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E-mail: commentletter@efrag.org

18 November/22 October 2010
(date of draft)

Ref.: ACC/HvD/TS/ID

Dear Ms. Flores,

Re: FEE Comments on EFRAG's Draft Comment Letter on IASB Exposure Draft Revenue from Contracts with Customers

- (1) FEE (the Federation of European Accountants) is pleased to comment on the EFRAG Draft Comment Letter on Exposure Draft Revenue from Contracts with Customers (the "ED").
- (2) FEE acknowledges the joint effort by the IASB and FASB to clarify the principles for revenue recognition and to develop a single contract-based recognition model. However, in our opinion, the IASB needs to further clarify key elements of the proposal.
- (3) We are concerned that the proposal in its current form does not provide a clear conceptual basis to ensure consistent application. The principles, in particular around the control concept, are not robust enough and need to be clarified in order to achieve an improvement compared to the current standards. Indeed, focussing solely on the principle of "transfer of control" may result in a too legalistic approach.
- (4) We propose areas that should be further addressed during the reassessment of the proposal. We recommend that the IASB re-deliberate the issues set out in this letter and then consider re-exposing the draft for further comments.
- (5) Like EFRAG, we are concerned that the ED has been issued without a thorough conceptual debate of what revenue should represent. Without a proper understanding of what revenue should represent it is difficult, maybe even impossible, to develop a clear model with unambiguous principles for revenue recognition.
- (6) We are very concerned that the principles addressing "control", as currently drafted, will not assist in assessing when control has passed for services arrangements, in particular construction and bespoke service contracts. The difficulties arise because the indicators of control appear to have been developed with sales of goods in mind and are less easy to apply to services. We would encourage the IASB to develop more robust principles around the concept of control upon which revenue can be recognised consistently.

- (7) We strongly disagree with the proposal that the entity should perform the onerous test at the performance obligation level. The onerous test should be applied in the context of the contract as whole. If the test is performed at the performance obligation level, a contract loss can be recognised at the inception of a contract that will be otherwise profit making as a whole. We recommend that the IASB reconsider this position.
- (8) In general, we agree with the concept that contracts need to be combined or segmented in certain circumstances. However, in our opinion the proposed principle and the related guidance on “price interdependence” and contract segmentation need further clarification.
- (9) We also agree with the concept of identifying separate performance obligations. However, we question whether the principles used to identify the separate performance obligations are clearly defined. In our view, the object of the contract agreed between the seller and its customer should be a crucial factor for establishing principles on separation of performance obligations. We suggest that the IASB deliberate this issue during its reassessment.
- (10) We also suggest that the IASB make it clear that an entity needs only to account for performance obligations separately to the extent that, overall, this will materially affect how revenue is reported.
- (11) Generally, we agree with the suggested first two steps of the five-step approach for segmentation/combination of contracts and the identification of performance obligations. However, these two steps are presented in a mechanical manner that fails to convey why the approach is important to achieve appropriate accounting. We urge the IASB to provide a clearer explanation of the purpose of the contract combination and segmentation on one hand and unbundling performance obligations on the other and on the eventual interaction, if any, between the two. An example illustrating how the two-step approach affects revenue recognition (e.g. allocation of discounts, contract modifications) would be useful.
- (12) We agree that the transaction price should be allocated to all performance obligations in proportion to the stand-alone selling prices of the good or service underlying each of those performance obligations at contract inception. However, the proposed allocation should be a rebuttable presumption. Where this allocation does not reflect the underlying commercial substance, an alternative approach should be permitted.
- (13) Also, we are concerned that the proposal in the ED would result, in some cases, in an inappropriate combination of a contract modification with the original contract, thus allocating to past services a discount negotiated on the basis of new circumstances. We believe that in most cases discounts granted as part of a contract modification will relate to goods/services to be provided in the future. We suggest that the Board contemplates establishing a rebuttable presumption that newly negotiated discounts apply to outstanding performances.
- (14) As indicated in our letter of 19 July 2010 on the IASB Exposure Draft *Conceptual Framework for Financial Reporting: The Reporting Entity*, we agree with EFRAG that it is necessary to provide a definition of control in the Conceptual Framework. Control is a pervasive concept influencing many different aspects of the financial statements and only specific issues (as well as consistency) need to be addressed at standard level.

- (15) We question whether the description of EFRAG's alternative model as "activity-based" properly captures the key principles in that model. Indeed, we believe that EFRAG's model is closer to the model proposed in the ED than what would be anticipated from a pure activity-based model. A more accurate description would help ensure that EFRAG's model gets the attention it deserves since we believe that it contains principles and guidance that could be used to improve the IASB model. However, we are suggesting some modifications to the EFRAG model to ensure that it captures more appropriately construction contracts that should result in continuous revenue recognition.
- (16) We agree with the proposed disclosure objectives. Alike EFRAG, we think that the overarching objective for the disclosures is clearly stated. However, we are not convinced that this principle-based approach has been consistently followed in the proposed disclosure requirements.

Our Comments on Appendix 1 and 3 of the EFRAG draft comment letter including responses to the questions in the Invitation to comment section of ED are contained in the Appendix to this letter.

For further information on this letter, please contact Tibor Siska, Project Manager, at the FEE Secretariat on +32 2 285 40 74 or via email at tibor.siska@fee.be.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Hans van Damme', written over a horizontal line.

Hans van Damme

President

Appendix – Comments on Appendix 1 and 3 of the EFRAG draft comment letter including responses to the questions in the Invitation to comment of IASB Exposure Draft on Revenue from Contracts with Customers

Appendix 1

Question to constituents

Do you support:

- (a) The approach of developing a new standard on revenue recognition, or do you think that amending IAS 11 and IAS 18 to address existing practical issues would be preferable?
- (b) The alternative revenue recognition model presented in Appendix 3 or the model proposed by the IASB in the ED?

Recognition

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?

- (17) In general, we agree with the concept that contracts need to be combined or segmented in certain circumstances. However, in our opinion the proposed principles and the related guidance on “price interdependence”, contract segmentation and contract modifications need further clarification.
- (18) We do not agree with the approach proposed in respect of contract modifications, which may lead in an inappropriate combination of a contract modification with the original contract thus allocating a newly negotiated discount to past services. We believe that in most cases discounts granted as part of a contract modification will relate to goods/services to be provided in the future. Please refer to our response to Question 7 for further details.
- (19) Additionally, it is not clear how the indicators of price interdependence, established in the context of segmenting a contract (paragraph 13) can be applied to determine whether or not a contract modification should be accounted for together with the original contract. Given that a contract modification is by definition not entered into at the same time as the original contract, the indicators in paragraph 13 do not appear relevant. We would expect that the IASB further clarify these principles along with more real life examples in order to ensure consistent application of the proposal.

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- (20) Furthermore, we find that the interaction between paragraphs 14 and 13 is unclear. In particular, from paragraph 14 which can be read as undermining paragraph 13, it is not clear to what extent it can be used to 'overrule' paragraph 13.
- (21) The intent of paragraph 14 is even further blurred by Example 2. Paragraph 14 states that a discount received in a contract as a result of an existing customer relationship does not establish a link between previous contracts and the current contract. In practice, we believe that it would be difficult to determine whether a discount is obtained solely as a result of a customer relationship or not. Example 2 in the application guidance does not help in that respect since the existence of a discount as part of the contract modification appears to lead automatically to the conclusion that the contract and the contract modification are price interdependent. As stated in paragraph 14, why is the discount not considered to reflect a customer relationship rather than price interdependence?

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 that principle? If not, what principle would you specify for identifying separate performance obligations and why?

- (22) Generally, we agree with the concept that the entity should account for each promised good or service in the contract as a separate performance obligation only if it is distinct.
- (23) In our response of 28 July 2009 to the IASB *Discussion Paper Preliminary Views on Revenue Recognition in Contracts with Customers* (the 'DP'), we supported EFRAG's view that the IASB should further assess whether the requirement to identify, separate and account for every single performance obligation would always result in a proper balance between cost and benefit. Unlike EFRAG, we are not convinced that the ED has addressed this concern entirely. Indeed, in our opinion, the criteria for identifying distinct goods or services (paragraph 23) do not provide clear guidance on when to separate or bundle performance obligations from an economic perspective. This key issue requires further clarification.
- (24) In particular, we suggest that the IASB make clear that an entity need only to account for performance obligations separately to the extent that, overall, this will *materially* affect how revenue is reported.
- (25) We agree with EFRAG that the reference to "other entities" in paragraph 23 (a) is irrelevant as we share the view that the business practice of other entities is not relevant in determining whether a good or service is distinct.
- (26) However, we think that merely deleting this reference will not resolve all the issues on how to separate performance obligations in practice. In fact, we do not believe that whether a good or service is distinct, is by itself sufficient to justify that they represent separate performance obligations.

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- (27) The key aspect that appears to be overlooked is the fact that the customer is not necessarily receiving the same thing when purchasing items (goods and/or services) as part of a bundle or buying the same elements separately. There will often be additional value to the customer when buying elements as part of an integrated set, partly because this ensures that the elements are functioning together. In such scenarios, recognition of revenue upon delivery of an isolated item in the bundle does not reflect the economic substance of what the customer has purchased. We fail to see the informational value of separating performance obligations more finely than what the customer would consider to be separate obligations in the specific contract.
- (28) Whether or not a good or service represents a separate performance obligation, the question should be evaluated in the context of the contract in which it is included. In our view, the object of the contract agreed between the seller and its customer should be a crucial factor for establishing principles on separation of performance obligations.
- (29) Generally, we agree with the suggested first two steps of the five-step approach for segmentation/combination of contracts and the identification of performance obligations. However, these two steps are presented in a mechanical manner that fails to convey why this two-step approach is important to achieve appropriate accounting. We urge the IASB to provide more robust general principles on the contract combination and segmentation on one hand and unbundling performance obligations on the other and on the eventual interaction, if any, between the two. An example illustrating how the two-step approach affects different aspects of revenue recognition (e.g. allocation of discounts, contract modifications) would be useful.

Question 3 — Do you think that the proposed guidance in paragraphs 25–30 and related application guidance is 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?

- (30) We are very concerned that the principles addressing “control”, as currently drafted, do not assist in assessing whether control has been transferred. The notion of control as the basis for revenue recognition is not intuitive, in particular with respect to services. The lack of clarity in paragraph 25-31 and the related application guidance, in our opinion, reflects the fact that the underlying principle itself is not clearly established. Unless the concept of control is developed in a robust and clear manner, it is unlikely that it will assist in improving financial reporting.
- (31) We are concerned that focussing solely on the principle of “transfer of control” and attaching less importance to risks and rewards may result in a too legalistic approach. In general, we believe that economic aspects always need to be given appropriate consideration.
- (32) We agree with EFRAG that, for construction-type contracts in which the asset under construction is not transferred to the customer on a continuous basis, the proposed principle would not provide decision-useful information in some cases, since revenue may not be recognised until the contract is fully complete.

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- (33) The difficulty in applying the control model to services is amplified by the fact that the indicators of control appear to have been developed with sales of goods in mind and are less easy to apply to services. The indicators in 30(b) on legal title and 30 (c) on physical possession are not relevant to services. The indicator in 30(a) on unconditional obligation to pay is likely to remain unsatisfied until the completion of the services at the end of the contract. The treatment proposed would result in revenue recognition being accounted for much later than it would be the case at present, causing a significant change from current practice the relevance of which has not been demonstrated.
- (34) Paragraph 30 (d) refers to customer specificity as an indicator of control. It states that if an entity cannot sell a customer-specific asset to another customer, it is likely that the entity would require the customer to obtain control of the asset (and pay for any work completed to date) as it is created. In practice, a contract may not contemplate that one of the parties would renege on its obligation. Even if the contract addresses this situation it may not specify the compensation that the defaulting party would need to pay or may specify an amount that is not necessarily proportional to the condition of the asset at the time the contract is broken. Hence we question whether this indicator is ever sufficient to establish that control has transferred and whether the amount specified in the contract would provide an appropriate measure of the revenue to be recognised at any point in time for contracts that are expected to be completed in due course.
- (35) Furthermore, as noted by EFRAG as part of the alternative model (Appendix 3 paragraph 4(b)), the assessment of the right of the entity to compensation as work progresses should not be limited to the contract itself but should also include rights that stem from law and law enforcement practices.
- (36) Paragraph 31 states that not one of the preceding indicators determines by itself whether the customer has obtained control. It is not clear what the IASB's intention was with this sentence. It may result in altering the nature of the guidance provided in paragraph 30 from indicators to criteria. We agree with EFRAG that the IASB should further clarify the role of the indicators.
- (37) As indicated in our letter of 19 July 2010 on the IASB Exposure Draft *Conceptual Framework for Financial Reporting: The Reporting Entity*, we agree with EFRAG that it is necessary to provide a definition of control in the Conceptual Framework. This would reflect the fact that control is a pervasive concept, which influences many different aspects of the financial statements and only the specific issues need to be addressed at standard level. We also maintain our recommendation that the IASB considers including a general definition of control at a higher level and ensure consistency with other relevant standards.
- (38) We question whether the description of EFRAG's alternative model as "activity-based" properly captures the key principles in that model. Indeed, we believe that EFRAG's model is closer to the model proposed in the ED than what would be anticipated from a pure activity-based model. A more accurate description would help ensure that EFRAG's model gets the attention it deserves since we believe that it includes principles and guidance that could be used to improve the IASB model. However, we are suggesting some modifications to the EFRAG model to ensure that it captures more appropriately construction contracts that should result in continuous revenue recognition. Please refer to Appendix 2 of this letter for more detail.

Measurement

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 criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

- (39) We agree that when the amount of the consideration is variable, the entity shall recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. However, similar to EFRAG, we do not believe that the expected value method yields an appropriate result in all circumstances.
- (40) In our response of 27 May 2010 to the IASB Exposure Draft *Measurement of Liabilities in IAS 37*, we expressed some concerns regarding the expected value approach. We noted that the expected value technique, based on a probability-weighted average, is most relevant to circumstances when there are large homogeneous populations of items. In the case of smaller populations with high volatility, and particularly for large, unique items, the expected value method would result in significant divergence from the actual outcome. These concerns are equally applicable to this ED. Therefore, we recommend that the IASB reassess the impact of these proposals in the context of non-homogeneous populations.

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?

- (41) We agree that it is appropriate to reflect uncertainty about the customer's ability to pay the consideration in the measurement of the transaction price when it is likely to have material impact on the transaction price. This would be consistent with the proposed criteria to recognise the impact of a financial component.
- (42) Additionally, when the transaction includes both the delivery of a product or service and a loan due to a significant financing component, the discount rate used to calculate the time value of money should be adjusted for the credit risk associated with that customer. In this case the consideration allocated to the financing component is appropriately recognised as an adjustment to revenue.
- (43) However, credit risk should not reduce the recognised amount when it is negligible. These circumstances include most transactions entered into under normal credit terms where the time value of money component of the transaction price is not material. The collectability risk, if any, should be recognised as an impairment of receivables.

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- (44) This appears consistent with the views expressed in BC100. Accordingly, we suggest that paragraph 43 be modified to clarify that the adjustment of the transaction price is required when the transaction contains a material credit risk.
- (45) We agree that the effect of subsequent changes in the assessment of credit risk associated with the right to consideration should be recognised as income or expense, not as 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?

- (46) Like EFRAG, we agree with the proposal that the entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component.
- (47) We also agree that the discount rate should reflect both the time value of money and the credit risk if there is a material financing component in the contract. The entity should present the effect of financing separately from the revenue for goods and services.

Question to constituents

Do you think that the proposals in the ED requiring adjusting revenue for the time value of money would result in significant costs compared to the current practice? If so, why, and do you have any suggestions on how the principle could be applied in a less costly manner?

- (48) While this question is best addressed by preparers, we note that paragraph 11 of IAS 18 already requires recognising interest revenue for the difference between the lower fair value and the nominal amount of the consideration if the inflow of cash is deferred. Therefore, we do not think that these proposals would result in significant costs compared to the current practice.

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?

- (49) We agree with the proposal that the transaction price should be allocated to all performance obligations that are required to be accounted for separately in proportion to the stand-alone selling prices of the good or service underlying each of those performance obligations at contract inception. However, the proposed allocation should be a rebuttable presumption. Where the proportionate allocation does not reflect the underlying commercial substance of a contract, the seller should be permitted to apply a more relevant allocation method.

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- (50) A common situation where the allocation based on selling prices would not make sense is where high margin items are bundled with low margin items. In such situations, allocating the discount proportionally on selling price may result in a loss on low margin items whereas in reality the discount should really be allocated to high margin items (the entity may be granting discount to entice customers to acquire the high margin item). In those cases, an allocation based on relative margin may make more sense. However, this alternative allocation method may not always be the appropriate solution.
- (51) We agree with EFRAG that subsequent changes in a transaction price should be allocated to performance obligations based on the relevant facts and circumstances at the date of the modification since such an allocation is more likely to reflect the economics of the modification. This implies that changes in the transaction price after contract inception should be allocated only to the *outstanding* performance obligations, unless it can be demonstrated that part of the change in transaction price relates to already completed performance obligations.

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 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?

- (52) Overall and similar to EFRAG, we support the proposed criteria for determining whether costs give rise to an asset since this ensures that contract cost should be recognised as an asset if, and only if, they fulfil the requirements of the definition of asset.
- (53) However, we find that the nature of the costs that are meant to be captured in paragraph 59(a) is unclear. We believe that costs of obtaining a contract would sometimes meet all of the criteria in paragraph 57 to be recognised as an asset. However, paragraph 59(a) could be interpreted as indicating that this would never be the case. Accordingly, we request the interplay between paragraphs 57 and 59 be clarified.
- (54) We also agree with EFRAG that costs related to securing a contract should be recognised as an asset if they can be separately identified, recoverability can be reliably estimated and it is highly probable that the contract will be obtained. Commissions paid to an agent, or marketing costs and other costs that are not incremental or directly related to the contract, should not be capitalised. This is consistent with the current requirements of IAS 11, the accounting for loan origination fees and the proposed requirements for insurance contracts.

Question 9 — Paragraph 58 proposes the costs that relate directly to a contract for the purpose 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 and why?

Capitalisation of costs

- (55) Subject to the comments raised in response to question 8, we agree with the costs described in paragraph 58.

Onerous performance obligations versus onerous contract

Question to constituents

Do you agree with EFRAG that the onerous test should be carried out at contract level, and not at performance obligation level? If so, do you, as EFRAG accept that nevertheless loss making performance obligations are reported as such when performed, disregarding when in the course of the contract that performance obligation is satisfied?

- (56) We strongly disagree with the proposal that the entity should perform the onerous test at the performance obligation level since this may result in recognition of a loss at the inception of a contract that will be profitable as a whole. The onerous contract test should be performed at the contract level.
- (57) In day-to-day business, it would be most unusual for an entity to enter into a contract unless the contract as a whole is profitable. While a customer may receive a significant discount on a given item, resulting in a loss on that obligation, this would generally be compensated by higher margins on another item. It is counter-intuitive for an entity to recognise at inception a loss due to an onerous performance obligation within a contract that remains profitable if not suggested otherwise based on facts and circumstances. We agree with EFRAG that the entity should recognise the loss on loss-making performance obligations when the obligation is satisfied.
- (58) We note that the IASB proposes to apply the onerous contract test at the performance obligation level in order to maintain consistency with the objective to reveal different margins on different parts of the contract. However, we consider this approach unnecessary and contrary to economic reality. Furthermore, to the extent that the loss is recognised when the related performance is satisfied, we disagree with the IASB that this would delay reporting any adverse impact on the contract.

Disclosure

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?

- (59) We agree with the proposed disclosure objectives. Similar to EFRAG, we think that the overarching objective for the disclosures is clearly stated. However, we are not convinced that this principle-based approach has been consistently followed in the proposed disclosure requirements and whether these requirements are justifiable on cost-benefit grounds.
- (60) We are concerned that the extensive requirements of paragraphs 73 to 80 will be regarded as a 'minimum list' and could result in a large amount of insignificant detailed information, despite the 'materiality threshold' described in paragraph 70. Accordingly, we would prefer that the requirements of paragraphs 73 to 80 be part of the Application Guidance as possible disclosures that may be relevant to meet the objectives of paragraph 69.
- (61) The reconciliation of contract balances as proposed in paragraph 75 of the ED appears to be particularly burdensome. If the IASB believes that this information is essential to users, an example may assist in clarifying the IASB's intention.

Question 11 — The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

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

- (62) While we agree that it may be useful to provide some information regarding performance obligations, we consider that gathering all the information necessary to comply with the requirements of paragraphs 77 and 78 may be problematic for entities with a high volume of small contracts.
- (63) We also are unclear about the manner in which the IASB expects the information required by paragraph 77 to be presented. We are particularly concerned by paragraph 77(c), which appears to require information at the contract level.
- (64) We question whether the information in paragraph 78 will really provide the information that users seek. Indeed, it cannot really serve as a prediction of future revenue since it reflects existing contracts only.

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- (65) We acknowledge that a separate disclosure of the future performance obligations would provide potential benefits in analysing trends in the amount and timing of revenue and assessing risks associated with future revenues, for example order receipts or order backlogs. However, we fail to see how the disclosures required under paragraph 78 would meet this expectation.
- (66) It should also be noted that this information is forward looking and accordingly would be more appropriately included in other parts of annual report such as in the management commentary.
- (67) Furthermore, the commercially sensitive data included in disclosure about onerous performance obligations in paragraphs 79 and 80 raise concern. They can reveal the entity's business approach on how it obtains a contract. We recommend that the IASB reconsiders this disclosure requirement from a competition point of view.
- (68) We also question the usefulness of the information required by paragraph 81. The information produced in response to this requirement may be "boilerplate" in nature.
- (69) Finally, the information required may trigger significant audit implications. We urge that IASB reconsiders the disclosure requirement in paragraph 81 in the context of practical application; where necessary it may consult with the IAASB.

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?

- (70) We agree with EFRAG that the disaggregation of revenue will not be uniform based on the examples provided in paragraph 74 of the ED. The wording needs to reflect that the categories could have more dimensions – for example a given product on a given marketplace.
- (71) We note that IFRS 8 Operating Segments already requires some disaggregation of revenue. The examples provided in paragraph 74 of the ED, and their relative ranking, should be reassessed to ensure greater consistency between the two standards.

Effective date and transition

Question 13 — Do you agree that an entity should apply the proposed requirements retrospectively (that is, as if the entity applied the proposed requirements to all contracts in existence at the effective date and in the comparative period)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost to preparers? If so, please explain the alternative and why you think it is better.

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- (72) In our opinion, retrospective application is the preferred method.
- (73) Since the retrospective application of the requirements proposed by this ED is likely to be burdensome, especially in the case of long-term construction contracts where the entity would be required to segregate contracts that were entered into many years ago, it is crucial that an extended lead time be provided between the issuance of the final standard and its effective date.

Question to constituents

Assuming that the proposals are to be applied retrospectively, how many years do you think would be necessary to implement the new requirements?

- (74) This question primarily is best answered by preparers of financial statements. To be able to apply a new standard, entities may need to adjust their financial information systems, specifically in cases where a new standard will lead to more unbundling, and/or will lead to a different timing or a different amount of revenue recognition.
- (75) We think that at least two full reporting periods between the date of issuance of the standard and the effective date are necessary. For example, if the standard is issued in 2011, the effective date should be for reporting periods starting after December 31, 2013. Entities would then have reasonable time for preparation to be able to apply the requirements of the standard to contracts as of 2013 (which would then be the basis for the comparative figures in the first financial statements under the new standard).

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 proposal operational? If not, what additional guidance do you suggest?

- (76) We agree with EFRAG that application guidance is not an appropriate means to address lack of clarity in the principles. We believe that the IASB should endeavour to establish clear and robust principles.
- (77) In our opinion, the proposed application guidance needs to be reassessed to ensure that it demonstrates how the principles are meant to be applied. Currently, the conclusion in some of the examples is the result of a very specific fact pattern. It would be preferable for the illustrations to explain how the facts contribute to the principle being met (e.g. example 2 as described in paragraph 20).
- (78) We also share the view that it may be necessary to include some guidance to address industry-specific issues.

Question to constituents

Do you think that the application guidance is sufficient to make the proposals of the ED operational in particular industries or are there any issues requiring specific consideration? If so, what are the issues?

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- (79) We agree with EFRAG's observations in paragraphs 98 to 99 of its draft comment letter. We are not aware of any other issues requiring specific consideration in the application guidance.

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?

- (80) We note that the IASB reconsidered the position expressed in the DP in response to the feedback received from respondents. Accordingly, the ED draws a distinction between a quality assurance warranty to cover the defects that exist in the product prior to the transfer to the customer, and an insurance warranty to cover the faults that arise after the product transferred to the customer. In both cases the ED proposes deferral of revenue, albeit for different amounts.
- (81) In practice, the differentiation between quality assurance warranties and insurance warranties will often be difficult. We note that the IASB tries to address this problem by describing some factors that should be considered in assessing the type of product warranties (paragraph B18). However, in our opinion, additional guidance would be necessary.
- (82) We agree that quality assurance warranties (included any required by law) should be distinguished from extended warranties. We agree that goods that will be replaced under a quality assurance warranty should be considered as "failed sales".
- (83) However, we believe that a further distinction should be made within the quality assurance warranty category to distinguish the defects that result in an outright replacement of the original item from other defects that will be resolved by repairing the original item. While we agree that the first type of defects should be treated as a failed sale (with revenue on the original sale being deferred), we believe that where the defective item will be repaired a provision for the costs to be incurred should be recognised.

Appendix – Comments on Appendix 1 and 3 of the EFRAG draft comment letter including responses to the questions in the Invitation to comment of IASB Exposure Draft on Revenue from Contracts with Customers

Question to constituents

Do you agree with the proposals in the ED regarding accounting for and distinguishing between a warranty and a failed sale? If so, on what basis should the distinction be made?

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

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

- (84) We do not agree that exclusivity, own its own, is the correct criterion for determining the pattern of revenue recognition. Exclusivity represents a bright-line distinction that may not be reflective of the performance obligation pattern of the underlying contract. A supplier may or may not have an ongoing performance obligation, but does not necessarily have one just because an exclusive licence has been supplied. We suggest that the IASB reconsider its position by taking into account the performance obligation pattern of the underlying contract for recognising revenue.
- (85) If the criteria were to be maintained, there might be application issues in respect of the unit of account and derecognition. For instance, an entity owns all worldwide rights associated with an intangible asset and, by contract, provides to a third party the exclusive right to use within a single country while retaining all rights in all other countries. If the exclusive right to use within one country is granted for (substantially) all of the intellectual property's economic life, the proposals in paragraphs B33, B34 and B37(b) seem to imply that the contract should be treated as a sale rather than a licensing of intellectual property. There is a need to clarify whether the entirety of rights is the unit of account in this case and whether a part of the intangible asset would be derecognised to reflect the sales contract. The final document should also set out how the previous carrying amount of the intangible asset would be allocated between the part that continues to be recognised and the part that is derecognised.



Appendix – Comments on Appendix 1 and 3 of the EFRAG draft comment letter including responses to the questions in the Invitation to comment of IASB Exposure Draft on Revenue from Contracts with Customers

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?

- (86) We agree with EFRAG that the requirements for recognition and measurement of gains or losses on the sale of some non-financial assets should be consistent with the requirements of the new standard.

APPENDIX 2

EFRAG's alternative model for revenue recognition

Questions to constituents

1	Are there issues that you would see in applying the proposed alternative model? If so, how could the model be further developed?
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(87) We note that the model proposed by EFRAG is not a pure activity-based model and therefore this should be clearly articulated. It deviates from such a model by restricting revenue recognition to circumstances where the entity holds an enforceable right to receive compensation for any of the work performed to date (subject to continued performance). We believe that this condition will result in excluding from the percentage of completion method many of the construction contracts that are currently dealt with under IAS 11.

(88) Indeed, we believe that the enforceable right to compensation by the seller is often a right to a “fair compensation”. For example, the amount of compensation that the seller would be entitled to receive from the customer in case of cancellation will take into account the ability of the seller to find an alternative buyer for the partly constructed item (including any costs required to standardise the item). Because the enforceable right held by the buyer does not cover all of the work performed to date, it would appear to fail to meet the criteria established in the EFRAG model.

(89) In our view, EFRAG should consider whether the following conditions would not capture more appropriately the contracts that should result in continuous revenue recognition as part of an activity-based model:

- a. Existence of a contract clearly establishing a link between the work being performed on a specifically identified asset and a specific customer. We would expect that the contract would be cancellable only in force majeure situations.
- b. Enforceable right of the seller to receive fair compensation for the work performed at any point in time (subject to continued performance by the seller).