



22 October 2010

International Accounting Standards Board  
30 Cannon Street  
London, EC4M 6XH

Dear Sirs

### **ED/2010/6 –REVENUE FROM CONTRACTS WITH CUSTOMERS**

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of £3.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, the Annual IMA Asset Management Survey shows that in 2009 IMA members managed holdings amounting to 40% of the domestic equity market.

In managing assets for both retail and institutional investors, IMA members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the standards governing how such companies prepare their financial statements as users. IMA welcomes the opportunity to comment on the proposals in the ED. Revenue recognition involves significant conceptual issues and we welcome the IASB working with the FASB on this as part of the convergence agenda. In addition, the 'performance obligation' approach in the ED is a sound basis for recognizing revenue. However, there are certain areas in the ED where we have concerns. We set out below our main concerns and in the attached, comments on the detailed questions raised.

- In the ED, 'control' is the main driver for revenue recognition, and is dealt with through a principle and four indicators. However, the intended meaning of the principle is unclear for all but the most straightforward of sales contracts and we have particular concerns with regard to service contracts. Also the indicators seem to allow for a degree of judgment that would compromise comparability across entities. Whilst the concept of 'control' works well when determining when consolidation should occur, it does not fit with revenue recognition and should be revisited.

- Clearer guidance is needed as to when to account for a contract modification in that pricing can be modified for a number of reasons and we do not believe a single principle can capture all of these. It is important that the accounting reflects the underlying economics.
- Whilst in principle revenue should be recognized where the transaction price can be reasonably estimated, this should not be the 'probability-weighted amount of consideration'. We did not support 'probability-weighted amounts' in the recent consultation on IAS 37 Provisions, Contingent Liabilities and Contingent Assets, on the basis that attaching probabilities to a range of possible outcomes is too subjective. Such an approach can only really be applied where the probable outcome can be reliably estimate, i.e. for large, homogeneous populations. To address other situations, there should be an option to value the consideration at the amount of the most likely outcome.
- We do not agree with a customer's credit risk being reflected in revenue in that credit provisions should be reported on a separate line in the income statement in operating expenses.
- As noted, we do not support probability-weighting or the proposal to use it to determine whether a performance obligation is onerous in paragraph 55. Unless the entity had past experience of the type of contract this would not produce reliable information. Nor do we agree with paragraph 54 that onerous contracts should be assessed at the level of the performance obligation. This may not reconcile with the commercial substance of the contract and could lead to the counter-intuitive situation where 'day one losses' are recognised on a profitable contract.
- The disclosure requirements are lengthy. In particular, the requirement to provide a reconciliation of contract balances could prove unnecessarily detailed for all but the most major of contracts (for example, construction and defence contracts) and it should be clarified that this information can be given on an aggregated basis.
- The distinction between warranties in paragraphs B13 to B19 is unclear and distinguishing defects into latent and post-sale, and associating a different type of warranty for each is likely to prove too subjective in practice. Entities are familiar with the calculation of likely warranty liabilities based on historical information and current practice, which is well understood, should be allowed to continue.
- We do not agree that the pattern of revenue recognition from the sale of a licence should depend upon whether it has been granted exclusively. This is an arbitrary and unconvincing distinction. Moreover, much of the underlying commercial substance is similar to the 'right to use' concept in a leasing agreement. It should be clear from the rights granted as to whether these types of agreement fall within the definition of leasing contracts in which case they should be covered by a future leasing standard.

Please contact me if you would like clarification on any of the points in this letter or the attached, or if you would like to discuss any issues further.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Liz Murrall', written over a horizontal line.

Liz Murrall  
Director, Corporate Governance and Reporting

## **IMA'S COMMENTS ON THE DETAILED QUESTIONS RAISED**

Set out below are IMA's comments on the detailed questions raised in the ED.

***1. Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether:***

- ***to combine two or more contracts and account for them as a single contract;***
- ***to segment a single contract and account for it as two or more contracts; and***
- ***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?***

Whilst we agree with the principle of interdependence in the ED, there needs to be clearer guidance as to when to account for a contract modification. Pricing can be modified for a number of reasons and we do not believe a single principle can capture all of these in that it is important that the accounting reflects the underlying economics. In this context, IMA notes that loss making contracts are not referred to. It would be unusual for an entity to enter into a contract that is not ultimately profitable and an initial loss making contract, therefore, is likely to be interdependent on another contract so the overall result is profitable. In such a situation users would regard a loss recognised on inception, as the proposals would seem to expect, as counter-intuitive.

***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?***

IMA generally agrees with the proposed guidance for separating performance obligations and the principle in paragraph 23 for determining when a good or service is distinct. However, we do not believe that the practices of another entity need to be considered (23(a)) in that it is only the practices of the entity itself that are relevant. In addition, the condition in (23(b) ii), the existence of a clear profit margin, lacks clarity and could lead to unwelcome subjectivity.

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

In the ED, 'control' is the main driver for revenue recognition, and is dealt with through a principle and four indicators. However, the intended meaning is unclear for all but the most straightforward of sales contracts. For example, it may be difficult to assess when control has passed for long-term contracts that have traditionally recognized revenue on a percentage of completion basis. In addition, we have particular concerns with regard to service contracts and the indicators seem to allow for a degree of judgment that would compromise comparability across

entities. Whilst the concept of 'control' works well when determining when consolidation should occur, it does not fit with revenue recognition and should be revisited.

***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?***

Whilst in principle revenue should be recognized where the transaction price can be reasonably estimated, this should not be the 'probability-weighted amount of consideration'. We did not support 'probability-weighted amounts' in the recent consultation on IAS 37 Provisions, Contingent Liabilities and Contingent Assets, on the basis that attaching probabilities to a range of possible outcomes is too subjective. Such an approach can only really be applied where the probable outcome can be reliably estimate, i.e. for large, homogeneous populations. To address other situations, there should be an option to value the consideration at the amount of the most likely outcome.

***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?***

For the reasons noted above, IMA does not agree with the use of probability-weighting as proposed in paragraph 43 for determining the expected revenue on satisfaction of a performance obligation. Nor do we agree with a customer's credit risk being reflected in revenue in that credit provisions should be reported on a separate line in the income statement in operating expenses.

***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?***

IMA agrees that an adjustment for the time value of money is appropriate in when payment is deferred for a period beyond normal credit terms.

***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?***

IMA agrees that the transaction price at inception should be allocated to all separate performance obligations in proportion to the stand-alone selling prices of the good or service underlying each of the performance obligations. However, another solution should be found if this were to result in an initial loss on an overall profitable contract.

**8. Paragraphs 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?**

IMA supports the proposals in paragraph 57 in that they will allow an asset to be recognized where it is clear that future economic benefits will be generated but are restrictive enough to prevent over-capitalisation.

**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?**

IMA agrees with the ED that both direct and allocated costs should be recognized as an asset. However, we do not agree with the use of probability-weighting as proposed in paragraph 55 to determine whether a performance obligation is onerous. This would not produce reliable information where the entity has no past experience of the type of contract in question and where a best estimate basis would be preferable. Nor do we agree with paragraph 54 that onerous contracts should be assessed at the performance obligation level. This may not reconcile with the commercial substance of the contract and could lead to the counter-intuitive situation where 'day one losses' are recognised on a profitable contract.

**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?**

IMA agrees with the disclosure objective in the ED in that it should assist with clarity and comparability. However, the disclosure requirements are lengthy, for example, the requirement to provide a reconciliation of contract balances could prove unnecessarily detailed for all but the most major of contracts (for example, construction and defence contracts).

**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?***

IMA agrees with the proposal. However, the requirement should be extended to include those contracts with an original timing of less than one year but whose timing has now been extended. Also as noted above, the disclosures are lengthy and for all but the most major contracts and it should be clarified that this information can be given on an aggregated basis.

***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?***

IMA agrees. An entity should be able to classify its contracts both by service type and geographically in a similar way to segmental information. It would be useful for investors to see more than one cut of the business engaged in by the entity if it operates in different geographies and lines of business.

***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 alternate 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.***

IMA believes that an entity should apply the proposed requirements retrospectively for all contracts in existence during any reporting periods presented because this allows for greater comparability both within entities and across entities.

***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?***

IMA has noted the volume of application guidance and agrees that there needs to be industry guidance in the interests of convergence with US GAAP. In addition, application guidance should not be the only means of clarifying principles-based standards in that the IASB should seek to clarify the principles in the standard itself.

***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?***

IMA believes the distinction between warranties in B13 to B19 is unclear and distinguishing defects into latent and post-sale and associating a different type of warranty for each is likely to prove too subjective in practice. Entities are familiar with the calculation of likely warranty liabilities based on historical information and current practice, which is well understood, should be allowed to continue.

***16. The boards propose the following if a licence is not considered to be a sale of intellectual property:***

***(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and***

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

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

We do not agree that the pattern of revenue recognition from the sale of a licence should depend upon whether it has been granted exclusively. This is an arbitrary and unconvincing distinction. Moreover, much of the underlying commercial substance is similar to the right to use concept in a leasing agreement. It should be clear from the rights granted as to whether these types of agreement fall within the definition of leasing contracts in which case they would be covered by a future leasing financial reporting standard.

***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?***

IMA agrees with the proposal.