THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND

KS/ASC-SUB/ks-mb

Ms Francoise Flores
Chairman
European Financial Reporting Advisory Group
35 Square de Meeûs
B-1000 BRUSSELS

30 September 2010

Dear Ms Flores

IASB EXPOSURE DRAFT ED/2010/6: REVENUE FROM CONTRACTS WITH CUSTOMERS

The Institute's Accounting Standards Committee has considered the above exposure draft and is pleased to forward a copy of the response letter to be submitted to the IASB – please see attached.

Yours sincerely

Karen Shaw

KAREN SHAW
Assistant Director, Accounting and Auditing
Secretary to the Accounting Standards Committee

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
LONDON
EC4M 6XH

October 2010

Dear Sir David

IASB EXPOSURE DRAFT ED/2010/6: REVENUE FROM CONTRACTS WITH CUSTOMERS

The Institute's Accounting Standards Committee has considered the above exposure draft and I am pleased to forward its comments to the IASB.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Accounting Standards Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The Committee fully supports the IASB in its efforts to draft a new revenue recognition standard to replace the existing IAS 11 and IAS 18. However, we are concerned with the substance of some of the proposals within the exposure draft. Adopting a model where revenue is recognised according to who "controls" the asset allows more scope for manipulation than would be allowed under a "stage of completion" model. Further guidance is also needed to explain how the "continuous transfer" approach would be used in practice.

We are particularly concerned that the guidance contained within the exposure draft will not be sufficient in a number of areas, in particular around construction contracts and service contracts. These are particularly difficult areas of accounting and we do not believe the illustrative examples are sufficient to explain how the principles should be applied in practice.

The Committee questions whether a revenue recognition standard is the most appropriate place to include criteria for the recognition of an asset – it would be more suitably included in another standards, for example IAS 2, given that the principles apply wider than simply revenue recognition.

Our responses to the specific questions can be found in the annex to this letter.

I hope our comments are useful to you. If you wish to discuss anything further please do not hesitate to contact me.

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ANNEX: RESPONSES TO SPECIFIC QUESTIONS

Question One
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?

The Committee agrees with the principle proposed in paragraphs 12-19. However, we do believe that the definition of a principle should be clear and concise and eight paragraphs of explanation risks obscuring the clarity of the definition. Keeping the definitions of underlying principles simple also aids in the translation of the principle into other languages.

We agree it is important to include practical examples illustrating to the reader how the principle should be applied in practice. However, we are concerned that the examples included within the application guidance could lead to more confusion, in particular Example 2. Paragraph 14 of the ED explains that the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount based on the existing customer relationship resulting from the previous contract – yet Example 2 seems to suggest the opposite. We strongly urge that this example be made clearer and explanation provided as to why this does not contradict the principle in paragraph 14.

Question Two
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?

We support the proposed principle for determining whether a good or a service is distinct with one qualification: we believe that it is the entity's own business practices which should be taken into account and not those of another entity. Therefore we would support the wording in paragraph 23 (a) being changed to reflect this.

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

We do not believe that the "contract" is a suitably objective measure for determining when control transfers to the customer and are concerned this might allow for manipulation of the timing of the transaction. For example, a dominant customer could decide when to take control of goods/services and negotiate the terms of the contract accordingly, thereby influencing the timing of revenue recognition by the seller. We strongly encourage the IASB to consider using a "continuous transfer" approach to determine control which is more reflective of the current accounting model in IAS 11. We also consider that additional guidance is required to clarify the conditions under which this approach should be used.

Question Four
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 an estimated transaction price. However we do not believe that the expected value approach is always the most suitable approach to estimate the transaction price. We raised a similar concern in our response to the IAS 37 exposure draft stating that we do not believe it is suitable for use on small populations and can create an illusion of accuracy.

We consider that the methodology used in Example 19 should be explained more clearly – for example by including two illustrative examples, one with a performance bonus and one without, rather than incorporating a potential refund. We also note that it is not clear from Example 19 exactly how in the final paragraph the figure of CU110,000 was reached.

Question Five
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?

The Committee agrees with the approach proposed in Paragraph 43 and we support the recognition of the customer's credit risk where its effects on the transaction price can be reliably estimated. We also agree that the customer's credit risk should affect how much revenue an entity recognises rather than the timing of satisfying the performance obligation.

Question Six
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?

The Committee agrees with this proposal.

Question Seven

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?

The Committee agrees that the initial transaction price of a performance obligation should be allocated in proportion to the stand-alone selling price (estimated if necessary). However, we are concerned about the implications of applying this approach where there are subsequent changes in the transaction price – there is a need to take into account the relevant facts and circumstances to ensure that a sensible outcome is achieved which reflects the economic reality of the transaction.

We are also concerned how this allocation might impact on the proposed requirement for onerous performance obligations. We would prefer an approach which tested whether a contract is onerous at an overall contract level. However, where a liability is to be recognised for an onerous performance obligation, despite the overall contract being profitable, we would support an alternative approach of allocating the transaction price to the separate performance obligations so that no performance obligation would be deemed onerous.

Question Eight
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 operation and sufficient? If not, why?

The Committee does not believe that an accounting standard dealing specifically with the topic of revenue recognition should include the criteria on whether contract costs should be capitalised. Capitalisation of contract costs has wider implications than this standard and the principles would be more appropriately included in another standard, for example IAS 2.

We agree with the principle that costs should be capitalised where those costs are directly attributable to the contract. However, we do not agree that the costs associated with securing the contract should always be expensed. In the UK, once a bidder attains preferred bidder status costs beyond this point are generally capitalised if they are expected to be recovered. We believe that this is appropriate and would not support the restrictions in the exposure draft which would result in some of these costs being expensed. Where costs meet the definition of an asset then they should be capitalised. We would support guidance on what types of costs incurred in securing the contract should be capitalised but we believe that the proposed guidance is too restrictive and results in costs being inappropriately expensed.

Question Nine
Paragraph 58 proposes the 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

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performance obligation.

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

We agree with the costs specified in paragraph 58. We also agree that the determination of whether or not a contract is onerous should be based on the full direct costs.

However we do not believe that a probability calculation is the most appropriate method for measuring onerous performance obligations – this method is only suitable where there is a large population and we believe it will not produce the most reliable information for the user. As we have already stated in our response to Question 7, we would prefer that the "onerous test" was performed at a contract level and not at an individual performance obligation level.

Question Ten

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?

The Committee agrees with the proposed objective of the disclosure requirements and we believe that the proposed disclosures will satisfy those objectives.
We note that it would be useful to include an illustrative example demonstrating the application of the reconciliation of contract balances in paragraph 75.

Question Eleven

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?

The Committee agrees with the proposed disclosure requirement.

Question Twelve

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?

The Committee was not entirely in agreement with this proposal. Although some Committee members were happy with the proposal, others questioned how the proposal fits with the current requirements of IFRS 8 which require disclosure of revenue by operating segments, as well as entity-wide disclosures relating to revenues by product/service and by geographical area. The Committee urges the IASB to ensure that the proposed requirements do not duplicate or even conflict with the provisions of IFRS 8.

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Question Thirteen
Do you agree that an entity should apply the proposed requirements retrospectively (i.e. as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

Is there an 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.

The Committee agrees with this proposal to apply the requirements retrospectively.

Question Fourteen
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?

The Committee believes that more illustrative examples are needed in certain areas. In the case of construction contracts, we believe that there is a need for more examples covering a variety of circumstances. We also believe there is a need for more guidance on the accounting for service contracts. Applying the concept of "control" to services is much more difficult than applying it to goods and therefore more illustrative examples would be helpful.

Question Fifteen
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?

The Committee agrees with the proposed principle. However we are concerned at how this requirement will be applied in practice. It is difficult to prove definitely that a fault was a latent defect as opposed to a defect due to wear and tear. Ultimately this will be a matter of judgement for management.

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

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

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

The Committee is not convinced that exclusivity is the most appropriate basis for distinguishing between licensing agreements. In addition, the Committee questions whether this would be more appropriately dealt with within the scope of the leasing project.

Question Seventeen

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?

The Committee supports this proposal.

Additional Specific Comments

It is intended that as a result of this IFRS, IAS 18 will be withdrawn. IAS 18 contains requirements relating to revenues arising from the use of others of entity assets yielding interest, royalties and dividends. Although some of these will be covered by the proposed requirements, the Committee believe that the IASB should clarify where the accounting for dividend and other non-contractual income streams is now dealt with in the standards.

With specific reference to the scope exemption in paragraph 6(e) the Committee believes that the word "homogeneous" should be included to make it clear that it is identical products which are being referred to (as explained in BC 25).

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