



Deloitte Touche Tohmatsu Limited
2 New Street Square
London EC4A 3BZ
United Kingdom

Tel: +44 (0) 20 7936 3000
Fax: +44 (0) 20 7583 1198
www.deloitte.com

Direct: +44 20 7007 0884
Direct Fax: +44 20 7007 0158
vepoole@deloitte.co.uk

Sir David Tweedie, *Chairman*
International Accounting Standards Board
30 Cannon Street
London
United Kingdom
EC4M 6XH

Email: commentletters@iasb.org

22 October 2010

Dear Sir David,

Re: Exposure Draft ED/2010/6 Revenue from Contracts with Customers

Deloitte Touche Tohmatsu is pleased to respond to the exposure draft, *ED/2010/6 Revenue from Contracts with Customers* (the 'ED').

We disagree with certain aspects of the ED's proposals and we have significant concerns over other aspects. Nevertheless, we continue to support the boards in their overall objective of creating a common revenue Standard, and we believe that the work done by the boards to date can, if further developed and modified, form the basis for a clear and robust Standard on revenue recognition.

Our main concern with the ED is that the material in relation to 'control' is neither well developed nor clearly explained. As drafted, the guidance could be interpreted in a number of ways, which could lead to significant diversity in practice. We note that it is particularly unclear how the proposed guidance should be applied to the provision of many services.

We believe the ED's proposals on how the transaction price should be allocated between performance obligations, and on how to account for contract modifications that are judged interdependent, should be modified. As currently drafted, they will sometimes result in accounting that fails to depict properly the economic substance of the underlying arrangements.

We disagree with certain of the ED's other proposals.

- We think some of the guidance in relation to assessing whether performance obligations are distinct is unclear. We would favour deleting paragraph 23(b)(ii) of the ED.
- We do not support the boards' proposals on how to measure variable consideration when applied to cases where the population is small, or only one sales transaction with a number of variable outcomes
- We do not favour adjusting the transaction price for a customer's credit risk. We believe it is more helpful to users to present all adjustments for bad debts as an expense.

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- We believe that provision should be made for onerous contracts, as at present, and not for onerous performance obligations.
- We do not support the forward-looking disclosures proposed by paragraph 78 of the ED. We believe that such disclosure could be encouraged in the management commentary, but should not be required in IFRS financial statements.
- In respect of intellectual property, we do not agree that additional performance obligations arise merely because a licence is exclusive.

Our detailed responses to the invitation to comment questions are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884.

Sincerely,



Veronica Poole
Global Managing Director
IFRS Technical

APPENDIX

Question 1

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

- (a) To combine two or more contracts and account for them as a single contract;***
- (b) To segment a single contract and account for it as two or more contracts; and***
- (c) To account for a contract modification as a separate contract or as part of the original contract.***

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

We agree that it is important to set out a principle as to when it is appropriate to combine two or more contracts and account for them as a single contract. However, we have concerns that the guidance around price interdependence is to some extent contradictory and confusing. We also believe that combining contracts in all circumstances in which the pricing of the former has clearly affected the pricing of the latter may be unnecessarily complex in practice, and that an alternative approach may be more practical.

We note that the words in paragraph 13, ‘an entity shall combine two or more contracts and account for them as a single contract if the amount of consideration for goods or services in one contract is dependent on the amount of consideration for goods or services in another contract’, appear to be qualified (or even contradicted) by the words used in paragraph 14, ‘the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts’. It is not clear how these paragraphs are intended to interact. In the absence of further clarification, this could lead to entities with similar types of revenue streams reporting that revenue very differently in the performance statement.

To illustrate, a customer wishing to purchase both product A and product B from the same seller at the same time may be prepared to sign different contracts for each, and to pay too much for product A providing a corresponding discount is given on product B. It would seem reasonable to us to regard the contracts as price interdependent and to account for them as a single contract. Yet the seller might, wrongly in our view, seek to argue that the conditions in paragraph 14 are met because the discount on product B is given ‘as a result of an existing customer relationship arising from previous contracts’, namely the contract to purchase product A. This would, apparently, allow the seller not to combine the contracts and instead to recognise excess margin on product A and insufficient margin on product B, which would seem inappropriate.

Separately, we are concerned that a requirement to combine all contracts that are price interdependent may be unnecessarily complex in practice. For example, in the case of customer loyalty programmes, the purchase of product A under a contract may result in the customer also receiving ‘points’ that it can use to receive further products in the future, free of charge. Under the language of the ED, it appears that the subsequent supply of products would be regarded as price interdependent with the first contract. This could mean that the amount of revenue allocated to product A would have to be revised in the future, depending on which further products the customer chose to receive. This may be contrasted with the approach currently adopted under IFRIC 13 *Customer Loyalty Programmes*, which ‘fixes’ the amount of revenue from the first contract that is attributable to the points. We believe that the

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approach taken by IFRIC 13 is considerably easier to apply in practice, and that the approach proposed by the ED would be unnecessarily complex in practice.

Accordingly, we would instead propose that where a contract includes a valuable option for the customer to obtain future products or services at a discount, the contract should not normally be combined with any subsequent contract(s) in which the customer claims the discount. Instead, as in IFRIC 13, a value should be placed on the option (and not subsequently remeasured), with revenue being deferred correspondingly, to be released on an appropriate basis as the discount is claimed. Example 27 demonstrates just how complex the approach proposed by the ED could be. In our view, this alternative approach would be much simpler to apply.

We would then only require two contracts to be combined and accounted for as one when, on entering into the first contract, it is clear that the second contract with the same customer will follow (i.e. there is no meaningful 'optionality' for the customer) and the main terms of that second contract are also clear.

We agree with the ED's proposals regarding the segmentation of a contract. However, we note that this aspect of the ED is confusing to many readers, particular as an entity is then separately required to identify performance obligations for the purposes of allocating discounts. There may be less confusion if the final Standard spells out that the only purpose of the segmentation stage is to ensure that any discounts compared to overall stand-alone selling prices are allocated in the most appropriate way.

We believe the guidance in respect of modifications to a contract is confusing, and we do not agree with certain aspects of the proposal. In effect, we understand the ED to propose that a modified contract should be regarded as independent of the original contract if it is priced in a way that is unaffected by the fact that the original contract existed. We agree with this aspect of the proposals, but we believe that the way in which it is expressed is very confusing to readers. This is because it is counter intuitive to think of a modified contract and the original contract as being 'independent' of each other – most readers will naturally regard them as being clearly linked. We suggest, therefore, that the approach should be explained more clearly.

Conversely, it appears from the ED that any modification part way through a contract that does not result in ongoing pricing that is 'on market' should always result in a 'catch-up' adjustment, as if the revised contract pricing had always applied. We do not agree with this approach, and we believe that in some cases it will result in financial reporting that will fail to depict properly the transactions that have occurred.

To illustrate, suppose a seller enters into a binding, non-cancellable contract to provide the same service for a period of ten years at a fixed price. However, at the end of the fourth year, there is a significant and unexpected change to input prices (either up or down). As a result, the market price for the service changes significantly and the buyer and seller agree to amend the contract pricing prospectively. However, in the case in which input prices rise, the buyer is prepared to accept a price increase, but not to the extent of the full current market price (conversely, for a decline in input prices, the seller may be prepared to concede a price reduction, but not as far as the current market price). It appears that the ED would require the change to the price charged to be allocated equally across all ten years, even though the commercial reality is that the revised pricing relates only to years five to ten. However, the costs recognised in years one to four will be significantly different from those recognised in years five to ten. This will result in abnormally low profits (or even losses) being recognised in some years and abnormally high profits being reported in the other years, which does not properly reflect the economic reality.

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Conversely, in other circumstances, there may be no change to the seller's input prices, or to market prices for the service, but the customer may be able to use its economic power to negotiate a price reduction from the seller. In some such cases, it might be reasonable to apply the approach illustrated in the ED, and to allocate the price reduction across all years of the contract – though, equally, other treatments might also seem appropriate.

Therefore, we do not believe it is appropriate to mandate a single approach for the treatment of contract modifications. Instead we believe that the accounting should reflect the economics of the modification by considering the underlying reasons for the modification. In some cases, it will be appropriate to account for a modification by way of a 'catch-up' adjustment, but in others the modification should be accounted for only from the modification date. We recommend that the final Standard should describe the different circumstances that can give rise to contract modifications, and should indicate the appropriate treatment of each.

Question 2

The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with this principle? If not, what principle would you specify for identifying separate performance obligations and why?

We agree with the concept of identifying distinct goods or services in order to account for the revenue related to the transfer of those goods or services, but we believe that certain aspects of the proposals relating to items that are not themselves sold separately should be reconsidered.

It is likely that some contracts that have historically been regarded as the provision of a single service, for example in the construction industry, could in theory be disaggregated into a very large number of separate services in accordance with paragraph 23. It would be helpful to clarify that unbundling of services is only necessary to the extent that it would lead to a material difference in the recognition of revenue, and that it will often be sufficient only to unbundle any stages that are identified as having a margin that is significantly higher or lower than the rest of the contract.

In our view, the test of whether a performance obligation is distinct should focus only on whether, in practice, the good or service would have stand-alone value to the customer, because that customer could in practice use that good or service in conjunction with other goods or services that are genuinely available to such a customer. In our view, the guidance in paragraph 23(b)(ii) merely confuses the issue and undermines a principle that is otherwise reasonably clear. We propose that paragraph 23(b)(ii) should be deleted. Example 11 attempts to illustrate the impact of paragraph 23(b)(ii), but it does so in a way that is unclear and unconvincing. For example, it treats site preparation and site finishing differently from the other contract activities, but it does not convincingly explain why. It is unclear whether it is intending to focus on a theoretical margin for services, or on the arrangements in the particular contract. It also asserts that the contract management service does not have a distinct profit margin, but the basis for this is unclear: it seems likely that the costs of that service can be identified separately from the other contract costs, and it also appears possible to estimate a stand-alone value for such a service. Indeed, in practice some companies sub-contract all other contract activities. Finally, we note that it is unclear how the proposed requirements in respect of distinct margin would be applied in a scenario in which there is a significant level of pooled costs between contracts, such as in a support helpline.

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Separately, we note that the principles set out in paragraph 23 place heavy emphasis on whether the entity, or another entity, sells an identical or similar good or service separately. In practice, an entity will often be aware of whether another entity sells a similar good or service, but this will not always be the case, particularly for goods or services that can be sourced from different geographical locations. It would be helpful to acknowledge this, such that a seller is able to apply paragraph 23 based on its existing understanding of the market into which it sells, without being required to conduct extensive and expensive research. Similarly, where an entity starts out in a monopoly market to sell, for example, a computer and software which initially is the only software that can be used with the computer, the entity may conclude that the computer and software sales are not distinct and therefore will not account for those sales separately. At a later date, another entity may develop and sell independently software that can be used with the computer. When this is the case, does the original entity have to separate the sales of the computer and software from this point for accounting purposes? It would be helpful to give some guidance around this.

In some cases, a contract may be structured to have the effect that two items, which might otherwise be distinct, should be regarded as combined. This may arise where it is essential to the customer that both items are supplied. For example, the contract may require the vendor to supply item A and item B, but may specify that, if one of the items is not supplied, the customer can return the other and receive a full refund. In such cases, we believe that the accounting should reflect the substance of the arrangement and the two items should not be treated as distinct.

Finally, we note that US GAAP (in SAB Topic 13) includes some guidance on the treatment of ‘inconsequential or perfunctory’ actions in an otherwise enforceable contract, which are those that, if not completed by the vendor, would not result in the customer receiving a refund or rejecting the delivered products to date. Examples might include ‘free gifts’ of insignificant value offered to a customer upon entering into a contract. We understand that, in effect, such items are not treated as separate performance obligations, but instead are ignored for the purposes of revenue recognition. In our view, it would be helpful for the final Standard to include equivalent guidance, such that it is not necessary for vendors to allocate revenue to such items that are clearly immaterial, both individually and in aggregate.

Question 3

Do you think 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?

No, we believe the proposed guidance is not adequate and leaves scope to be interpreted in a number of ways, which could lead to significant diversity in practice. In particular, the proposed guidance does not deal well with the provision of services or many construction-type contracts.

We support the principle of revenue being recognised when a promised good or service is transferred to the customer. Where this necessarily involves activity by the seller over a period of time, we also support an approach that focuses on whether any ‘work in progress’ should be regarded as an asset of the customer or of the seller, with revenue being recognised only in the former case. However, we believe that it is unhelpful and confusing to draft the requirements of a revenue standard in terms of ‘control’; that the overall principle set out in the standard is neither properly developed nor clearly expressed; and that the indicators of

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control are inadequately explained and likely to lead to significant diversity in practice. These points are explained more fully below.

As noted above, we would support an approach to revenue recognition that focuses on whether any 'work in progress' should be regarded as an asset of the customer or of the seller. We note also that the concept of 'control' is an important part of the definition of an asset. Nevertheless, we think it unhelpful and confusing to readers to draft the requirements of a revenue standard in terms of 'control'. The term is not always easy to apply in the context of a contract for the supply of goods or services, because in practice neither the buyer nor the seller typically has the same unfettered freedom of action as may usually be associated with a concept such as 'control' – in reality, the contract itself will often act as a significant constraint on both parties. Moreover, because the term has little natural meaning for readers in this context, there is a risk of 'control' being interpreted through too literal and narrow a focus on title or physical possession. This is exacerbated by the fact that the other two indicators listed in paragraph 30 of the ED (unconditional obligation to pay, design or function is customer-specific) are not well explained. This will often lead to inappropriate accounting, not least because there are many contracts for which a focus on customer title or possession is entirely misleading. To give just one example, a customer may contract with an advertising agency to devise and film a television advertisement and then arrange for it to be broadcast. The customer will often be closely involved throughout this process, particularly the first two stages, but there may be no point at which the customer takes title to or possession of the filmed advertisement. Nevertheless, we would typically expect the customer to have 'control' of any work in progress associated with such a contract, for reasons that are explained later in this response.

The ED sets out the principle that a customer 'obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Control includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service'. We do not necessarily disagree with this principle, but we believe that it has not been sufficiently developed. For example, it is particularly difficult to interpret how the principle should be applied in the context of many professional services and many construction-type contracts.

We believe that paragraph 27 of the ED is correct to focus on the customer's 'present right' in respect of the goods or services that exist at that stage of the contract, rather than looking forward. However, we believe the principle could be translated into language that would be far easier for readers to understand. In particular, we believe that the principle can be explained in terms of whether, looking at the circumstances overall, the seller or the customer is in a position to determine what will happen to the goods or services in their present state. To give just a few examples by way of illustration:

- while goods that are not customer-specific are being manufactured on the seller's premises, the seller can typically choose whether to sell them to this customer or to another customer, so the customer is not in a position to determine what will happen to the goods;
- conversely, while goods that are customer-specific are being manufactured on the seller's premises, the seller typically cannot choose to sell them to another customer. Therefore, in practice, the customer will typically be in a position to determine what happens to the goods: specifically, if the customer seeks to terminate the contract, the seller is likely to cease work and to seek recompense from the customer where possible. Providing the customer cannot avoid paying for the work done to date, the seller should recognise revenue;
- similar logic would apply to part-complete professional services that are entirely customer-specific: if the benefits associated with the work done to date cannot be

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transferred to another customer, then the customer will typically be in a position to determine what happens to the ‘work in progress’ because if the customer seeks to terminate the contract, the seller is likely to cease work and to seek recompense from the customer where possible. Providing the customer cannot avoid paying for the work done to date, the seller should recognise revenue; and

- when goods have been delivered to a customer but subject to a retention of title clause as security against customer payment, typically the customer can choose what to do with the goods, even though it does not yet have title – the seller is not usually able to recover the goods and sell them to someone else except where the customer fails to pay.

We believe that illustrating how the principle translates into real-life revenue scenarios, as above, will make a final Standard much clearer and, correspondingly, more robust.

One aspect of the ‘control’ principle that we believe should be brought out more clearly is that, in order to have control, it is not necessary for the customer to be able to take possession of any ‘work in progress’. The principle already states (correctly, in our view) that control ‘includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service’. Thus, as illustrated in the bullet points above, where ‘work in progress’ is customer-specific, such that it could not be sold to someone else, the customer is likely to have control even if it is not in a position to take possession of that ‘work in progress’ in its present state. Unhelpfully, Scenario 1 in Example 15 ducks this issue by stating that the customer ‘has the ability to take possession of the equipment during manufacturing and engage another entity to complete the manufacturing’. This is not a common contractual term, and Scenario 1 in Example 15 would be more helpful if this factor was removed – as explained above, we do not believe this would alter the analysis of that scenario. (Similarly, it is unhelpful that Example 16 includes a promise to share findings with the customer each month – by our analysis, as discussed further below, that factor would be unnecessary.)

If better guidance is provided around the guiding ‘control’ principle, then our concerns over the indicators set out in paragraph 30 will be somewhat reduced. However, as presently drafted, the guiding principle in the ED is not well enough explained, with the result that some readers are likely to place too much emphasis on the indicators set out in paragraph 30 to assess whether control has passed. This may lead to some inappropriate outcomes, because the list of indicators does not claim to be comprehensive. Moreover, the relevance of some of the indicators to the guiding principle is not sufficiently well explained. The result may be that some entities will take a ‘checklist’ approach to the indicators, assuming that if they have met, for example, two of the indicators, that control has transferred to the customer without properly considering the substance of the transaction. Whilst we agree with the indicators that have been identified, we believe that additional clarification should be provided for some of them.

For example, with regard to whether a good or service is customer specific, it should be clarified that it is neither necessary for the customer to have the ability to take physical possession of any work done by the seller to date, nor that the customer could request a third party to complete that work. As explained above, the fact that the seller could not transfer the benefits of the work done to date to another customer is itself sufficient.

We suggest also that the guidance around a customer’s ‘unconditional obligation to pay’ should be clarified. An obligation to pay is, by itself, not significant if the customer can demand repayment of any amounts transferred. Moreover, there are likely to be very few contracts that leave the customer with an unconditional obligation to pay, and no right to demand any refund, even in the event of non-performance by the seller. We believe instead that this indicator should focus on whether the customer can, in practice, avoid making

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payment for work done by the seller to date, for example by cancelling the contract. The guidance should make clear that, even where a contract does not explicitly allow for cancellation by the customer, in practice that option will sometimes be open to the customer and should therefore be considered. For example, in some jurisdictions, if a customer seeks to cancel a contract for the supply of non-customer specific goods, the courts would be unlikely to award anything more than nominal damages to the seller, on the basis that the seller can instead sell the goods to another customer. In these circumstances, the customer would not have an unconditional obligation to pay. Conversely, if the customer would not be able to avoid paying fair compensation to the seller for work done to date (even if not specifically provided for in the contract), then the indicator would be met.

We also encourage the boards to consider whether there are some combinations of indicators that will always demonstrate that the customer has control. For example, as explained above, if the customer has an unconditional obligation to pay for work done by the seller to date, and that work is customer-specific such that it could not be sold to a different customer, in our view that is sufficient to demonstrate that the customer has control. To the extent that the boards can set out circumstances in which customer control is clearly established, this will reduce the risk that different readers interpret the requirements differently.

Finally, once the boards have properly developed the principle and indicators around 'control', we urge them to draft the final Standard with as much clarity, and using language that has as much natural meaning for readers, as possible. It will need to be applied by a wide variety of businesses, so it is essential that the final Standard is understandable by accountants with a variety of backgrounds. Although it is clear that the boards have tried to make the ED understandable, some aspects – particularly those dealing with control – have a very theoretical flavour and, consequently, are difficult to interpret and apply.

Question 4

The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

We agree that an entity should recognise revenue on the basis of the estimated transaction price and the criteria proposed in paragraph 38, but we disagree with some of the associated guidance.

In the case where there is a large population of items which are similar in nature but independent of each other, the weighted average approach proposed by the ED seems an appropriate basis of calculation for the variability in the transaction price. However, in the case where the population is small, or only one sales transaction with a number of variable outcomes, it would be misleading to use a transaction price which is calculated on a weighted average basis, but which results in a revenue number being reported in the income statement which can never materialise in reality. Therefore, we encourage the boards to devise an alternative approach that will avoid this problem. In practice, in the latter scenario, an entity will often not be in a position to make a reliable estimate of probabilities. Nevertheless, the point remains important because there may be some cases in which the associated

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probabilities can be determined with some accuracy even though the population is small – for example, where those probabilities relate to external factors.

We would apply the same perspective to the requirement in paragraph 37 to measure a refund liability at the probability-weighted amount. Similarly, we disagree with Example 14, in which a single asset is sold, but only half of it is derecognised, with revenue being recognised only for that half. We do not believe it is appropriate to apply this kind of weighted average approach to a single item. It is unclear what it is intended to represent, or how it can be said to reflect future cash flows.

We believe that the estimated transaction price should explicitly exclude any amounts that the customer can simply choose not to pay. For example, where royalty payments only become due to the entity each time the customer chooses to make a further sale, we would expect this variability to be excluded from the estimation of revenue. This might be the case, for example, where a computer manufacturer must make a royalty payment each time it sells a computer that includes a chip from a particular supplier. The manufacturer has no liability in relation to future sales, because it can choose not to make them – it could instead choose to use a chip from a different supplier. Accordingly, because the manufacturer does not yet have a liability in relation to those future sales, it follows that the seller does not yet have a receivable.

We note that the approach proposed in the ED may result, in some cases, either in apparent mismatches with associated expenses or in a counter-intuitive profile of revenue recognition. We illustrate these issues below, and encourage the boards to consider, in conjunction with affected parties, whether the approach might be refined to address them.

- Where a vendor is acting as the principal in a transaction that may give rise to variable consideration, the vendor will sometimes agree arrangements with its employees or sub-contractors that mirror the variable consideration element. For example, a vendor may be entitled to a bonus from the customer if it meets a specified deadline, and the vendor may agree that part, or all, of that amount will be paid to the relevant sub-contractor if the sub-contractor enables the deadline to be met. In profit terms, the vendor may be exposed to significantly less than all of the variability associated with the variable consideration – indeed, in an extreme case, it may be exposed to none of the variability. Yet it appears possible that the vendor might sometimes be required to accrue the bonus payable to the sub-contractor before it is permitted to accrue the variable consideration from the customer. This would reflect a mismatch that could never occur in practice. (We note that there is some analogy here with the mismatch for sub-lessors in the leasing project, which the boards have attempted to address.)
- Further clarity would be welcome where variable consideration is linked to changes in the value of financial instruments. For example, an investment manager may report quarterly and may, at the end of the calendar year, be entitled to a bonus calculated as a percentage (say 1%) of the average value of net assets under management during the year. At the end of the first quarter that average value will be known for the first three months (e.g. £100 million) – but should it be assumed as zero for the remaining nine months because it is susceptible to market volatility and therefore cannot be reasonably estimated? If so, then the profile of revenue recognition may be counter-intuitive. To illustrate, if the net asset value remained unchanged at £100 million for the rest of the year, revenues might be recognised as follows:

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Quarter	Cumulative revenue calculation:	Cumulative revenue £'000	Revenue for the quarter £'000
1	$1\% \times 3/12 \times [(\pounds 100\text{m} \times 3/12) + (\text{nil} \times 9/12)]$	63	63
2	$1\% \times 6/12 \times [(\pounds 100\text{m} \times 6/12) + (\text{nil} \times 6/12)]$	250	187
3	$1\% \times 9/12 \times [(\pounds 100\text{m} \times 9/12) + (\text{nil} \times 3/12)]$	548	298
4	$1\% \times \pounds 100\text{m}$	1,000	452

Finally, we believe that the ED does not provide enough guidance as to how the measurement of revenue under the proposed Standard should interact with the measurement requirements of IAS 39 *Financial Instruments: Measurement and Recognition*. Once a seller has satisfied all its performance obligations under a contract, any amounts still receivable will meet the definition of a financial asset and would therefore apparently be within the scope of IAS 39. However, the amount of consideration may still be variable at this point, with the result that the measurement under the proposed Standard (which excludes some variable consideration) is likely to be different from, and lower than, fair value as required on initial recognition under IAS 39. In order to avoid a disconnect, it might be appropriate for such amounts to remain within the scope of the proposed revenue Standard until the associated variability has been resolved, but more guidance is needed on precisely how this might work.

Question 5

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

We do not agree with this proposal. This will be a major change in practice from the current IFRS approach without persuasive merits. Where the expected level of bad debts is material to the financial statements, the users of the financial statements will wish to understand the level of bad debts and associated trends, and this information will be obscured if the treatment in the ED is carried forward into the final Standard. We believe that users will receive information that is more useful if all adjustments for bad debts are reported as an expense, rather being split between an expense and an adjustment to revenue.

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

We agree with this proposal.

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Question 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

We believe that the final Standard should first spell out the underlying principle that drives the allocation of the transaction price between separate performance obligations. In our view, the appropriate principle is that the allocation should reflect the economic value of each performance obligation when viewed in the context of the contract as a whole.

We agree in principle that the starting point for allocating the transaction price to the separate performance obligations should be the stand-alone value of the individual performance obligations. We believe that the approach proposed by the ED will result in an appropriate allocation in the majority of cases. However, in an important minority of cases we believe that it will result in an inappropriate allocation, which will fail to reflect properly the underlying economics of the transaction. This will be the case, for example, when high and low margin items are combined in a single profitable contract but a very significant discount is granted on the high margin items. For example, a software company may combine a high-margin licence and subsequent lower margin services. In these circumstances, the approach proposed by the ED will allocate too little of the discount to the licence and too much to the subsequent services, possibly with the result that they become loss-making. In our view this will fail to depict the economic substance. It will also lead to advance recognition of revenues that we believe should properly be recognised only when the services are provided.

Accordingly, we propose instead that entities should be permitted to adopt an alternative approach in circumstances where they judge that the default approach proposed by the ED would fail to depict properly the underlying economics. Such a departure should be permitted only where the default approach would allocate excessive discounts to an item (or items), such that the allocated amount is lower than the range of prices for which it is sold or would be sold. An entity wishing to depart from the default approach should be required to identify those classes of transaction for which the default approach would not be appropriate, and to apply an alternative approach consistently to all transactions within that class. It should disclose that it has departed from the default approach, and describe the class of transactions to which the alternative approach has been applied.

The final Standard should specify those alternative approaches that are permitted, and give an indication of circumstances in which each might be judged appropriate. We suggest that such alternative approaches could include:

- allocating the overall discount (compared to the aggregate of stand-alone selling prices) pro rata to the individual margin on each performance obligation; or
- a residual approach, in which the entire discount (compared to the aggregate of stand-alone selling prices) is allocated to a single performance obligation. This approach may be appropriate where price variability for the class of transactions relates primarily to an individually significant item supplied at the start of a contract (e.g. a software licence).

Please see the example at the end of this appendix for an illustration of the approach proposed above.

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should only 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?

We agree that with these proposals for accounting for the costs of fulfilling a contract.

However, we believe that the drafting of paragraph 59(a) in relation to costs that should be expensed should be amended in order not to cause confusion. At present, that paragraph indicates that 'bid and proposal' costs should be expensed. We suggest that further clarification should be provided to the effect that this is not intended to encompass those bid and proposal costs that would relate to the fulfilment of the contract, if awarded, such as design work and costs of developing a prototype.

In some circumstances, a seller may pay a third party to transfer an existing contract such that the seller will take over the third party's obligations (to deliver goods or services to a customer) and rights (to receive consideration from the customer). It would be helpful for the final Standard to clarify that such payments should not be recognised as an expense, but should instead be capitalised.

Where a seller has a contract to manufacture a large number of similar items, in many cases, it will incur additional but necessary costs at the start of the manufacturing process, including learning costs, as it determines the optimum process to be adopted. We recommend that the boards clarify that necessary costs of this type relate to future contract fulfilment and, hence, are eligible to be capitalised.

Question 9

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

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

We agree with the proposed costs specified in paragraph 58. However, we disagree that liabilities should be recognised for onerous performance obligations and instead, would propose recognising liabilities only for contracts that are onerous as a whole, as at present. Whilst it is appropriate to segment a contract into performance obligations for the purposes of recognising revenue, an entity should assess a contract as a whole to see if it is economically beneficial and it is therefore in these terms that we consider the entity should record when a contract is onerous. In particular, the proposals in the ED would sometimes lead to a loss being recognised when an entity wins a contract that will be profitable overall. An entity is better off, not worse off, as a result of winning such a contract, and we do not believe that recognising a loss in these circumstances is a fair depiction of the event.

Question 10

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

We agree that there is a need for improved disclosures in connection with revenue from contracts with customers. We have concerns and comments in respect of certain proposals as discussed below.

Overall, it may be difficult for entities to judge the extent of disclosure that is required, and the guidance in paragraph 70, while helpful, provides little to assist this judgement. Some more realistic examples, illustrating the intended extent, would make it easier for entities to assess whether they are providing too much or too little information.

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 the proposed disclosure requirement? If not, what if any, information do you think an entity should disclose about its remaining performance obligations?

In our view, this disclosure should not be required in IFRS financial statements. The information is inherently forward-looking and, in many cases, only partly within the control of the entity. This will make it susceptible to change and inherently unreliable, which may create risk exposures for the entity and for its directors, not least because a forecast of future performance obligations is, in effect, a forecast of future revenues. Correspondingly, it will often be extremely difficult or impossible to audit.

In addition, we note that there is insufficient clarity over how the requirement should be interpreted. For example, many contracts permit a level of discretionary spend by the customer (e.g. calls and texts under a mobile phone contract). Should such discretionary spend be included or excluded?

Accordingly, if the IASB wishes to encourage a disclosure along these lines, we propose that it should be given outside the IFRS financial statements, in the management commentary.

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?

We agree that such disclosures would be helpful. We note that paragraph 72 already includes a cross-reference to IFRS 8, indicating that it may sometimes be possible to align the proposed disclosures with those under that Standard. It might be helpful to strengthen that link, for example by indicating that entities not within the scope of IFRS 8 may nevertheless find it helpful to consider the requirements of IFRS 8 when deciding how to provide the disclosures required by the proposed Standard.

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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 period 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.

We can see that, in theory, retrospective application is desirable, in that it will achieve the greatest level of comparability between entities. However, it seems likely to us that many entities will find it a very significant challenge to apply the proposed requirements retrospectively. In some cases, full retrospective application may be impracticable; in other cases, it may be possible but disproportionately expensive. Therefore, we encourage the boards to weigh properly the needs of users for comparability with the concerns of preparers (including first-time adopters) around practicability and expense.

If retrospective application is to be required, it is essential that the effective date of the Standard is set so as to allow sufficient time for the very extensive restatement work that will sometimes be needed.

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?

In our view, the wide variety of revenue-generating activities that exist means that a Standard dealing with revenue will typically need more extensive application guidance than many other Standards.

We do not agree that the application guidance included with the ED is sufficient to make the boards' proposals operational. In particular, we think that the application guidance around the transfer of control is inadequate, particularly in the context of services. However, as explained above, this is primarily a criticism of the principle and indicators included within the body of the ED. If that material were improved, and corresponding amendments were made to the application guidance, it might not be necessary greatly to extend the application guidance on this topic.

Where we have commented above on particular aspects of the application guidance (e.g. Examples 11 and 12), we do not repeat those comments here.

In some industries, for example life sciences, it is common for a development contract to have multiple stages, each with associated milestone payments, and for the contract to terminate if a stage is unsuccessful, with the seller retaining the payments made to date. As there is no guidance in the ED on the treatment of milestone payments, it would be helpful to include an example of how the ED's proposals would be applied in such a scenario.

Slotting fees (Example 23)

We disagree with the analysis in Example 23. Where a retailer acts only as an agent, it seems possible to us that a slotting fee could represent a distinct service to the principal (i.e. the supplier of those goods). However, where a retailer sells goods as a principal, we do not see that a slotting fee is a distinct service – because the 'service' is being provided to the retailer

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itself. Any increased revenues will flow directly to the retailer, not to the supplier. It is true that if the retailer manages to sell more of a particular product, it may be likely to purchase more from the supplier in future. Nevertheless, the value to the supplier of those increased sales is entirely reflected in the net amount that the supplier will pay for those future purchases. Therefore, it seems to us that, in such circumstances, a slotting fee should be regarded as an adjustment to the price paid by the retailer to the supplier for the products.

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?

We agree with the proposed accounting for warranties that provide customers with coverage for faults that arise after the product is transferred.

We believe that the ED is inconsistent, and unnecessarily complex, in the way that it approaches warranties relating to latent defects. Paragraph B14 indicates that a warranty in respect of a latent defect does not give rise to a separate performance obligation. However, paragraph B15 indicates that, where a latent defect will be dealt with by repair rather than replacement, part of the product transaction price should be deferred. It seems to us that, within the ED's model, this can only be appropriate if in fact the repair work is regarded as a separate performance obligation. Otherwise it would seem necessary to defer all of the revenue relating to the faulty product, because the performance obligation to deliver a non-faulty product has not been satisfied. We would not favour deferring the entire product price in such circumstances.

We therefore encourage the boards to adopt a single model for all warranties, namely to regard them as separate performance obligations. If this approach is adopted, a distinction between latent defects and other faults covered by warranty will only be of significance when seeking to estimate a stand-alone selling price for warranties. For the latter, a stand-alone selling price will often be directly observable, because customers can often choose whether or not to purchase an 'extended warranty'. Conversely, it will often be necessary to estimate the former, and we suggest that this should be on the basis of estimated direct costs plus an appropriate margin.

Question 16

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

- ***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***
- ***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 additional performance obligations arise merely because a licence is exclusive. Regardless of whether a licence is exclusive, an entity has either transferred to the customer the right to use that intellectual property for a period or it has not. If that right has been transferred, then it seems to us a contradiction in terms to say that the entity satisfies over time a performance obligation to permit the use of the intellectual property – on the contrary, that permission was transferred at the outset. In reality, the entity is unlikely to be able to prevent the customer from using the intellectual property over the agreed period.

We assume that the boards are seeking to minimise any incompatibility between the proposed Standards on revenue and leasing. We do not think it is helpful to achieve this by undermining the meaning of a performance obligation. If the boards believe it is necessary to recognise income over time where an exclusive licence is granted for only part of the life of intellectual property, we believe this would be better achieved by scoping such arrangements out of the proposed revenue Standard and into the proposed leasing Standard.

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?

In principle, we agree that such an approach would be appropriate, but this is subject to our comments on the ED as set out above. For example, we have raised a concern that the material on variable consideration may not be suitable for a small population of items. This is likely to be particularly applicable to disposals of intangible assets and property, plant and equipment.

We suggest that the boards should specifically identify those non-financial assets to which the proposed recognition and measurement principles would be applied. For example, under IFRSs, these might include property, plant and equipment within the scope of IAS 16 and intangible assets within the scope of IAS 38. Some non-financial assets are scoped out of all other Standards (e.g. certain assets relating to the extractive industries), so we would not favour a blanket requirement for all non-financial assets.

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Drafting and other points

Protective rights (paragraph 28)

We suggest that it would be helpful to provide more guidance around paragraph 28, as there is otherwise a danger that it may be misconstrued. It seems clear to us that it is intended to cover the scenario in which a seller retains title to goods that have been supplied until the customer pays, as security against non-payment. It is not clear whether it is also intended to cover other scenarios. If it is, it would be helpful for those other scenarios also to be explained.

Inability to make a reasonable estimate of variable consideration (paragraph 40)

In some cases, a seller may transfer an asset to a customer in exchange only for variable consideration that cannot reasonably be estimated. An example might be when the variable consideration consists of an uncertain stream of future royalties. It would be helpful to provide guidance on whether, in such circumstances, it is necessary to recognise the previous carrying amount of the asset as an expense or whether, instead, the seller could transfer the previous carrying amount to intangible assets on the basis that it has, in effect, purchased a future royalty stream.

Principal versus agent considerations (paragraphs B20 – B23)

We recognise and support the guidance in paragraph B22, which is consistent with existing revenue Standards. Nevertheless, we note that the guidance was developed in the context of revenue models that are not based on the concept of ‘control’. In our response to question 3 above, we set out our concerns over the lack of clarity around the control concept and we ask the boards to develop and clarify that concept. Once that process is complete, we suggest that the boards should revisit paragraphs B20 – B23 to ensure they are consistent with the underlying principle. It would also be helpful for these paragraphs to include specific discussion of the use of sub-contractors, and to set out examples.

Licensing and rights to use (paragraph B37)

We suggest that a fourth category might be “(d) application – use of the technology in a specific product or area of application of the technology”.

Defending and maintaining patents (paragraph B38)

This paragraph indicates that a promise to maintain and defend patent rights is not a performance obligation. We do not understand the rationale for this statement. Where the seller is recognising licence income from the customer over time, then it might not be necessary to regard the promise as a separate performance obligation, because there would be no change to the pattern of revenue recognition. But where the licence income from the customer has been recognised at the outset, it seems to us that there is a remaining performance obligation to maintain and defend the rights that have been transferred to the control of the customer. Although the value of the performance obligation may not always be significant, it seems to us that it exists.

Customer acceptance (paragraphs B69 – B73)

In our view, these paragraphs paint too black and white a picture of customer acceptance by implying that in all cases control has either been transferred in its entirety or not at all. In some cases, the practical effect of customer acceptance clauses may be to require a small amount of additional work on the part of the seller, but without calling into question whether the customer has obtained control. In our view, this is akin to the description in paragraph

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B15 of a warranty relating to a latent defect being satisfied through a repair being performed: revenue should be deferred in relation only to the repair, not the whole of the contract.

Outsourcing services with set-up activities (Example 28)

It would be common in such circumstances for the customer to make a payment to the entity in relation to the set-up costs. We suggest that the example should be amended to include this factor and to make clear whether the entity would, as a result, be entitled to recognise revenue in relation to the set-up activities.

Inputs and assumptions used to estimate stand-alone selling prices (Example 31)

The disclosures illustrated in the final sentence of Example 31 appear very generic and, arguably, uninformative. We question whether it is worthwhile requiring entities to provide disclosures unless they will actually set out useful information.

Amendment to IFRIC 12 (Appendix C)

It is not clear how IFRIC 12, including the cross- reference to IAS11, might be amended as a result of the proposals in the ED. In particular, Appendix C does not make clear whether there might be a fundamental change to the accounting required by IFRIC 12 or whether the changes might be essentially cosmetic. Accordingly, we encourage the Board to consider the appropriate due process if the accounting under IFRIC 12 will be affected.

Amendments to IAS 39 and IFRS 9 (Appendix C)

At present, IAS 18 includes guidance on the appropriate accounting for dividend income. The Board should consider whether to relocate this guidance to IAS 39 and/or IFRS 9 when IAS 18 is superseded.

*Comment Letter on ED/2010/6 Revenue from Contracts with Customers***Example relating to question 7: scenario in which a departure from the default methodology would be permitted**

Company X sells software licences, usually bundled with other items such as training, helpline support and some consumables. Those other items are all also sold separately. The consumables are sourced externally and sold at a very small mark-up, mainly for the convenience of customers.

Company X is often prepared to discount the software licences, but the amount of any discount is entirely down to customer negotiation – there is, for example, no pricing stratification for different classes of customer on licences. Company X does not offer any discounts on other items.

Company X sells the following package to Customer Y. The normal undiscounted selling price for the package would be 30,000. Customer Y is given a total discount of 12,000. If Customer Y wishes to purchase additional training, helpline or receivables it will be asked to pay the full normal price.

Normal pricing, before discounts

	Licence	Training	Helpline	Consumables	Total
Stand-alone price	20,000	1,000	4,000	5,000	30,000
Direct cost	-	500	2,000	4,900	7,400
Normal margin	20,000	500	2,000	100	22,600

Using ED methodology

	Licence	Training	Helpline	Consumables	Total
Stand-alone price	20,000	1,000	4,000	5,000	30,000
Discount pro rata to stand-alone price	8,000	400	1,600	2,000	12,000
Allocated revenue	12,000	600	2,400	3,000	18,000
Direct cost	-	500	2,000	4,900	7,400
Margin	12,000	100	400	(1,900)	10,600

The consumables show a loss, which arguably does not reflect the underlying contract economics. The training, helpline and consumables have all been allocated an amount of revenue that is lower than the range of prices for which they are sold or would be sold. Accordingly, based on the approach we propose in our response to question 7, Company X would be permitted to depart from the default methodology set out in the ED.

Revised allocation using ‘individual margin’ methodology

	Licence	Training	Helpline	Consumables	Total
Stand-alone price	20,000	1,000	4,000	5,000	30,000
Discount pro rata to margin	10,620	265	1,062	53	12,000
Allocated revenue	9,380	735	2,938	4,947	18,000
Direct cost	-	500	2,000	4,900	7,400
Margin	9,380	235	938	47	10,600

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Revised allocation using 'residual' methodology

Company X negotiates discounts based entirely on the licence, because licence revenues are, in effect, pure profit. Accordingly, it allocates any discount entirely to the licence.

	Licence	Training	Helpline	Consumables	Total
Stand-alone price	20,000	1,000	4,000	5,000	30,000
Discount	12,000	-	-	-	12,000
Allocated revenue	8,000	1,000	4,000	5,000	18,000
Direct cost	-	500	2,000	4,900	7,400
Margin	8,000	500	2,000	100	10,600