the Exposure Draft). The IASB appears to have concluded that disclosure is required of complete reconciliations of all major balances in balance sheets but without providing justification for such a blanket approach to determining disclosure requirements.
- Disclosure of detailed information about performance obligations may require disclosure of too much detail (paragraph 77 of the Exposure Draft). In addition, the detailed information required to be disclosed could be considered commercially sensitive.
- The proposed disclosures in paragraphs 81 to 83 of the Exposure Draft in respect of significant judgments in the application of the proposed standards would require disclosure of too much detail and potentially duplicate the disclosures required by IAS 1 regarding judgements made in the process of applying the entity's accounting policies and information about sources of estimation uncertainty.

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?

13. The FRSB considers that it is not necessary to require an entity to disclose the amount of its remaining performance obligations and the expected timing of their satisfaction. 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 (in accordance with IAS 1). This existing classification provides users with appropriate, sufficient 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?

14. The FRSB considers that the proposed level of disaggregation may result in too much detailed information being disclosed. The FRSB recommends that the disclosure requirements be more generic and limited to types of goods and services and possibly geographical analysis thereof, as per the entity-wide disclosures in IFRS 8 *Operating Segments* relating to revenue. Therefore, for entities already complying with IFRS 8, no additional disclosures would be required. Otherwise, the proposals would be just an extension of the IFRS 8 requirements to other entities not already complying with IFRS 8.

Effective date and transition (paragraphs 84-85 of the Exposure Draft)

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?

15. The FRSB agrees with the IASB's intention that the proposed requirements should be applied to all contracts in existence during any reporting periods presented. However, the FRSB considers that the transition requirements as drafted do not make it clear that this is the intention and recommends that the IASB clarify the transitional provisions to make its intention clear.

Application guidance (paragraphs B1-B96 of the Exposure Draft)

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?

16. In some instances, the examples accompanying the Exposure Draft seem to conflict with the principles in the Exposure Draft (for example, scenario 2 of example 2). Part of the concern with IAS 18 is that the accompanying illustrative examples are inconsistent with the principles in IAS 18. If the IASB proceeds with the Exposure Draft and related application guidance it will perpetuate the same concern. Set out below are the concerns the FRSB has with specific examples.
17. Also, the FRSB questions whether a proposed standard supplemented by up to 50 pages of mandatory application guidance is indeed principles-based.

Example 11 – Construction contract

18. In illustrative example 11 it is simply stated that the customer obtains control of the material and equipment as they are delivered. This is not particularly useful as the question in practice will be, how is it determined that control has passed to the customer? Also, it is unclear why site preparation and site finishing are distinct services when management services would cover these activities too. If the IASB proceeds with this example the FRSB recommends providing in the example the rationale for the IASB's conclusions.

Example 18 – Management fees based on an index

Example 19 - Consulting services with a performance bonus/penalty

19. The FRSB does not agree with the outcome illustrated in example 18. In example 18 it is concluded that the entity cannot recognise as revenue any portion of the variable consideration due to the uncertainty arising from the wide range of possible outcomes. However, there is insufficient information given to support this conclusion, thereby giving the impression that the conclusion applies to all situations in which the performance fee is based on the fund's performance. However, depending on the type of investments held by the fund, there could be situations in which the amount of the fee could be reasonably estimated.
20. In general, the FRSB considers that the proposals in paragraphs 38 and 39 of the Exposure Draft regarding the circumstances in which an entity's experience is relevant in estimating the transaction price are too prescriptive and therefore give rise to a situation where an entity, having met a milestone in a contract, is still unable to recognise revenue because the entity does not know what the ultimate contract revenue will be.

21. Also, in both example 18 and example 19, the FRSB considers that measurement at the most likely amount is preferred and would provide users with the most relevant and useful information. The FRSB considers that may be extremely complex and costly to measure amounts using detailed probability-weighted averages of all possible outcomes. As such, the proposed approach to dealing with measurement uncertainty would create: (i) considerable compliance cost; (ii) overly complex reported amounts (that do not equate to actual or expected outcomes); and (iii) tension between reporting entities and their auditors.

Example 20 – Customer credit risk

Example 21 – Customer payment in arrears

22. The FRSB strongly disagrees with example 20.
23. Firstly, the FRSB disagrees with the proposal to factor a customers' credit risk into the measurement of revenue, for the reasons explained in our covering letter.
24. In addition, presumably other customers would buy the same product of CU1,000 cash i.e. the customer in the example does not pay extra for the extended credit for 30 days. Therefore, there is no justification for recognising revenue at less than CU1,000. Surely the 'loss' arises from the financing activity (i.e., extending credit for 30 days). Therefore this should be an IAS 39 *Financial Instruments: Recognition and Measurement*/IFRS 9 *Financial Instruments* issue. Even if one accepts the proposals as illustrated in example 20, it is unclear how the entity would account for the 'gain' of CU100 in the event of the customer paying the full consideration. If the 'gain' is interest income it would be interest at an astronomical rate of 133%. If the 'gain' is additional revenue, deferring recognition until payment is inconsistent with the proposals in the Exposure Draft since recognition as revenue would not coincide with the transfer of control of the good to the customer.
25. Also, the FRSB considers that, if the IASB proceeds with the example 20 and example 21 (customer payment in arrears), example 20 and 21 should be combined to provide a more realistic and useful example.

Example 23 – Slotting fees

26. In example 23 it is concluded that, although the product placement service is not sold separately (i.e. without related products), the service is distinct because it has a distinct function and a distinct profit margin. The FRSB considers that it is unclear how it was concluded that the product placement service has a distinct profit margin when the product placement service is intertwined with the purchase and sale transaction for the goods in question. In addition, it is unrealistic to require estimation of the fair value of the service since such services often are not sold separately. If the IASB proceeds with this example, the FRSB recommends providing in the example the rationale for the IASB's conclusions.

Example 24 – Sales incentive

27. In example 24 it is concluded that, if the manufacturer issues the coupons before it transfers the product to the retailer, the manufacturer would recognise revenue at the transaction price less the maximum discount provided by the coupons. The FRSB considers that it is unclear why the timing of the issue of the coupons by the manufacturer affects the accounting by the manufacturer. Whether the manufacturer issues the coupons prior to or after transferring products to the retailer, the substance of the issuing of the coupons does not change and, therefore, the accounting for such coupons should be the same regardless of when the coupons are issued. The FRSB considers that example 24 provides a structuring opportunity for the manufacturer to manipulate the timing of revenue recognition.

Example 25 – Estimating the stand-alone selling price of an option for additional goods or services

28. The FRSB considers that example 25 is difficult to follow and recommends that each step required to be undertaken in accordance with the proposed standard be explained in more detail. The example seems consistent with paragraph B87 of the Exposure Draft. However, there is an issue with paragraph B87(a) of the Exposure Draft. If this factor is considered for a reasonable period (e.g. one year), it would be difficult to determine whether there will be a sale or when the voucher is actually redeemed and it is questionable whether this should be part of the estimated price. The FRSB suggests the deletion of paragraph B87(a).

Example 27 – Maintenance services with a renewal option

29. The FRSB considers the proposed approach illustrated in example 27 to be too complex and costly to apply, and therefore, is unlikely to be accepted in practice. The FRSB considers that it may be extremely complex and costly to measure amounts using detailed probability-weighted averages over multiple years. As such, the proposed approach would create: (i) considerable compliance costs; (ii) overly complex reported amounts that do not equate to actual or expected outcomes diminishing the usefulness of reported amount for users; and (iii) tension between reporting entities and their auditors.
30. In addition, the FRSB considers example 27 to be inconsistent with the principles in the exposure draft. If the entity charges CU1,000 per year and still does so in years 2 and 3, then that would be price for the service. This seems at odds with earlier examples (such as the examples on contract modification) that are focused on prices charged for services, whereas example 27 seems more focused on matching revenues and expenses.

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?

31. In principle, the FRSB agrees with the proposals to distinguish between the types of product warrants and rights of return. However, the FRSB does have concerns with the practicality of doing so and with presentation thereof in the statement of comprehensive income and statement of financial position. Refer to our covering letter for our comments in this regard.

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?

32. The FRSB considers that the distinction between exclusive and non-exclusive rights to use intellectual property is artificial. In the case of both exclusive and non-exclusive rights, the FRSB considers the performance obligation to be the requirement to provide the good for the customer to enjoy over a period of quiet access. Whether the right is exclusive or non-exclusive, the right to use does not differ from the customer's viewpoint (except maybe in value in the case of a rare right). The proposals appear to create an unnecessary and inappropriate distinction much like the distinction between an operating and a finance lease that the IASB is attempting to eliminate in its project on lease accounting.

Consequential amendments

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?

33. The FRSB agrees with the proposed consequential amendments considering that the accounting for revenue or similar items should be consistent across all standards as far as possible.

Non-public entities

Question 18 [FASB only]

Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organisations)? If so, which requirements(s) and why?

34. If the proposed standard were to be applicable to non-public entities, but for disclosure concessions, the FRSB's expectation is that little, if any, modification would be appropriate. This is because the proposed standard specifies the accounting for revenue arising from contracts with customers which are primarily exchange transactions rather than accounting for revenue from non-exchange transactions such as some forms of government grant or donations. However, some consideration will need to be given to whether or not the term 'contract' is defined in a manner that would ensure that the proposed revenue standard would apply to situations where the 'customer' is not the provider of funds, such as in the case of a private hospital that receives funding from the government to provide health services to a particular area of the public or particular patients where the 'customer'/patient is not the one paying for the services.

35. In addition, more thought may need to be given to 'distinct profit margins' as transactions may not be commercial and hence profit margins would not be a key consideration as to whether the goods and services are distinct.

Other issues

Application of the proposed revenue model to transactions in which the recipient of the good or service is not the one paying for the good or service

36. In some contracts control of the good or service never passes to the customer. It passes to the customer's agent or a defined beneficiary. For example, take a private hospital where the government or a health fund pays for a particular patient. The IASB's proposals would be able to be applied to more transactions that are similar in substance if the focus was instead on when the entity satisfied its performance obligations or if the proposals explicitly acknowledged that control may pass to a third party at the request of the customer. This is likely to be an issue that would need to be considered when IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is revisited.
37. If control were viewed from the perspective of the entity losing control more thought would need to be given to the price interdependency principle for combining and segmenting contracts as prices may not always reflect the economics of a transaction in a not-for-profit situation.

Sale and repurchase agreements

38. The FRSB notes that paragraph 29 of the Exposure Draft regarding accounting for sale and repurchase agreements preserves the status quo that, when assessing whether a customer obtains control of an asset, an entity considers any related arrangements entered into at or near the same time as, or in contemplation of, the contract. This will need to be revisited once the IASB completes its project on derecognition.