ICAC comments on EFRAG's Draft Comment Letter on IASB's Exposure Draft ED/2010/6 Revenue from contracts with customers

General comments

ICAC is pleased to give its comments on this project and we appreciate the effort made by the corresponding boards in asking and taking into account the input from different organisations.

Firstly, giving the significance of the issue "Revenue recognition" for many reasons, like the calculation of the profit or loss of the year, company's classifications depending on certain thresholds, performance evaluations, tax implications in some countries..etc, we find that the ED lacks of further explanations; for example:

> Paragraph IN 25 states that "*for some contracts the proposed requirements would have little, if any effect on current practice. However, the proposed requirements would differ from current practice in the following ways:…(a) the construction contract: "if the customer controls the asset as it is developed" (b)separate performance obligations: "might separate a contract into units of accounting that differ from those identified in current practice." (c) licences:"the pattern of revenue recognition might differ from current practice"….*"

The boards have been too schematic or summarising when describing the impact of the new standard. Many affirmations like the ones stated before, assume that the reader will know immediately the effect of the change in that issue, and it is just the opposite. It should be assumed that the reader is getting to know the change through the ED, the content and effects of the change being proposed. We would appreciate more extension on its reasonings and more examples of "how it was treated before", and "how it will be accounted for in the future according to the proposals in the ED" all along the Exposure Draft.

We would like to highlight the need of more clarification by examples in the ED, and also we have noted a lack of reasoning between "how it is accounted with the current standard" and "how would it be accounted for in accordance with the proposal", this issues would be much appreciated and would ease the understanding of the project proposals.

ICAC's answers to the issues raised on EFRAG's draft Comment Letter

EFRAG 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?

In relation to question (a), as it is stated above, ICAC agrees with the proposal of developing one unique standard on revenue recognition that supersedes IAS 11 and 18.

Regarding question (b),

EFRAG's activity based approach, as we have come to understand from Appendix 3, it seems to propose, for certain transactions, the same issue as it is already covered by paragraph 16 of IFRIC 12:

> "*The operator shall recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.*"

So, if IFRIC 12 will continue to be applicable after the new standard on Revenue is developed, it doesn't seem to be necessary to clarify accounting for operations covered by Appendix 3 of EFRAG's comment letter.

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.

ICAC finds reasonable the proposed approach based on price interdependence, for combining and segmenting contracts.

In relation to contract modifications, we find the proposals not easy to understand and in some cases unnecessarily confusing. We suggest that the boards should clarify the treatment of contract modifications, as they have been very much developed and have become much more specific in the ED in comparison to IAS 11 and IAS 18.

The ED requires distinguishing different types of modifications:

1. **Changes in the amount of consideration**:

   In paragraph (p.16) the ED states:" *If an entity segments a contract…shall allocate the total amount of consideration to each identified contract in proportion to the stand-alone selling prices of the goods or services in each identified contract. An entity shall allocate subsequent changes in the amount of consideration only to the identified contract to which those changes relate…*"

   We agree with this approach.

2. **Contract modifications**:

   In relation to the following paragraphs:

p.17: "*A contract modification is any change in the scope or price of a contract*…"

p. 19: "*An entity shall account for a contract modification together with the existing contract if the prices of the modification and the existing contract are interdependent. In that case, the entity shall recognise the cumulative effect of the contract modification in the period in which the modification occurs. Hence, the cumulative accounting after the contract modification shall be the same as it would have been if the modification had been included in the existing contract. If the prices of the contract modification and the existing contract are not interdependent, the entity shall account for the contract modification as a separate contract*."

The ED gives very different accounting treatment depending on interdependency of prices: either recognise the total cumulative effect of the modification in the year of the modification (in an extreme situation it could even lead to no-revenue recognised), or recognise the effect of the modification along the subsequent periods.

Interdependency as it is covered in paragraphs 13, 14 and 15 of the ED seems to be more useful in order to segment or combine contracts (entered at the same time, single commercial objective and concurrent or consecutive performance) (separate selling and not significant discount), but not for contract modifications. We refer to Example 2 of the ED, it does not give a clear reasoning for the interdependency of prices in contract modifications: "*Although the services are provided continuously, the price of the services in the first two years and the price of the subsequent services are negotiated at different times and in different market conditions (as evidenced by the significant change in the stand-alone selling price of the service)*." In our opinion this will happen in most contract modifications.

Paragraph BC84, when treating subsequent changes in the transaction price in variable considerations, it states: "*After contract inception, an entity revises its expectations about the amount of consideration to be received as uncertainties are resolved or new information about remaining uncertainties becomes available…the board decided that the entity should update its estimate of the transaction price …The boards believe that depicting current conditions would provide more useful information to users than retaining the initial estimates, especially for long term contracts subject to significant changes in conditions during the life of the contract*."

In line with the preceding paragraph, p. BC85 continues saying: "*The boards rejected the alternative of recognising the entire amount of a change in the estimate of the transaction price in profit or loss when that change occurs. In the boards view, that alternative could result in a pattern of revenue recognition that does not faithfully depict the pattern of the transfer of goods or services. Moreover, recognising revenue immediately (and entirely) for a change in the estimate of the transaction price, would be prone to abuse in practice*."

The reasoning of the two paragraphs stated above seem to account differently transactions that may be economically similar "a change in an estimate of the transaction price (p.BC84-85)" in comparison to "a contract modification (we refer to p.19 stated before)". As we mention in the following paragraphs, there are many estimates in determining transaction price, therefore we think there is, in practice, a very thin line dividing some "contract modifications" and "transaction price modifications". We suggest the boards revising this issue.

Therefore, giving the importance of the issue, we suggest the boards to work for more clarity in the accounting for contract modifications. Also taking into account other possibilities like those covered in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

3. Changes in transaction price to performance obligations

With regard to the following paragraphs**:**

p.53: "*After contract inception, an entity shall allocate any changes in the transaction price to all performance obligations on the same basis as at contract inception. Amounts allocated to satisfied performance obligations shall be recognised as revenue, or a reduction of revenue, in the period in which the transaction price changes. An entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception*."

In BC 87 the boards state that an entity should allocate a change in the transaction price to all performance obligations in the contract because the cumulative revenue recognised would depict the revenue that the entity would have recognised if, at contract inception, it had the information that was available at the subsequent reporting date. Consequently, the transaction price that is allocated to performance obligations that have already been satisfied would be recognised as revenue immediately.

In our opinion, this is one possibility, but not the only one. Indeed some changes in transaction price may require determining "*the cumulative revenue recognised would depict the revenue that the entity would have recognised if, at contract inception, it had the information that was available at the subsequent reporting date*."

But some changes in the transaction price of the contract may also occur because of new circumstances or new directives for example; that normally will only take into account subsistent performance obligations for the renegotiation of the price, and, with no relation to the price interdependence that existed at the inception of the contract. Because price interdependence, also depends on other external factors that may have changed.

In BC88, when considering the allocating of the "*change in transaction price only to that performance obligation to which the uncertainty primarily relates, the boards argue that they rejected because the goods or services in a single contract have interdependent prices".*

This approach, as we have understood, requires to identify within a contract, each separate performance obligation (p.23*: "A good or service, or a bundle of goods or services, is distinct if either: (a)..(b)…*"), but the revenue recognised related to each performance obligation, in each period, will be conditional or subordinate, to the continuance of the contract under the same conditions until the end. If any performance obligation causes any modification on the transaction price, the entity will have to re-evaluate and allocate this change to the rest of performance obligations, the ones already performed and the existing ones.

In our opinion, it is reasonable to recognise the amount of revenue according to the price interdependency between obligations at the inception, as it represents the terms signed by both parts in the contract and interdependency of prices at that date. According to the ED, subsequent changes of the transaction price (even though if those changes only relate to remaining performance obligations) will affect revenue recognised in earlier periods in already performed obligations. It doesn't seem to be totally in line with p.25: "*An entity shall <u>recognise revenue when it satisfies a performance obligation identified</u> in accordance with paragraphs 20-24 by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service*."

Moreover, we wonder whether the reasons set by the boards in p.BC88 would lead to a revenue recognition criteria consistent with the "performance representation" requirement set in BC73: "…*an entity must determine the amount of performance obligations satisfied during each reporting period - ie the entity must <u>measure its performance</u>*.". And paragraph BC74: "…*an entity should select a revenue recognition method that <u>best depicts the entity's performance under the contract</u>. …an entity performs only when it transfers goods or services to a customer*."

BC88 continues saying "*Allocating a change in the transaction price to only some performance obligations would be inconsistent with the requirement to allocate the transaction price at contract inception to all performance obligations on a relative selling price basis...would result in a lack of discipline on how an entity should identify separate performance obligations and allocate consideration to them*."

We don't see this lack of discipline, when a good or service is transferred, a performance obligation is performed, and its revenue recognised according to the transaction price allocated to it within the terms of the contract. Any subsequent changes should reflect the real evolution of the entity's performance of each obligation, the economic substance of the performance obligation, not only price interdependency.

The relative selling price basis takes into account the total number of performance obligations in the contract at the inception date, so if some performance obligations have been performed after a time, they do not continue forming part of the contract, they have disappeared from the totality, control has been transferred, and therefore relative selling prices of the obligations remaining have changed over the time, this also influences new circumstances and possible transaction price changes, inherent to any contract, that nothing has to do with performance obligations already satisfied and their relative selling prices at the inception. Unless those changes relate to that performed obligations.

4. Estimations

As stated in several paragraphs of the ED, many of the requirements are based on estimates, evaluations, allocations…; therefore we suggest to consider maintaining what is said <u>in p. 38 of IAS 11</u> "…*the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract,* *is accounted for as a change in accounting estimate (see IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors). The changed estimates are used in the determination of the amount of revenue and expenses recognised in profit or loss in the period in which the change is made and in subsequent periods*."

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?

ICAC supports EFRAG's view that in considering whether goods or services are distinct, the entity's own customary business practice should be considered rather than the business practice of any other entity.

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?

In relation to the "control model proposed" in the ED, we suggest the boards to introduce more explicit and clear examples on "acquisition of control of goods or services". For example, explanation in BC65 does not give a clear answer about the treatment for construction contracts, it states "*…the customer receives the promised goods or services during construction only if the customer controls the work in progress. In contrast, if the customer does not receive the goods or services until the work is completed, the entity would not recognise revenue until then.*"

Additionally and related to our general comments, there has been a change in the model as present IAS 18 talks about transmission of risks and rewards and control as both necessary in order to recognise revenue, and the ED only talks about control. We think the ED should include examples that reflect how the new control approach modifies the recognition of revenues, especially in comparison to present IAS 18.

In relation to EFRAG's comments on "perspective" we support the ED's perspective on control, the customer's perspective. According to paragraph 26 of the ED:

> "*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 through substantially all of its remaining economic life or to consume the asset. Control includes the ability to prevent other entities from directing the use of and receiving the benefit from a good or service".*

In line with paragraphs BC60 (a) the "control" model of accounting revenue proposed in the ED, seems more consistent with the Conceptual Framework:

According to the Framework:

P49.a) "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity"

p89: An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

About the indicators for determining whether control of a promised good or service has been transferred to a customer included in paragraph 30 and 31 of the ED, we agree with EFRAG's comments. From our point of view, indicators should give more information, especially p.30(b) mentions the "legal title" but in the end it says that "however, in some cases, possession of legal title is a protective right and may not coincide with the transfer of control to a customer".

Finally, when getting to paragraph 31 it increases uncertainty by saying that "no one of the preceding indicators determines by itself whether the customer has obtained control of the good or service."

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 reasonable 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?

We find reasonable the indicators of the ED.

Finally, in relation to variable consideration for "revenue recognition", brings us to mind if the recognition criteria are the same contained in IAS 37 for contingent assets, and the need of having a coherent accounting treatment for both.

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?

ICAC does not agree that a customer's credit risk should affect how much revenue an entity recognises. In this sense, the sales of good and the rendering of services reflect the performance of the entity arising from it's ordinary activity and the true and fair view of such performance cannot be obtained including the credit risk of the customer, which has different nature.

We believe users of financial statements obtain more relevant information if they are able to see in separate lines of the income statement the amount revenue derived from the sale of goods or rendering services and the expenses due to customer's credit risk.

In addition, we must bear in mind that the amount of such revenue is taken into account for auditing and other legal purposes, so in our opinion it should not be affected by estimations of the credit risk.

Finally we wonder if the objective of the initial adjustment of the transaction price included in paragraph 43, is to go towards the "expected loss model" included in the IASB's ED on amortised cost and impairment.

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?
55 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?

On one hand, we agree with the proposal to adjust the amount of promised consideration to reflect the time value of money if it is material. Nevertheless, we would like to highlight the need of "materiality" in order to adjust the amount of the consideration to reflect the effect of time value.

When the customer pays in advance or after the recognition of revenue, revenue should be measured at the fair value of the consideration at the date it is recognised and not when the payment is received, so therefore the financing component should be recognised separately from revenue from goods or services.

We have noted that the boards have used a "capitalisation method" to determine the transaction price in order to reflect the time value of money. We suggest the board to consider a "discount method", in which transaction price would be measured at the "fair value of the consideration at the transaction date". So, payment received in advance comprises principal plus interests.

In relation to the treatment given to the entity in relation to the "time value of money" in the ED: Will it be the same for the customer? Will the customer have to actualise? And when accounting this issue in other standards like IAS 16 and IAS 38, will it be the same for the seller and the buyer? We don't see the answer clear in the ED.

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?

ICAC generally supports EFRAG's views.

We agree with the definition of stand-alone selling price of a good or service as the price at which the entity would sell a good or service separately to the customer. Also we find it reasonable to require an entity to allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception.

According to the ED, after initial inception, an entity shall allocate <u>any changes</u> in the transaction price to all performance obligations in proportion to the stand-alone selling price of the good or service at contract inception.

We think that two different situations can be distinguished:

> (a) If it is possible to determine that the cause of the change is directly related to a concrete obligation, in order to reflect more faithfully the substance of the transactions, changes should be allocated to that performance obligation. This result in giving important information to users of financial statements in relation to the obligation affected. This would be in line with EFRAG's view in taking into account the different facts and circumstances.
>
> (b) If the causes of the change can not be determined to be related to one or more concrete obligation, then a good method of allocating transaction price method would be the stand alone selling price at the inception.

We believe that the proportion of the stand alone selling price at contract inception should be a "subsidiary/alternative/residual" method, in case price changes can not be allocated to a concrete obligation.

We also refer to our answers to questions 1 and 4.

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?

In our opinion the cost incurred in securing the contract should be capitalised in the terms covered in paragraph 21 of IAS 11, which should be maintained in the new revenue recognition standard:

> "*Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a*

> *contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period*."

We also believe that commissions paid for getting a new contrarct be eligible for capitalisation,, and be recognised as an expense as stated in p.59 (a).

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?

We agree with the cost specified, taking into account our response to question 8.
We wonder if the ED in some circumstances may be contradictory with "performance reporting" philosophy. We think that the outcome of transactions should be reported at "good or service" level. Each performance obligation should be reported individually with its positive or negative outcomes (liabilities) related to it.

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 find the objective proposed reasonable and, in relation to the disclosures, we find the boards have given an important extension to the requirements demanded to entities, extension that some may argue that they are excessive.

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?

We refer to question 10.

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?

ICAC agrees with de disaggregation.

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.

ICAC agrees that the proposed requirements should be applied retrospectively.

Related to our general comments, we suggest the boards, to include some examples of how the new standard could affect previous transactions accounted under IAS 18..

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?

We generally think that the application guidance is sufficient, except what relates to "contract modifications" as we have pointed out in our answer to question 1.

In relation to paragraph 99 of EFRAG's draft comment letter related to contracts in which the customer does not pay the full amount of consideration for goods or services received, we agree with EFRAG's proposal.

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?

Conceptually ICAC agrees with the ED proposal of distinction between both types of product warranties, although it is not clear for us the difference of their accounting regime.

In addition we would like to highlight that the ED is not clear about the measurement after recognition of warranties in letter a), in particular as regards the allocation to profit and loss. Examples on warranties and clarification would be of great usefulness.

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?

We agree with EFRAG's Alternative 3: a 'rights to use' is in substance a leasing agreement regardless of whether the right relates to the use of tangible or intangible assets. We therefore think that such arrangements should be scoped into the new standard on leases instead of being dealt with in within the revenue standard.

We also would like to note the interaction that exists between service contracts and leases. So therefore we suggest the boards to further explore this issue-The need to distinguish clearly between service contracts and leases. We believe that this distinction is hard to make in practice.

In addition to EFRAG's arguments, we think that for these licences, an entity will normally find it difficult to apply all requirements set in paragraph 2 of the scope in ED.

In case the proposals of the ED are maintained in the final standard, we agree with the ED.

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?

We find the proposal reasonable and we refer to the last paragraph of our answer to question 6.

Madrid, 30 September 2010