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Comment Letter No. 272

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EXPOSURE DRAFT 2011/6 – A REVISION OF "REVENUE FROM CONTRACTS WITH CUSTOMERS"

Dear Sir / Madam,

In response to your invitation to comment, and as a preparer of accounts under International Financial Reporting Standards, I am pleased to attach our comments on the above mentioned Exposure Draft (ED). We agree that IFRS revenue recognition requirements need to be reviewed and support the objective of convergence in this area. From this viewpoint, we welcome the re-exposure of the revenue recognition proposals. Our detailed replies to the questions in the revised ED are given below.

Yours Faithfully,

James Halliwell
Group Financial Controller

Recognition of Revenue

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?*

We agree with the proposal contained within paragraphs 35 & 36 of the ED, that as an entity transfers control over time revenue should also be recognized over time.

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) or ASC Topic 310 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 do not support the proposal to show credit losses as a separate item adjacent to the revenue line, however we do agree that the issue should be dealt with within the new financial instruments standard and not as part of the new revenue standard. At present the new IFRS 9 has not been finalized so we reserve our opinion on that standard and its requirements until we are asked to comment.

In our view, we believe this represents two separate and distinct points within a transaction stream. The event which gives rise to the generation of revenue is distinctly different to the subsequent event which may give rise to credit loss. We therefore believe that credit risk should be recognized and measured separately.

At the point of inception of a transaction, the customer would believe that there was reasonable assurance that the credit would be settled, or the sale would not be recognized in the first instance. 'Normal business practice' would suggest that a transaction would not be entered in to without a belief or experience that payment would be received from the customer. A further deterioration of credit would therefore happen at a later point in time, representing a change in the conditions that were initially present at the point of sale. Showing an effect of credit risk at the point of sale would therefore not accurately reflect the information available at the point of sale and such 'subsequent experience adjustments' should be shown as a separate line.

We also do not believe that the current proposals would result in increased useful information.

We consider it worth noting the differences in reporting and comparability between credit losses on contract assets which would impact gross margin, while similar credit related losses would be presented as a non-operating financial expense.

Furthermore, we believe that the current requirements for disclosure of provisions for bad and doubtful debts are adequate. This has worked well in the past and we believe it will continue to do so. In our view the new model is better suited and more relevant to financial institutions.

***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 agree that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue recognized should not exceed the amount to which the entity is reasonably assured to be entitled.

However, we consider that the criteria and definitions as they currently stand in paragraphs 81-83 of the ED are not sufficiently specific or comprehensive to allow preparers, auditors and regulators to reach consistent conclusions from similar fact patterns when determining whether variable consideration can be considered reasonably assured. The only specific guidance in the ED itself is for sales based royalties (paragraph 85), and the only illustrative application examples relate to management fees and trailing commission (nos. 13 and 14). The Board should provide further application guidance to cover other commonly encountered situations involving contingent or uncertain revenue.

***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 believe that paragraph 86 should not only apply to contracts which satisfy conditions over a period of greater than one year, but all contracts with customers. As a principle we believe that if a contract is onerous the provisions of the ED should apply with no exception, which will ensure consistency of application and aid comparability.

We also consider that the onerous test should be at a contract level rather than at performance obligation level. We do not believe that a future loss relating to a specific performance obligation within a contract which is profitable at an overall level should always be recognized as a liability for an entity.

To counter the argument that an entity could 'bundle' both profitable and loss making orders into a single agreement to avoid recognizing losses, we suggest that an entity should be required to recognize a liability for an onerous performance obligation within a contract if the entity sells separately the good or service underlying that performance obligation and the entity's costs to fulfil that obligation exceed the entity's separate selling price for the good or service. However, if a contract is profitable in total, it is questionable whether losses recognized on individual performance obligations which do not have observable relevant individual selling prices, and which under the ED proposals would have an amount of revenue allocated to them - any allocation method being by its nature arbitrary - would meet the definition of a liability under the IASB's Conceptual Framework.

If this onerous test requirement was applied only to contracts of greater than one year, other contracts which may be less than one year in duration, but at the balance sheet date are onerous, would be considered out of scope. For example, a contract with length of less than one year may have significant losses being incurred in future compared with a smaller contract whose duration is greater than one year, but would find itself outside the scope. These losses would be recognized as inventory provisions under IAS 2 only if the related inventories had already been purchased or manufactured before the reporting date, which would not always be the case. This could therefore present a misleading position to users of the financial statements and as such we propose that the test is extended to all contracts of any duration.

Question 5*: The boards propose to amend IAS 34 and ASC Topic 270 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 believe that these proposed requirements are in accordance with the principles on which IAS 34 is based. IAS 34 requires an entity to include in its interim financial report an explanation of events and transactions that are significant to understanding the changes in financial position and performance of the entity since the end of the last full reporting period. In considering para. 15B of IAS 34, although the list is not exhaustive, this requirement appears to be excessive and would arguably not improve the information available to users to make informed decisions. We believe that the cost of providing such routine information in each interim report far outweighs any benefits that may be gained from its provision. A principle-based approach to interim reporting would focus disclosure on material changes in the nature of revenue related items and related accounting estimates compared to the prior period. This more focused approach to disclosure might include items such as major changes in the portfolio of products and services offered, new forms of consideration, significant changes in estimates of reasonably assured revenue or onerous contract provisions, and material impairments of contract assets.

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, or ASC Topic 360), 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 concur with the proposals that would be applied to the transfer of control of a non financial asset that is not considered part of the ordinary activities of the entity as this is consistent with current IFRS requirements. However we would consider some improvements to the wording of the amendments. These include consistency of wording with regard to recognition of consideration: reasonably assured (IAS16, 38, 40) v variable element (ED), which we believe should be aligned.

Other comments

Sale and repurchase agreements

We note the wording in para. B46 regarding the conclusion that if the repurchase price exceeds that of the expected market value of the repurchased asset then this is in effect a financing arrangement. This wording is relevant to contract manufacturing arrangements in which the product originally sold undergoes a manufacturing process and becomes a component of the repurchased product. As drafted, the comparison with the market value of the transformed product appears to apply only where repurchase of a sold product occurs via a put option and not where it occurs via a forward or a call option, where the way the ED is worded suggests that the repurchase price would be compared to the historical selling price of the product originally sold. We believe that the B46 wording should be added to B40 because if an asset is enhanced while 'in channel' then this component of the repurchase price should not be considered a financing arrangement. We do not believe there is any principle-based reason why the purchase of manufacturing services should be accounted for as a financing cost because it is embedded within a sale and repurchase agreement with a forward or call option structure, rather than within an agreement with a put option structure or a straightforward contract for services.

Presentation

We note the requirement to show the net contract position (contract asset or liability) on the face of the statement of financial position. We propose instead that entities be allowed to show contract assets and liabilities within receivables and payables in the balance sheet and to disclose them separately within the notes to the financial statements.