2011-230 Comment Letter No. 302



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Dear Mr Hoogervorst

Invitation for Comment on Exposure Draft "Revenue from Contracts with Customers"

We welcome the opportunity to comment on Exposure Draft "Revenue from Contracts with Customers" (the exposure draft) issued by the IASB in November 2011.

Consistent with our comments on the 2010 exposure draft, we believe that the requirements of financial statement users are better served by the revenue recognition principles encompassed in the current revenue standard. The current revenue recognition principles are easily understood, applied well in practice and relevant to all transaction types (not just transactions with customers). Although there may be some improvements necessary to finesse their application, we do not believe the wholesale changes proposed in this exposure draft provide a better platform for preparers to account for revenue and for users to understand the revenues reported.

In addition, the exposure draft appears to have been drafted as a hybrid of IFRS principles and US GAAP rules. We disagree with this approach as not only does it not accord with a principles based framework but it results in inconsistent outcomes between similar types of transactions depending upon whether they have been addressed specifically by a rule or left to be determined by the principle. We were of the understanding that US companies would be adopting a principles based IFRS in the future, not that the IASB would be redrafting IFRS as an amalgam of IFRS and USGAAP.

Furthermore, we find the language and expression of the exposure draft complex and as a result of the quasi principle/rule approach difficult to understand and verbose, particularly compared to the current standard. We are firmly of the belief that this will result in confusion and diversity in practice amongst preparers and other users of the financial statements should this exposure draft become a standard.

The exposure draft has been drafted with a focus on recognising revenue when an entity has relieved itself of a performance obligation, rather than when the entity has actually performed (i.e. there is more of a focus on recognising revenue when the entity's liability is extinguished rather than when the entity has created a right to be compensated for actually performing the transaction and exchanging rights of control). This is demonstrated by the focus on revenue being recognised when the customer obtains control of a good or service as opposed to the seller losing control (i.e. transfer of significant risks and rewards). We believe a revenue recognition model which is based on

¹ Exposure Draft "Revenue from Contracts with Customers" (the Exposure Draft) issued by the IASB in June 2010.

recognising rights acquired and exchanged by the reporting entity would be more intuitive than a model based on extinguishing obligations.

Our responses to each of the questions raised in the Exposure Draft as well as additional comments on some of the proposals within the ED are outlined below.

Question 1: Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

Subject to our comments above about using the notion of control to determine when to recognise revenue, we agree with the principle that revenue should be recognised over time for performance obligations that an entity satisfies over time. However, we have significant concerns as to whether the paragraphs will achieve an appropriate application of the revenue recognition principle.

Furthermore, we find the language of paragraphs 35 to 48 complex and difficult to understand. We are firmly of the belief that this will result in preparers and users experiencing difficulty in applying this exposure draft should it become a standard.

Notwithstanding the above comments, we agree with the boards' decision to supplement the notion of control with criteria/guidance that focuses on when a performance obligation is satisfied, rather than the nature or the type of the performance obligation. However, we are concerned that the criteria in paragraph 35 for determining when a performance obligation is satisfied over time may not appropriately capture all arrangements where revenue should be recognised over time. For this reason we believe it would be more appropriate to articulate a principle and provide guidance/indicators illustrating the application of that principle.

We note that for each of the criteria in paragraph 35 there is an underlying theme of the customer receiving/consuming a benefit from the entity's performance completed to date. This is particularly the case for paragraphs 35(a) and 35(b)(i) and (ii). Even the 'right to payment' criterion in paragraph 35(b)(iii) presupposes the customer deriving some benefit from the entity's performance to date. Accordingly, we propose that an entity may be considered to satisfy a performance obligation over time and therefore recognise revenue over time when a customer is considered to receive/consume a benefit from the entity's performance completed to date. Each of the criteria within paragraph 35 could then be expressed as an indicator of when the customer may be considered to receive/consume a benefit from the entity's performance to date. Paragraphs 38-48 would continue to prescribe methods for measuring progress towards complete satisfaction of a performance obligation over time. To the extent that a customer is not considered to receive/consume a benefit over time, the performance obligation would be considered to be satisfied at a point in time. Paragraph 37 would continue to provide indicators to determine the point in time when a customer obtains control of a promised asset.

We also note that paragraph 31 could be interpreted as placing undue emphasis on the physical transfer of a good or service rather than on satisfaction of a performance obligation. This is inappropriate as physical transfer is not always required for control to pass. Paragraph 31 appears in bold type and is therefore intended to state the principle for revenue recognition. We believe it would be appropriate to remove this emphasis from the revenue recognition principle. We suggest combining the two sentences of paragraph 31 in order to remove this emphasis as follows:

"An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring control of a promised good or service (ie an asset) to a customer."

Question 2: Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

We agree with the proposal to exclude the effects of the customer's credit risk from the transaction price and recognise revenue at a gross amount that represents the amount of consideration to which the entity expects to be entitled.

Further, we agree with the application of IFRS 9/IAS 39 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk.

However, we do not agree with presenting any impairment of receivables arising from contracts with customers in profit or loss as a separate line item adjacent to the revenue line item. Such a treatment implies a nexus between current period revenue and impairment losses when this may not be the case (i.e. impairment losses recognised in the current period may relate to revenue recognised in previous periods). We believe that it would be more appropriate to present impairment losses on receivables arising from contracts with customers in the same line item as all other financial asset impairment losses.

To the extent that information on the impairment of receivables arising from contracts with customers (on initial recognition and subsequently) is considered necessary, we suggest that this information would be better disclosed in a note to the financial statements. Having said that, we believe the disclosures currently required by IFRS 7 are sufficient and that separate disclosure of impairment of receivables arising from contracts with customers is unnecessary.

Question 3: Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

We do not agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations. Paragraph BC198 indicates that the reason for including the proposed constraint is "because revenue is an important measure for users when valuing an entity and because a significant portion of errors in financial statements have related to the overstatement or premature recognition of revenue." We do not consider these reasons to be consistent with the development of principle-based standards.

We also note the use of new terminology to label the 'qualitative threshold' for revenue recognition, 'reasonably assured', and query how this relates to the 'reliable measurement' recognition criterion within the Framework. To the extent that the Boards consider 'reasonably assured' to represent a different threshold to 'reliable measurement', it would be useful for this point to be clarified in the final standard. If the thresholds are not considered to be different, then we would recommend use of 'reliable measurement' to be consistent with the recognition criteria established in the framework and incorporated in other IFRSs.

We believe that revenue should be recognised in accordance with the recognition criteria established in the Framework. Accordingly, upon satisfaction of a performance obligation an entity would recognise revenue to the extent that it is probable that the economic benefits associated with the performance obligation will flow to the entity and the amount of revenue can be reliably measured. The proposed criteria within paragraph 81 could be expressed as indicators on when revenue can be reliably measured. Further, the indicators within paragraph 82 could be expressed as indicators of when revenue may not be reliably measured.

We are also concerned with the proposed requirement relating to sales-based royalties on licensed intellectual property in paragraph 85. Specifically, we are concerned about the treatment of other transactions with similar economics. See our response to Question 6 below for further discussion.

Question 4: For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

We do not agree with the boards' proposals in relation to onerous performance obligations.

Firstly, we do not agree with including requirements for onerous performance obligations in a standard dealing with revenue recognition. We believe that a revenue standard should focus on requirements relating to the recognition, measurement, presentation and disclosure of revenue. We do not think that it should deal with the recognition and measurement of liabilities relating to onerous performance obligations. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prescribes the accounting for onerous contracts. We think it is inappropriate and potentially confusing to prescribe two different models for onerous performance obligations/contracts within IFRS. We believe that IAS 37 is the appropriate standard to prescribe the accounting for onerous performance obligations (although note our comment below on unit of account).

Secondly, we do not agree with the proposed unit of account. Consistent with the unit of account in IAS 37 we believe that the onerous test should be performed at the contract level and not at the performance obligation level. We note that the Boards rejected the contract level as being the unit of account because they thought it would "add complexity and be inconsistent with recognising revenue at the performance obligation level" (BC207). We are interested in understanding the additional 'complexity', particularly when current IFRS applies an onerous test at the contract level.² We believe that recognising a loss for a performance obligation in an otherwise profitable contract does not necessarily reflect management strategy and therefore the economics of the transaction. For example, management will often negotiate terms in order to secure an arrangement with the customer that will generate an overall profit for the entity. We believe recognising a loss on an aspect of such a contract is inappropriate and potentially misleading to users of the financial statements.

The Boards also noted that specifying the contract as the unit of account could be arbitrary because the unit of account would depend on whether the entity provides its goods or services in one contract or more than one contract. In this regard we think the Boards' concerns would be better served by incorporating the principle of accounting for linked transactions as one transaction rather than prescribing requirements that could result in accounting outcomes that do not reflect the economics of the arrangement.

² IAS 11 Construction Contracts (paragraph 36) and IAS 37.66.

Finally, we do not agree with the Boards' proposal to limit the scope of the onerous test to performance obligations that are satisfied over a period of time that is greater than one year. Such a limitation could result in material short-term onerous obligations not being recognised. We do not think this is appropriate and note that it would be inconsistent with the outcome of the onerous test within IAS 37. We consider this supports the inclusion of one model for onerous performance obligations/contracts within IFRS.

Question 5: The boards propose to amend IAS 34 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports. The disclosures that would be required (if material) are:

- The disaggregation of revenue (paragraphs 114 and 115)
- A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- An analysis of the entity's remaining performance obligations (paragraphs 119–121)
- Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)
- A tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

We do not agree that an entity should be required to provide each of these disclosures in its interim financial reports. Specifically, we do not believe that the proposed disclosures are consistent with the intention of interim financial reporting.

IAS 34.6 states "the interim report is intended to provide an *update* on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported." (Italicised for emphasis)

We consider the proposed disclosures to be excessive for the purpose of interim reporting. Consistent with the stated intention of interim reporting, we believe that disclosures provided within the interim report should aim to provide users with an update of events and transactions that are significant to an understanding of the changes in the financial position and performance of the entity since the end of the last annual reporting period. Accordingly, we believe disclosure of any significant new contracts or of any significant changes in judgements or estimates relating to existing contracts would be sufficient for the purposes of interim reporting.

Refer to our additional comments section below for further discussion on proposed disclosures.

Question 6: For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

We believe that the requirements relating to de-recognition and measurement of consideration for the transfer of non-financial assets should be consistent with requirements for revenue arising from contracts with customers. Accordingly, subject to our comments above about using the notion of control to determine when to recognise revenue, we agree that an entity should apply the proposed control and measurement requirements to the transfer of non-financial assets.

Having said that, we have concerns about the accounting in situations where the consideration for sale of a non-financial asset includes a variable component. Specifically, we are concerned that the application of 'reasonably assured' criterion. For example, an entity may negotiate a sale that comprises both fixed and variable consideration. Whilst the sale may be considered to be profitable the application of the 'reasonably assured' criteria may result in a loss being recognised upon derecognition of the non-financial asset (ie because the entity does not have experience that is considered to be predictive of the amount of consideration to which the entity will be entitled).

We are particularly concerned with the proposed requirement relating to sales-based royalties on licensed intellectual property in paragraph 85 and how this may be applied to other transactions with similar economics. For example, in the extractive industries it is common for sale-based royalties to form part of the consideration in sales of mineral/petroleum rights. It is not clear under current IFRS how such arrangements should be accounted for and we understand that there is diversity in practice. The proposed model does not provide additional clarity and therefore this diversity may continue.

Additional comments

Application of scope exclusions

We appreciate that the Boards have introduced a scope exclusion for "non-monetary exchanges between entities in the same line of business to facilitate sales to customers" to avoid the inappropriate 'grossing up' of revenue associated with certain product swaps.

However, we consider that the application of the scope exclusion will still result in the 'grossing up' of revenue associated with certain contracts. For example, in some instances both a sale and a purchase contract are put in place to affect a location swap of products, such contracts being settled in cash. The scope exclusion proposed would not apply to these contracts and as such, revenue would be recognised on both the sale to the 'other supplier' and the sale of the product to the final customer.

In this case, we believe that rather than a scope exclusion, this situation would be more adequately addressed by incorporating the current provisions of IAS 18 para. 13 which requires "the revenue recognition criteria to be applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole". This clearly provides the correct outcome for contracts, which whilst settled in cash for their respective fair values, would not be entered into the absence of the other.

Contract costs

Similar to our concern regarding onerous performance obligations, we question the relevance and appropriateness of including requirements for the treatment of contract costs in a revenue recognition standard. We believe that the capitalisation of costs should be determinable by entities referencing the definition of an asset in the Framework and other IFRSs and should therefore be omitted from the final standard.

Disclosures

We note that despite concerns raised by respondents to the 2010 exposure draft about the costbenefit of providing the volume of disclosures that were proposed, the Boards have reaffirmed the proposed disclosures. Consistent with our response to the 2010 exposure draft, we believe the proposed disclosure requirements are too onerous, costly to implement, reflect information that is unlikely to be used by management in its decision making and will provide a level of disaggregation that will detract from, rather than enhance, the usefulness of the financial statements. For these reasons we recommend the Boards consider field testing the proposed disclosures with preparers and users across different industries in order to make an informed assessment as to whether the perceived benefits of the disclosures outweigh the cost of implementation.

We believe the focus of financial reporting disclosures should be on the risks faced by the entity in deriving its revenue, which is not addressed by the proposed disclosure set.

With regard to the disclosure involving disaggregation of revenue we are concerned that this disclosure conflicts with, rather than supports, the disaggregation of information required under segment reporting (e.g. entity-wide disclosures as required by IFRS 8 *Operating Segments* para.'s 31 - 34). We recommend that the Boards consider these potential conflicts with IFRS 8 before incorporating additional and potentially duplicative disclosures into a final revenue standard. This could be performed as part of the field testing previously mentioned.

With regard to the disclosure involving contract balances, whilst a reconciliation of opening to closing contract asset and contract liability balances is seen as good practice from a financial record management perspective we do not believe such reconciliations are a useful output of financial reporting. Paragraph BC256 states that "...users commented that the disclosure was important because it would help them understand the interaction between revenue that has been recognised and the movements in cash and receivables, as well as to understand contract assets and contract liabilities". We are not convinced that the benefits of providing this disclosure would necessarily outweigh the costs of preparing the reconciliation. We have similar concerns with regard to the reconciliations proposed for onerous performance obligations and assets recognised from the costs to obtain or fulfil a contract with a customer. The cost-benefit of these disclosures should be considered as part of the field testing previously mentioned.

With regard to the disclosure involving performance obligations, we believe that the proposed disclosure about remaining performance obligations and the expected timing of their satisfaction is unlikely to be useful to users of the financial report. This disclosure would only relate to existing recognised but unperformed contractual obligations, and for many entities is therefore likely to be a small subset of all performance obligations to be settled in the future. As such, it is difficult to see how a user could assess the ability of an entity to meet its future performance obligations with disclosure of only those that are presently contracted. Similarly, it is difficult to see how a user could assess the future revenue generating potential of an entity with such disclosure.

If these disclosure requirements were to be introduced, the Boards need to provide greater guidance with respect to the level of granularity required and level of aggregation permitted in order to achieve meaningful disclosures and comparability between market participants.

We would like to thank the IASB in providing the opportunity to comment on this important issue.

Yours sincerely,

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Brett Rix

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