EFRAG
European Financial Reporting Advisory Group

DRAFT COMMENT LETTER
Comments should be submitted by 22 September 2010 to
Commentletters@efrag.org

Notes to constituents: During EFRAG's consultation period, EFRAG will consult with preparers from different industries to learn about industry specific issues related to the IASB exposure draft.

XX October 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Revenue from Contracts with Customers

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, *Revenue from Contracts with Customers* ('the ED'). This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRSs in the European Union and European Economic Area.

Under current IFRSs, there are two main standards on revenue recognition – IAS 11 *Construction Contracts* and IAS 18 *Revenue*. EFRAG acknowledges that the standards are based on inconsistent principles, and experience shows that some practical application questions remain unanswered.

The IASB and FASB have jointly decided to develop a fully-converged revenue standard based on a single set of principles for recognition and measurement that would be applied to revenue-generating activities in contracts with customers only.

EFRAG welcomes the work being carried out on this subject. In our opinion, revenue recognition is the cause of some practical problems and a fully-converged and simplified standard will be beneficial to financial reporting. Furthermore, EFRAG recognises that revenue recognition involves significant conceptual issues, including performance reporting, and therefore believes that a fundamental overhaul of the existing standards is appropriate.

In EFRAG's view, the driving factor for preparing standards on financial reporting should be information usefulness. EFRAG is concerned that the ED has been issued without thorough conceptual debate on why revenue is an important figure, what it should represent and why it provides useful information.

The ED proposes that revenue should be recognised only when control of goods and services is transferred to the customer. EFRAG does not support that model and considers that the IASB has not explained why the proposals would result in useful information. Without awaiting the finalisation of the conceptual framework, but prior to completing this project, we encourage the IASB to examine how the revenue figure could be most useful.

EFRAG believes that financial statements would be most decision-useful were revenue to be considered a measure of activity carried out to fulfil a contract with a customer, subject to specific conditions being met. In Appendix 3 to this letter, EFRAG presents an alternative activity-based revenue recognition model and explains why it would result in information that is more useful. In EFRAG's view, such a model would trigger fewer changes to existing revenue recognition patterns than the IASB's proposals. In Appendix 3, EFRAG responds also to the arguments the IASB has put forward to reject an activity-based revenue recognition model.

In the Basis for Conclusions to the ED, the IASB infers that the proposed model will bring discipline to the earnings process approach. While EFRAG may agree that the proposals have such potential, this improvement does not justify in itself the fundamental change made to the revenue recognition model. A change in the revenue recognition model may prove costly for both preparers and users of financial statements. EFRAG believes that these costs should be justified. We note that a proper assessment should be carried out to conclude whether the benefits of a new standard on revenue recognition would outweigh its costs.

Putting aside EFRAG's fundamental concern regarding the model for revenue recognition and focusing on the model proposed, we agree with many of the requirements proposed in the ED. Our detailed comments on the ED – which are set out in Appendix 1 and 2 to this letter – can be summarised as follows:

- EFRAG supports overall the proposed guidance on combining and segmenting contracts and contract modifications.

- Generally, EFRAG supports the proposed guidance for separating performance obligations. However, in considering whether a promised good or service is distinct, EFRAG believes that only an entity's own customary business practices should be considered, rather than the business practices of other entities.

- EFRAG considers that the definition of control should be developed at the conceptual framework level to ensure consistency across the standards and has concerns in relation to how the notion should be applied in the context of revenue recognition for service contracts. Additionally, EFRAG is concerned about the usefulness of the indicators included in the ED for determining whether control of a promised good or service has been transferred to a customer.

- EFRAG does not think that a customer's credit risk should be reflected in revenue.

- EFRAG believes that subsequent changes in the estimated transaction price should be allocated to different performance obligations based on facts and circumstances, rather than automatically in proportion to the stand-alone selling prices.

- EFRAG does not consider that an entity should recognise a liability if a performance obligation included in an overall profitable contract is onerous.

Our comments should be read in the context of existing IFRSs. We recognise that future developments in standards – for example, derecognition of financial instruments, insurance contracts and the Framework – will have implications on the principles underlying a general standard for revenue recognition in contracts with customers.

If you would like to discuss our comments further, please do not hesitate to contact Rasmus Sommer or me.

Yours sincerely

Françoise Flores

EFRAG, Chairman

APPENDIX 1

EFRAG's responses to the questions asked in the exposure draft

General comments

1 EFRAG has a fundamentally different view as to what revenue is and when it should be recognised to the one proposed in the ED. However, rather than repeating this point throughout our responses to individual questions, EFRAG has chosen to answer the questions asked in the ED on the basis that the 'control model' for revenue recognition – that revenue is recognised only when the customer obtains control over the good or service transferred by the entity – would be applied. The activity-based approach that EFRAG favours and the main differences and similarities between this approach and the model in the ED are discussed in Appendix 3.

2 It should also be noted that a minority of EFRAG members think that the benefits achieved by the activity-based approach presented in Appendix 3 could be achieved by keeping, but amending, IAS 11 and IAS 18.

3 Appendix 2 includes EFRAG's comments on some issues of the ED not directly addressed by the questions of the ED.

Question to constituents

4 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?

Notes to EFRAG's constituents

5 *The ED requires an entity to combine two or more contracts and account for them as a single contract if the amount of consideration for goods or services in one contract is dependent on the amount of consideration for goods or services in another contract (price interdependence).*

6 *The ED includes the following indicators that two or more contracts have interdependent prices:*

(a) *the contracts are entered into at or near the same time;*

(b) *the contracts are negotiated as a package with a single commercial objective; and*

(c) *the contracts are performed either concurrently or consecutively.*

7 *The prices of two contracts are not interdependent solely because the customer receives a discount on goods or services under one contract because of an existing customer relationship arising from another contract.*

8 *Also, the ED requires a single contract to be segmented into separate contracts if the prices of some goods or services in the contract are independent of the price of other goods or services in the contract. This is the case when both of the following conditions are met:*

(a) *the entity, or another entity, regularly sells identical or similar goods or services separately;*

(b) *the customer does not receive a significant discount for buying some goods or services together with other goods or services in the contract.*

9 *Finally, the ED specifies a contract modification as any change in the scope or price of a contract. 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. 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.*

EFRAG overall supports the proposed guidance on combining and segmenting contracts and contract modifications. However, we think that the guidance should be clarified.

10 EFRAG is supportive overall of the proposed guidance for combining and segmenting contracts and contract modifications. However, we are not sure how exactly to interpret 'price interdependence' as the term is applied in the ED and explained in the application guidance.

11 We understand that contracts are priced interdependently when a customer receives a discount in one contract in exchange for paying a premium in another contract. From the ED, it also appears that the price of one contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in a contract because of an existing

customer relationship arising from previous contracts. Between these two situations, however, we think that a 'grey' area may exist.

12 We consider that 'price interdependence' in this 'grey' area may be addressed in the application guidance of the ED. Example 2 in the application guidance illustrates how to account for an extension of a service contract. It illustrates that if the customer, in relation to the extension of the existing contract, receives a discount reflecting that the current stand-alone selling price of the remaining part of the original contract has decreased, the extension is a separate contract. However, if the discount is more substantial, the extension should be accounted for as a contract modification. Unfortunately, we do not understand how the IASB has reached this conclusion, and the example is therefore not helpful to us. We also note that the conclusion in this example does not seem to be consistent with the guidance included in paragraph 14 of the ED, which proposes that the price of one contract is not interdependent with the price of another contract solely because the customer receives a discount as a result of an existing customer relationship. We think that if the reasoning behind the conclusion is unclear to other parties as well, it could result in diverging accounting practices. This, in turn, would reduce the comparability and the usefulness of financial statements. Therefore, we consider that the principle of 'price interdependence' requires further clarification.

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?

Notes to EFRAG's constituents

13 *The ED states in paragraph 23, that a good or service, or a bundle of goods or services, is distinct if either:*

(a) *the entity, or another entity, sells an identical or similar good or service separately; or*

(b) *the entity could sell the good or service separately because the good or service meets both of the following conditions:*

(i) it has a distinct function – a good or service has a distinct function if it has utility either on its own or together with other goods or services that the customer has acquired from the entity or are sold separately by the entity or by another entity, and

(ii) it has a distinct profit margin – a good or service has a distinct profit margin if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.

14 *The ED also states that when an entity transfers promised goods or services to a customer at the same time, it may not be necessary for the entity to apply the recognition and measurement requirements to each performance obligation separately.*

EFRAG generally supports the proposed guidance for separating performance obligations, but believes 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.

15 In response to the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* (the 'DP'), EFRAG noted that it could be very costly for some entities to account separately for every performance obligation. The ED has removed this concern by requiring that an entity should only account for a performance obligation separately if the promised good or service is distinct from other goods or services promised in the contract.

16 Paragraph 20 of the ED states that an entity should evaluate the terms of the contract and its customary business practice to identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation. We approve of requiring an entity to consider its *own* business practice in determining how to unbundle performance obligations. However, the wording of paragraph 23 (a) of the ED suggests that an entity should also consider what *other* entities do. We disagree with this and believe that unbundling should be based on an entity's own business practice alone.

17 If a painting contractor does not sell paint separately then we do not believe that paint should be identified as a separate performance obligation by that contractor. However, the guidance in paragraph 23 (a) suggests that if *some* entities sell paint separately, then *every* entity should treat delivery of paint as a separate performance obligation (assuming, of course, that it is not transferred to the customer at the same time or the contract involves an overall contract management). We do not think that an entity (or an operating segment in an entity), which performs painting services and does not have as customary practice to sell paint separately, should consider delivery of the paint as a separate performance obligation. We therefore, believe 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.

18 As mentioned below in our response to question 9, EFRAG does not think that an entity should determine whether its obligations are onerous at the level of individual performance obligations as the ED requires. In our view, the definition of a contract boundary based on price interdependence would be contrary to considering any performance obligation being onerous in isolation of an overall profitable contract. However, in case the IASB would proceed with this proposal, EFRAG has discussed how the requirement of the ED to recognise a provision for onerous performance obligations would interact with the option not to account separately for distinct performance obligations that are satisfied at the same time. In our opinion, it is not clear from the ED if an entity would be permitted or required to test whether or not its obligations are onerous at a bundle level, considering all distinct performance obligations within a contract that are satisfied at the same time as the bundle, or at a level where distinct performance obligations are considered separately. If an entity were to carry out the test on a bundle, then it might avoid recognition of losses by satisfying performance obligations at the same time. EFRAG does not think that there are good reasons for accounting differently for performance obligations that are satisfied at the same time when it comes to testing onerous performance obligations. Accordingly, if the onerous test is to be performed at the performance obligation level (and we disagree with this), it should be performed for each of the distinct performance obligations.

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?

Notes to EFRAG's constituents

19 *The ED requires an entity to recognise revenue when it satisfies a performance obligation 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. 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.*

20 *When assessing whether a customer obtains control of a good or service, an entity shall consider any related arrangements entered into contemporaneously with, or in contemplation of, the contract, for example, in repurchase agreements. It appears from the application guidance that when an entity has an unconditional obligation or an unconditional right to repurchase an asset, the customer does not obtain control of the asset and the entity shall account for the sale and repurchase agreement as a lease or financing arrangement.*

21 *The ED includes the following indicators, which are meant to assist in determining whether the customer has obtained control of a good or service:*

(a) *the customer has an unconditional obligation to pay;*

(b) *the customer has legal title;*

(c) *the customer has physical possession;*

(d) *the design or function of the good or service is customer-specific.*

22 *However, the ED specifies that not one of the indicators determines by itself whether the customer has obtained control of the good or service.*

EFRAG does not support the proposed control model for revenue recognition, as it believes that an activity-based model would result in more decision-useful information (see Appendix 3).

EFRAG believes that the definition of control should be developed at the conceptual framework level to ensure consistency across the standards and the application and the implementation of the notion should be set at a standard level.

EFRAG has concerns about the application of the proposed guidance to service contracts.

If the IASB proceeds with the proposed control model, EFRAG believes that the transfer of control should be considered from the seller's rather than from the customer's perspective.

EFRAG is concerned about the indicators included in paragraph 30 of the ED for determining whether control of a promised good or service has been transferred to a customer.

23 EFRAG does not agree with the revenue recognition model based on the transfer of control over goods or services. EFRAG supports an activity-based model, under which revenue is recognised as the entity progresses towards the fulfilment of the contract and acquires an irrevocable right to receive consideration from the customer subject to continued performance. The model proposed by EFRAG is further explained in Appendix 3.

24 Having said that, our comments below address the proposed control model, should the IASB decide to proceed with it. EFRAG does not believe that the ED proposes sufficient guidance in paragraphs 25–31 and in the related application guidance for determining when control of a promised good or service has been transferred to a customer. Our two main concerns relate to the application of the proposed control model to services contracts and the indicators included in paragraph 30 of the ED.

25 Before elaborating on our concerns, we would draw attention to a more general observation. As indicated in our comment letter on the ED *Conceptual Framework for Financial Reporting: The Reporting Entity*, we believe that, as a first step, the general definition of control should be developed in the *Conceptual Framework,* as 'control' is a pervasive notion used in many standards. The application and the implementation of the control notion then should be set out at a standard level to deal with specific issues. We appreciate that the IASB attempts to define control in relation to revenue recognition and control of a good or a service at an individual standard level in the ED. However, we urge the IASB to consider this cross-cutting issue at a higher level to achieve greater consistency. We think that by addressing control on a piecemeal basis, consistency could easily be lost.

<u>Control in relation to services</u>

26 EFRAG is concerned that for services it is frequently difficult to determine when control is transferred to a customer. Therefore, the resulting information may not be decision-useful. For example, if a customer orders a container to be shipped from Rotterdam to New York within 60 days, should the shipping company recognise half of the profit when the ship is in the middle of the Atlantic Ocean?

27 According to 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. The ED explains that control includes the ability to prevent other entities from directing the use of and receiving the benefit from a good or service. Additionally, it explains that the ability to direct the use of an asset refers to the customer's present right to use the asset for substantially all of its remaining economic life or to the asset in the customer's business activities. For example, if an entity is cleaning a customer's offices, the control of the cleaning service is transferred to the customer as the cleaning takes place, not least because other customers would not be able to benefit from the cleaning service. However, in the above shipping example, it not clear to us how one would decide whether control of the shipping service had been transferred to a customer, particularly because the customer may have no control over how the service is being performed (how the container is transported to New York). Indeed, the customer may not receive any benefit from a half-way transported container (certainly not if the container is

first shipped to places further away from New York in order to be pooled with other containers).

We do not think our shipping example above is particularly complex. We therefore think that if the revenue recognition principles suggested in the ED are difficult to apply in this example, they will be difficult to apply in many situations.

Control from the customer's perspective

28 In addition to the fact that, overall, the control model seems to be difficult to apply to service contracts, we think it adds to the complexity that control should be assessed from the customer's rather than from the seller's perspective. We believe that it would be more complicated for an entity to evaluate the customer's situation rather than its own.

29 Also, we think that the requirement to focus on the customer may be difficult to follow when the party receiving the good or service from the entity is different to the party entering into the contract with the entity and being liable for payment.

30 We appreciate that the IASB has chosen to consider control from the customer's perspective, as the IASB focuses on the assets that the customer receives. We understand that the IASB's concern is that if control was assessed from the entity's perspective, some activities, for example, assembling a workforce, could result in recognition of revenue although the customer would not receive anything from this activity. However, we do not share this concern as we think that the focus should be on the activities carried out by the entity. We refer to our alternative model described in Appendix 3, under which the assembling of a workforce should result in revenue recognition if certain conditions are met.

Indicators that the customer has obtained control

31 Paragraph 30 of the ED includes four indicators that control of a good or service has been transferred to the customer. We have two concerns in relation to these indicators:

(a) it is unclear whether the indicators should be applied in interpreting and assessing when control has been transferred; and

(b) in particular, the fourth indicator (paragraph 30(d) of the ED) does not adequately reflect what the ED considers to be 'control'.

32 EFRAG is concerned that the role of the indicators may not appear clearly from the ED. It is our understanding that the indicators are only included in the standard in order to provide examples of circumstances under which control often would be considered to have transferred to the customer.

33 EFRAG thinks that the unauthorised use or possession of an asset does not constitute control under the ED. If a customer, for example, could use or even sell an asset but is prohibited from doing so by the terms of the contract or by law, the customer does not control the asset according to EFRAG's interpretation of the ED. This assumption seems to be supported by the fact that, under the ED, a customer does not control an asset if the seller has an option to require the asset to be returned. Accordingly, it is our understanding that a customer's ability to direct the use of, and receive the benefit from the good or services transferred should be (legally) enforceable. Whether a customer has an enforceable right to

direct the use of an asset seems to us to be a matter of contractual rights and relevant legislation.

34 It is therefore our understanding that an entity would always have to assess whether the contract and the relevant legislation provide the customer with control (that is, the ability to direct the use of, and receive the benefit from the good or service). We believe that there may be cases, in which control may not have been transferred even when all (or none) of the indicators stated in paragraph 30 are met. For example, control has not been transferred, even though all of the indicators have been met, when the seller has an unconditional repurchase option.

35 Accordingly, it is our understanding that the indicators are nothing more than the impairment indicators in IAS 36, which do not offer conclusive evidence about the existence or absence of an impairment loss.

36 However, when reading the ED and the Basis for Conclusions, the role of the indicators could be understood differently. Paragraph 31 of the ED, for example, states that not one of the preceding indicators determines by itself whether the customer has obtained control. This paragraph could be read in line with our interpretation of the role of the indicators. However, it could also be read as requiring that if two or more indicators have been met, then control is considered to have been transferred.

37 Also, paragraph BC 66 of the Basis for Conclusions is unclear. It states "[t]he Boards think that applying the proposed definition of control and the proposed indicators of control to a construction contract would be consistent with the requirements currently contained in IFRIC 15 [...]". This statement could be read as saying that the indicators listed in paragraph 30 should be considered when interpreting the control notion of the standard.

38 In order to avoid the indicators being used as a kind of checklist for when control exists, we think the role of the indicators should be clarified. This seems particularly important when the indicators do not always reflect what control is according to the ED, as the use of the indicators could result in revenue being recognised at different points in time than paragraphs 25 to 29 of the ED would result in.

39 EFRAG has also considered whether the list of indicators is helpful and would result in decision-useful information by improving consistency.

40 In particularly the indicator in paragraph 30 (d) of the ED does not seem to reflect the model proposed in the ED for revenue recognition. The ED (paragraph 30 (d)) states that because an entity cannot sell a customer-specific asset to another customer, it is likely that the entity would *require* the customer to take control of the asset as it is created. While this could be the case, we think that in many instances it would be more important for the entity to secure the payment from the customer for the work performed rather than to ensure that the customer takes control of the asset. We acknowledge that in some cases the customer will pay only if it receives the asset. However, we would like to emphasise that in these cases the entity would not necessarily *require* the customer to take control of the asset as it is created, but would have an *option to require* the customer to take control of the asset being created. It is our understanding that such an option of the seller to require the customer to take control of an asset (a put option) does not result in the customer controlling the asset. We therefore think this indicator is relatively weak. We think that a stronger indicator might be to consider whether a

customer should take a good if the contract is terminated by either party. If that were to be the case, we consider the customer to be in control of the good.

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 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?

Notes to EFRAG's constituents

41 *The ED requires an entity to consider the terms of the contract and its customary business practice to determine the transaction price based on the probability-weighted amount of consideration that an entity expects to receive.*

42 *An entity shall recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. This is only the case if both of the following conditions are met (paragraph 38 of the ED):*

(a) *the entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and*

(b) *the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.*

43 *Factors that reduce the relevance of an entity's experience include:*

(a) *the consideration amount is highly susceptible to external factors (for example, volatility in the market, judgement of third parties, and risk of obsolescence of the promised good or service);*

(b) *the uncertainty of the amount of consideration is not expected to be resolved for a long period of time;*

(c) *the entity's experience with similar types of contracts is limited; and*

(d) *the contract has a large number of possible consideration amounts.*

EFRAG agrees with the proposal.

44 EFRAG agrees that when the transaction price (or part of the transaction price) is variable, revenue should only be recognised if the transaction price can be measure reliably (or for the part for which it can be measured reliably). However, EFRAG disagrees that the use of the expected value method would be appropriate in all circumstances.

45 In response to other discussion papers and exposure drafts from the IASB, we have often opposed to the use of probability-weighted amounts, especially in respect of single items. That is because, in our view, the use of the expected value method is appropriate when applied to large population of items only (please refer more particularly to our comment letter on IAS 37 amendments.

46 We welcome paragraph 38 criteria and agree that these criteria should be met if an expected value approach is to be applicable to variable revenue measurement. However, we believe that variable revenue should be recognised only if and when, in addition to conditions set in paragraph 38, variable revenue is measured for a large population of contracts.

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?

Notes to EFRAG's constituents

47 *The ED requires an entity to adjust the amount of promised consideration to reflect the customer's credit risk. Hence, when an entity satisfies a performance obligation, the entity shall recognise revenue at the probability-weighted amount of consideration that the entity expects to receive. Once the entity recognises a receivable, the effects of changes in the assessment of credit risk shall be recognised as income or expense rather than as revenue.*

EFRAG does not agree that the customer's credit risk should be reflected in revenue. EFRAG believes that credit losses should not affect the revenue line.

48 EFRAG does not agree that a customer's credit risk should be reflected in revenue for two reasons:

(a) Firstly, we understand that users of financial statements usually find it useful if revenue amount represents quantity of goods or services sold multiplied by prices of these goods or services, and they usually consider a credit loss on a receivable separately. We understand that the main reason for this is that amounts related to credit losses have a different predictive value as they represent an estimate and require more judgement than the quantity of goods multiplied by their prices. Also, we understand that under the proposed model, there may be cases when revenue recognition criteria for some goods or services are met before the definition and the recognition criteria are met for a receivable. In these cases, an entity would recognise revenue and a contract asset. If changes in the estimated credit risk occur prior to recognition of a receivable, then the contract asset would be adjusted in correspondence with the revenue line. We believe that this could create unnecessary volatility of the revenue amount (not at least because improvements in customer's credit ratings could also affect revenue), that would reduce the ability of the users to forecast future cash flows.

(b) Secondly, we believe that credit risk should be presented consistently across different standards. Therefore we do not find arguments for a different treatment of credit risk in the revenue recognition standard compelling.

Particularly this is because the IASB proposes in the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* that credit risk be presented separately from interest income.

49 In relation to credit risk, some may argue that the requirements included in paragraph 43 of the ED are not sufficiently clear about the option to estimate a credit risk on a portfolio basis, although the application guidance seems to allow such approach. We suggest that this point be clarified in paragraph 43.

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?

Notes to EFRAG's constituents

50 *The ED will require an entity to adjust the amount of promised consideration to reflect the time value of money if it is material. The discount rate to be used is the rate that would be used in a separate financing transaction between the entity and its customer. The effect of financing shall be reported separately from the revenue from other goods or services. The entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the cash sales price of the good or service. The requirement would apply to both deferred consideration and amounts received in advance. Current IAS 18 paragraph 11 includes guidance on separating the financing component from revenue only where the cash inflow occurs after the recognition of revenue.*

EFRAG agrees with the proposal.

51 EFRAG agrees with the proposal. In cases where a customer pays in advance, we notice that the liability recognised by the entity (the performance obligation) is generally not a monetary item; therefore, one can argue that since no cash flows occur in the future, the time value of money notion should not be applied to advances received.

52 Still, EFRAG thinks that if a customer pays in advance of the goods being delivered or services being provided, then the transaction contains a financing arrangement, i.e., customer financing of the supplier. Therefore, revenue should be measured at the fair value of the consideration at the date the revenue is recognised and not when the payment is received. The underlying assumption is that receiving consideration before the service is rendered is like entering into a finance arrangement and a service arrangement simultaneously, i.e., receiving a loan, paying interest, repaying the loan and then providing the services and receiving the customer's consideration. The customer would not pay the consideration in advance without getting a discount to compensate for the lost interest, i.e., the customer would be required to pay a higher amount if the payment was made at a later date. For example, an entity sells goods to a customer in one year, and the customer can choose either to:

(a) pay 90 cu now and receive the goods after one year;

(b) pay 94 cu when the goods are received in one year time; or

(c) pay 100 cu one year after the goods are received.

53 We think that revenue amount should be the same in all three scenarios (provided the differences reflect the time value of money) and that the financing component should be recognised separately from revenue.

Question to constituents

54 Although EFRAG agrees with the principle that the amount of promised consideration should be adjusted to reflect the time value of money, some members think that the principle could be very costly to implement. These members note that the principle should be applied to each distinct performance obligation included in a contract. Accordingly, the terms of payment under a contract should be compared with the satisfaction of each distinct performance obligation under the contract, and if material the entity should account for the financing component in relation to each distinct performance obligation.

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?

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?

Notes to EFRAG's constituents

56 *The ED define 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. The ED also requires 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. After initial inception, an entity shall allocate any changes in the transaction price to all performance obligations in proportion to the stand-alone selling price of the good or service at contract inception.*

EFRAG agrees that the initial (estimated) transaction price should be allocated to all separate performance obligations in a contract in proportion to the stand-alone selling price. However, after the initial allocation changes in the estimated transaction price should be allocated to different performance obligations based on the relevant facts and circumstances.

57 As mentioned below in response to question 9, EFRAG is concerned that the proposed model could lead to the recognition of a liability for onerous performance obligations that are part of an overall profitable contract. EFRAG does not support a model with this result. Although our solution would be to test whether a contract is onerous at contract level, we are aware of other solutions. One other solution could be to allocate the transaction price to the separate performance obligations in a manner so that no performance obligation would be deemed onerous. If the

IASB would not follow our suggestion to test whether a contract is onerous at contract level, we would favour such other solution. However, in other cases we agree that the transaction price at contract inception should be allocated to all separate performance obligations in proportion to their stand-alone selling prices. In most cases, we think the stand-alone selling prices ought to be readily available and the method ought to be relatively simple to apply.

58 However, we do not agree that changes in the estimated transaction price should be allocated in all cases to different performance obligations based on the initial stand-alone selling prices without considering the relevant facts and circumstances. Consider the following example:

An entity enters into a contract to sell two fire engines: one vehicle containing the water tank (V1) and the other being a ladder truck (V2). V1 is to be delivered in year 1 and V2 and year 2. The two vehicles are regularly sold separately at the stand-alone selling prices of 100 cu for V1 and 150 cu for V2. For budgeting reasons the contract states that the price of V1 is 125 cu and the price of V2 is 125 cu. V1 is delivered in year 1. However, in year 2 it is clear that V2 can only be delivered in year 3. Parties agree that, because of the delay, the overall contract price will be reduced by 20 cu.

59 In this example, the contract is not separated into two separate contracts as the goods are priced interdependently (V1 is 'overpriced' and V2 is 'underpriced'), but under the proposals in the ED the delivery of the two fire engines should be accounted for as two separate performance obligations and the transaction price of 250 cu is allocated to each performance obligation based on their stand-alone selling prices: V1 – 100 cu and V2 – 150 cu.

60 Under the proposals in the ED, when the entity delivers V1 in year 1, revenue of 100 cu is recognised. In year 2, when the price reduction of 20 cu is agreed, the entity should allocate the price reduction to both performance obligations on the same basis as at the contract inception. The entity should therefore recognise negative revenue of 8 cu (100 cu / 250 cu * 20 cu) in year 2 reflecting that the transaction price for V1 was only 92 cu (100 cu – 8 cu). In year 3 revenue of 138 cu (150 cu / 250 cu * (250 cu – 20 cu)) should be recognised when V2 is delivered to the customer.

61 EFRAG does not believe that the proposed treatment fairly reflects the economic substance of the transaction. EFRAG thinks that in the example above, the entire price reduction of 20 cu should be allocated to V2, as it relates entirely to that performance obligation.

62 Therefore, EFRAG thinks that changes in a transaction price should be allocated to the performance obligations based on the relevant facts and circumstances. We acknowledge that such an allocation would require more judgement by management compared to the mechanical model proposed by the ED. However, we think that in most cases, it should be relatively clear whether a change in the transaction price relates to completed or uncompleted 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?

Notes to EFRAG's constituents

63 *The ED states (in paragraph 57) that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with another IFRS, an entity shall recognise an asset only if those costs:*

(a) *relate directly to a contract (or a specific contract under negotiation);*

(b) *generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is, the costs relate to future performance); and*

(c) *are expected to be recovered.*

64 *Costs that relate directly to a contract are expected to be limited to (paragraph 58):*

(a) *direct labour (for example, salaries and wages of employees who provide services direct to the customer);*

(b) *direct materials (for example, supplies used in providing services to the customer);*

(c) *allocation of costs that relate directly to the contract or contract activities (for example, costs of contract management and depreciation of tools and equipment used in fulfilling the contract);*

(d) *costs that are explicitly chargeable to the customer under the contract; and*

(e) *other costs that were incurred only because the entity entered into the contract (for example subcontractor costs).*

65 *IAS 2 will be amended so that the guidance on inventories of a service provider will be deleted (IAS 2.19). Accordingly, a service provider can recognise expenses as an asset only if the above requirements are met.*

66 *The ED explicitly mentions that the following costs associated with contracts with customers should be recognised as expenses when incurred:*

(a) *costs of obtaining the contract (for example, the costs of selling, marketing, advertising, bid and proposal, and negotiations);*

(b) *costs that relate to satisfied performance obligation in the contract (that is costs relating to past performance); and*

(c) *costs that relate to abnormal amounts of wasted materials, labour, or other resources to fulfil the contract.*

EFRAG does not agree that the costs of securing a contract should always be expensed as incurred.

EFRAG thinks that requirements regarding capitalisation of contract costs should be included in IAS 2.

67 Overall EFRAG supports the Board's effort to specify which costs are eligible for capitalisation as contract costs, however we do not agree with the placement of the proposed guidance or with the proposal to exclude from the list of eligible costs *any* costs incurred before contract inception unless they are used in the process of satisfying performance obligations related to the good or service to be delivered to the customer. For example, cost of an architect's sketches should be capitalised if the sketches are used for the construction, but commissions paid to an agent to secure a contract cannot be capitalised. In our view, if commissions and similar costs are incremental, necessary, directly related to a contract and will be recovered through the contract, they should be capitalised and not recognised as expenses when incurred. We think that the cash flows related to securing a contract are directly related to the contract and should therefore be accounted for as part of the contract. We believe that this is consistent with the current requirements in paragraph 21 of IAS 11 in respect of costs incurred in securing a contract. It is also consistent with the proposed requirements for insurance contracts, and with the accounting for loan origination fees, which are included in the calculation of the effective interest rate. We are not convinced that the proposal would result in more decision-useful information than the current requirements.

68 Except for the requirements on the costs of securing a contract, EFRAG does not think that a revenue recognition standard should include requirements about costs incurred in fulfilling a contract. We acknowledge that the replacement of IAS 11 *Construction Contracts* means that some guidance regarding contract costs will have to be included in another standard. However, instead of incorporating requirements regarding these costs in a revenue recognition standard, we think that the requirements should be included in IAS 2 *Inventories*. Also, the requirements regarding inventories of services providers should remain in IAS 2.

69 Apart from the comments above, EFRAG thinks that the requirements on accounting for the costs of fulfilling a contract are operational and sufficient.

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?

Notes to EFRAG's constituents

70 *The content of paragraph 58 is specified above in relation to question 8. The ED requires an entity to recognise a liability and a corresponding operating expense if a performance obligation is onerous. A performance obligation is onerous when the present value of the probability-weighted costs that relate directly to satisfying that performance obligation exceed the amount of the transaction price allocated to that performance obligation.*

EFRAG agrees that an entity should capitalise contract costs based on the full direct cost method. Similarly, an entity should determine whether a contract is onerous based on the full direct costs.

EFRAG does not agree with the proposal to require the use of the probability-weighted technique for the costs in performing the "onerous test".

EFRAG does not agree with the proposal to require the "onerous test" at a performance obligation level as this could result in recognition of a provision for an onerous performance obligation within an overall profitable contract.

Capitalisation of costs

71 EFRAG agrees that an entity should apply the full direct cost method (i.e., including in the cost of an asset both incremental and allocated costs that relate directly to the asset) as suggested by the ED for measuring contract costs eligible for capitalisation.

72 As mentioned in our response to question 8, we also think that costs of securing a contract should be capitalised in certain circumstances.

Measurement of onerous performance obligations

73 Referring to our previous comments on the use of the probability-weighted amounts, we believe that the availability of the reliable information is critical for the application of the expected value method and that the expected value approach should not be applied to single items. We do not think that the proposed requirements for onerous tests would result in reliable information in situations where the entity does not have past experience of the type described in paragraph 38 of the ED or the contract does not belong to a large population of similar items. In those circumstances, we believe that contract costs should be estimated on "the most likely estimate" basis.

Onerous performance obligations versus onerous contract

74 In addition, we do not believe it would be appropriate that a performance obligation is deemed onerous even if the performance obligation is part of a contract that is overall profitable. We also think that the proposed approach is inconsistent with the approach in IAS 37, which requires an entity to consider the unavoidable costs of meeting the obligations and the economic benefits expected to be received under the contract as a whole.

75 For example, consider that an entity enters into a contract containing the following performance obligations:

	Performance obligation 1	Performance obligation 2	Performance obligation 3
Stand-alone selling price	100	100	100
Costs	95	50	70
Margin	5	50	30

The contract price is agreed with the customer as 270 cu. The entity therefore obtains a profit of 55 cu (270 cu – 95 cu – 50 cu – 70 cu) from the contract. The ED requires the transaction price to be allocated to the performance obligations based on their stand-alone selling prices. That is, the allocated transaction price to each performance obligation is 90 cu (270 cu/3, as the performance obligations have identical stand-alone selling prices in this case). Accordingly:

	Performance obligation 1	Performance obligation 2	Performance obligation 3
Allocated transaction price	90	90	90
Costs	95	50	70
Margin	-5	40	20

This means that performance obligation 1 will be considered onerous and the entity should recognise a provision for it when entering into the contract.

76 We believe that it is inappropriate to provide for an onerous performance obligation if the entire contract is profitable. Instead, a provision for an onerous contract should only be recognised if the entire contract is onerous. We think that, for commercial reasons, it is not uncommon that an entity would enter into a contract were some performance obligations are onerous but the entire contract is profitable. However, it is part of the cost of the contract to satisfy these onerous performance obligations. We think that it would be overly prudent and the information in the financial statements would therefore not be neutral and reliable.

77 We acknowledge that the fact that contracts are unbundled into performance obligations, and revenue is recognised based on the satisfaction of these, will result in a loss being recognised when an onerous performance obligation is satisfied. However, we think that this is not a problem as this purely reflects that loss making performance obligation has been satisfied.

Question to constituents

78 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?

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?

Notes to EFRAG's constituents

79 *The objective of the revenue recognition disclosures is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.*

80 *The ED requires the following disclosures:*

<u>Contracts with customers</u>

(a) *disclosures about an entity's contracts with customers in sufficient detail to help users understand the amount, timing, and uncertainty of revenue and cash flows from those contracts including:*

(i) a disaggregation of revenue for the period;

(ii) a reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities; and

(iii) information about the entity's performance obligations, including additional information about its onerous performance obligations.

<u>Disaggregation of reported revenue</u>

(b) *disclosures about revenue disaggregated into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Examples of categories that might be appropriate include:*

(i) type of good or service (for example, major product lines);

(ii) geography (for example, country or region);

(iii) market or type of customer (for example, government versus nongovernment customers); or

(iv) type of contract (for example, a fixed-price versus a time-and-materials contract).

<u>Reconciliation of contract balances</u>

(c) *a reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities. The reconciliation shall at a minimum show each of the following separately, if applicable:*

(i) *the amount(s) recognised in the statement of comprehensive income arising from:*

a. *revenue from performance obligations satisfied during the reporting period;*

b. *revenue from allocating changes in the transaction price to performance obligations satisfied in previous reporting periods;*

c. *interest income and expense; and*

d. *the effect of changes in foreign exchange rates;*

(ii) *cash received;*

(iii) *amounts transferred to receivables;*

(iv) *noncash consideration received; and*

(v) *contracts acquired in business combinations and contracts disposed.*

(d) *a reconciliation of the opening and closing aggregate balance of contract assets and contract liabilities to the amounts presented in the statement of financial position.*

Performance obligations

(e) *disclosures about its performance obligations in contracts with customers, including a description of:*

(i) *the goods or services the entity has promised to transfer, highlighting any performance obligations to arrange for another party to provide goods or services (that is, if the entity is acting as an agent);*

(ii) *when the entity typically satisfies its performance obligations (for example, upon shipment, upon delivery, as services are rendered, or upon completion of service);*

(iii) *the significant payment terms (for example, whether the consideration amount is variable and whether the contract has a material financing component);*

(iv) *obligations for returns, refunds, and other similar obligations; and*

(v) *types of warranties and related obligations.*

(f) *for contracts with an original expected duration of more than one year, disclosures about the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period that are expected to be satisfied in each of the following periods:*

(i) *not later than one year;*

(ii) *later than one year but not later than two years;*

(iii) *later than two years but not later than three years; and*

   (iv) *later than three years.*

<u>*Onerous performance obligations*</u>

(g) *disclose of the amount of any liability recognised for onerous performance obligations together with a discussion of:*

   (i) *the nature and amount of the performance obligations for which the liability has been recognised;*

   (ii) *why those performance obligations have become onerous; and*

   (iii) *when the entity expects to satisfy the liability.*

(h) *a reconciliation from the opening to the closing balance of the liability recognised for onerous performance obligations. The reconciliation shall include the amounts recognised in the statement of comprehensive income attributable to each of the following, if applicable:*

   (i) *performance obligations that became onerous during the period;*

   (ii) *performance obligations that ceased to be onerous during the period;*

   (iii) *amount of the liability satisfied during the period;*

   (iv) *the time value of money; and*

   (v) *changes in the measurement of the liability during the reporting period.*

<u>*Significant judgements*</u>

(i) *disclosure about the judgments, and changes in judgments, made in applying the standard that significantly affect the determination of the amount and timing of revenue from contracts with customers. That disclosure shall explain the judgments used in:*

   (i) *determining the timing of satisfaction of performance obligations; and*

   (ii) *determining the transaction price and allocating it to performance obligations.*

<u>*Determining the timing of satisfaction of performance obligations*</u>

(j) *for performance obligations satisfied continuously, disclosure about:*

   (i) *the methods (for example, output methods, input methods, and methods based on the passage of time) used to recognise revenue; and*

   (ii) *an explanation of why such methods are a faithful depiction of the transfer of goods or services.*

<u>*Determining the transaction price and allocating it to performance obligations*</u>

(k) *disclosures about the methods, inputs and assumptions used:*

(i) *to determine the transaction price;*

(ii) *to estimate stand-alone selling prices of promised goods or services;*

(iii) *to measure obligations for returns, refunds, and other similar obligations;*

(iv) *to measure the amount of any liability recognised for onerous performance obligations.*

EFRAG agrees with the objective of the proposed disclosure requirements and thinks that the disclosure requirements will help in meeting the objective.

81 EFRAG agrees with the disclosure objective. Also, we think that the disclosure requirements proposed by the ED will provide information that will be helpful in meeting the objective.

82 Two of the disclosure requirements (the requirements regarding disaggregation of revenue and the maturity analysis of performance obligations) are considered in more detail in our answer to question 11 and question 12 below.

83 We have discussed whether a reconciliation of contract balances provides decision useful information to users. We think that it would provide useful information in relation to, for example, construction and defence contracts as the reconciliation could indicate if an entity would be facing different problems (for example, not being able to bill customers for recognised revenue). We also think that in many other cases the information would be less useful. However, we think that in those cases the contract balances would represent small amounts. It could therefore be argued that the materiality threshold would ensure that the information is not provided when its usefulness is questionable.

Question to constituents

84 EFRAG would welcome comments regarding the usefulness and the cost of preparing the disclosures required by the ED and an assessment of whether an acceptable trade-off between costs and benefits is met.

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?

Notes to EFRAG's constituents

85 *For contracts with an original expected duration of more than one year, the ED requires disclosure of the amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period that are expected to be satisfied in each of the following periods:*

(a) *not later than one year;*

(b) *later than one year but not later than two years;*

(c) *later than two years but not later than three years; and*

(d) *later than three years.*

EFRAG agrees with the proposal.

86 EFRAG agrees with the proposal. We have discussed whether the requirement should also apply to contracts with an originally expected timing of less than one year. However, we agree with the IASB's cost/benefit consideration on this issue.

87 We have discussed whether the requirement should apply to contracts with an originally expected timing of less than one year, but where the actual duration at the balance sheet date either is or is estimated to exceed one year. We think that many construction-type entities could easily provide that additional information. However, the disclosure requirement would affect many other types of contracts than construction-type contracts, for example, IT service agreements. We think that it would often be more difficult for those other types of entities to provide the information if it was not based on the original expectations. We therefore also agree with the cost/benefit consideration taken by the IASB to require only information for contracts with an original duration of more than one year.

88 We have also considered whether it would be more useful to have information about when performance obligations would result in cash-inflows rather than when the revenue recognition criteria in the ED are expected to be met. We think that the cash-inflow information is important. However, as paragraph 77 (c) of the ED requires an entity to disclose its significant payment terms; we think that it should be possible for users to obtain some information about the expected cash flows from the performance obligations.

89 Finally, we think the wording of paragraph 78 of the ED should be clarified to make it unambiguous that the information should be provided on an aggregate level and not for each performance obligation.

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?

Notes to EFRAG's constituents

90 *The ED requires than an entity disaggregate revenue into categories that best depict how the amount and timing of revenue and cash flows are affected by economic characteristics. Examples of categories that might be appropriate include:*

(a) *type of good or service (for example, major product lines);*

(b) *geography (for example, country or region);*

(c) *market or type of customer (for example, government versus non-government customers); or*

(d) *type of contract (for example, a fixed-price versus a time-and-materials contract).*

EFRAG agrees with the proposal, however, thinks that the wording should specify that a single category could reflect multiple factors – for example, a given product on a given marketplace.

91 EFRAG agrees with the proposal. It is important that an entity can break down revenue into categories that it finds relevant. We think that the requirement is worded in a manner that would allow this. However, we would like to note that the ED could give the impression that the categories could only be based on one factor – for example, geography – and we do not think that this is fortunate. In fact, we think that in order for the information required to be as useful as possible to fulfil the objectives of the notes, it is important, that unlike items are not grouped together.

92 Consider, for example, an entity, which has two very different products (the products A and B) that are sold on very different markets (the markets X and Y). The entity considers that it has three different streams of revenue that are affected differently by economic characteristics (revenue from Product A on Market X; Product A on Market Y; and Product B on Market X and Y).

93 We therefore recommend that final requirements are clarified so that disaggregation is to be based beyond any possible doubt on a single or multiple factor basis, whichever makes the information disclosed relevant.

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.

Notes to EFRAG's constituents

94 *The ED proposes that the final standard on shall be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.*

EFRAG agrees that the proposed requirements should be applied retrospectively.

95 EFRAG agrees that a new standard on revenue recognition should be applied retrospectively. If prospective application were to be required, this could result in the same revenue being recognised twice (or not at all) in the same set of financial statements. Alternatively, if the prospective application would require the new revenue recognition model to be applied only for new contracts, an entity could apply different revenue recognition criteria to identical contracts agreed at different

times. To avoid these types of anomalies, which cause confusion among users, we favour retrospective application.

Question to constituents

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

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?

Notes to EFRAG's constituents

97 *The ED contains application guidance that is an integral part of the proposal. The application guidance gives guidance on the following issues:*

(a) *segmentation of a contract;*

(b) *contract modifications;*

(c) *identifying performance obligations;*

(d) *determining whether a good or service is distinct;*

(e) *satisfaction of performance obligations;*

(f) *determining the transaction price;*

(g) *allocating the transaction price to separate performance obligations;*

(h) *contract costs;*

(i) *presentation; and*

(j) *disclosure.*

EFRAG generally thinks that where the standard is unclear this should be addressed by clarifying the principles rather than by way of application guidance. However, we are aware that it may be necessary to include some guidance to address industry-specific issues.

98 As it appears from our other comments, we think that some changes and clarifications are required before a standard is issued. Generally, we prefer a standard with clear principles and no application guidance over a standard with weak principles and elaborate application guidance. Accordingly, where the proposal is unclear, we think that the IASB should first consider clarifying the principles rather than adding application guidance. However, we are aware that application guidance may be needed for particular industries.

99 One issue, which is not addressed in the proposed standard or the application guidance, and which, we believe, requires specific attention is the accounting for

contracts in which the customer does not pay the full amount of consideration for goods or services received. This happens when part of the amount is paid by a third party (e.g., in some jurisdictions part of the consideration for the production of renewable energy is paid by a third party).

Question to constituents

100 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?

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?

Notes to EFRAG's constituents

101 *The ED requires that an entity should distinguish between a product warranty that provides a customer with coverage for latent defects in the product and a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer.*

102 *If the objective of a product warranty is to provide a customer with coverage for latent defects in the product (that is, defects that exist when the product is transferred to the customer but that are not yet apparent), that warranty does not give rise to a separate performance obligation. Instead, the warranty acknowledges the possibility that the entity has not satisfied its performance obligation to transfer the product specified in the contract. Therefore, at the end of the reporting period the entity shall determine the likelihood and extent of defects in the products that it has sold to customers and, hence, the amount of unsatisfied performance obligations with respect to those products.*

103 *Consequently:*

(a) *if the entity would be required to replace defective products, it does not recognise any revenue for those defective products when it transfers them to customers;*

(b) *if the entity would be required to repair defective products, it does not recognise revenue for the portion of the transaction price allocated on a relative selling price basis to the products' components expected to be replaced in the repair process.*

104 *An entity recognises revenue only for products (or components of products) that are transferred to customers in the condition promised to customers. Otherwise, the entity would not have satisfied its performance obligations.*

105 *If the objective of a warranty is to provide a customer with coverage for faults that arise after the product is transferred to the customer, that warranty gives rise to a performance obligation for warranty services that is separate from the performance obligation to transfer the promised product. Therefore, the entity shall allocate the transaction price (on a relative selling price basis) between the promised product and the promised warranty service.*

106 *In assessing the objective of the product warranty the entity considers factors such as:*

(a) *whether the warranty is required by law – if the entity is required to provide a warranty by law, typically that indicates that the warranty is not a separate performance obligation, because such requirements exist to protect customers from the risk of purchasing defective products.*

(b) *whether the product could have been sold without the warranty – if the product could not be sold without a warranty, this indicates that the warranty is not a separate performance obligation. Conversely, a warranty that is sold as an optional extra is a separate performance obligation.*

(c) *the length of the warranty coverage period – the longer the coverage period, the more likely that the warranty (or part of the warranty) is a separate performance obligation because it is more likely to provide coverage for faults arising after the product is transferred to the customer.*

EFRAG supports the proposal.

107 EFRAG agrees that it is necessary to distinguish a warranty from an uncompleted or failed sale. In addition, it is necessary to distinguish a warranty from an insurance contract.

108 Considering first how to distinguish a warranty from an insurance contract, EFRAG is aware that the IASB is in the process of finalising its proposals in the insurance project and the issue will be addressed as part of this project. We will therefore consider the issue once the exposure draft on insurance contracts has been issued.

109 On distinguishing between a warranty and an uncompleted sale, most EFRAG members agree with the proposal. That is, if an entity transfers to a customer a product that does not meet the specifications or the required quality level, the customer has not received what was ordered, and no sale should be recognised.

110 The majority of members agree that a line has to be drawn in a manner such that a defect, that would reflect that a customer has not received the contracted good or services (i.e., defects that existed at the date of the transfer), should be accounted for as a failed sale. Coverage for future defects should, on the other

hand, be accounted for as a separate performance obligation. The majority of members acknowledge, however, that in some cases it would be difficult to distinguish between the defects in a product that exist at the time of sale from those that arise after the sale. In such cases, management must apply judgement. However, the outcome of management's judgement on the financial statements may be limited as both types of warranties would result in a similar accounting outcome – deferral of revenue.

111 Other EFRAG members have different views as to where the line should be drawn between warranties and a failed sale. These members have presented the following alternatives:

(a) The distinction should be made at the time of transfer to the customer. If the item transferred does not work at that time, no sales should be recognised. Obligations to repair, replace or refund defects discovered after the transfer should be accounted for as warranties.

(b) The distinction should be based on whether the warranty would be a separable service with a distinguishable fair value. If so, it should be accounted for as a separate performance obligation. Otherwise it should not be accounted for as a separate performance obligation. In those cases, the amount of deferred revenue should be measured by reference to the cost of repairing or replacing an item (i.e., not by reference to the stand-alone selling price of the repair service).

(c) The distinction should be made with reference to the indicators included in the application guidance. That is, a warranty is something not required by law, the product could have been sold without it and it covers a relatively long period. Also, a distinction should be made between the requirement to replace, to refund or to repair a good. If an entity has an obligation to provide a refund then a separate performance obligation should be recognised and measured by reference to the stand-alone selling price of the goods. Otherwise – if an entity can choose to repair or replace the goods – the amount of the deferred revenue should be measured by reference to the cost of replacement or repair.

Question to constituents

112	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?

Notes to EFRAG's constituents

113 *The ED states that when a customer obtains control of substantially all the rights associated with the entity's intellectual property, the contract shall be considered to be a sale rather than licensing of the intellectual property. This would be the case, for instance, if an entity grants a customer the exclusive right to use its intellectual property for the duration of the property's economic life.*

114 *If a customer does not obtain control of all the rights associated with the entity's intellectual property and the entity has promised to grant exclusive rights, the entity has a performance obligation that it satisfies over the contract period as it permits the customer to use its intellectual property. An entity might grant exclusive rights on the basis of time, geography and distribution channel.*

115 *Rights to use are not exclusive if an entity can grant similar rights to other customers under substantially the same terms. In these cases, the promised asset gives rise to a single performance obligation. The entity satisfies that obligation when the customer is able to use the rights and benefit from them.*

116 *If an entity has a patent on intellectual property that it licenses to customers, the entity may represent and guarantee to its customers that it has a valid patent, and will defend and maintain that patent. That obligation to maintain and defend patent rights is not a performance obligation because it does not transfer a good or service to the customer. Satisfying that obligation protects the intellectual property to which the entity has represented itself as having enforceable rights.*

EFRAG is split on this issue, but has considered different alternatives. Under the first alternative, EFRAG agrees with the ED. Under the second alternative, EFRAG thinks that continuous involvement should be the principle for distinguishing between different licensing arrangements. Under the third alternative, EFRAG thinks that the right of use of an intangible asset should be dealt with in the IASB's forthcoming leasing standard.

Alternative 1

117 EFRAG agrees with the proposal. We concur with the IASB that there is a difference between an exclusive right of use of intellectual property and a non-exclusive right that should result in these contracts being accounted for differently.

118 We think that an exclusive right is comparable to a transfer of a tangible asset, that is, when an entity has transferred a tangible asset or an exclusive right to one customer, it cannot transfer it to another customer. On the other hand, the customer is receiving something that no one else can use (a right to use a specific asset). The same is the case when an entity grants a customer an exclusive right for a period. The customer receives something that no one else can use. Other customers can have similar but *not identical* rights.

119 We note that paragraph 26 of the ED states that a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Also, control includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service. We therefore think that the performance obligation in relation to the right to use a tangible asset is satisfied over the period for which an entity grants an exclusive right to use that tangible asset to the customer, and we think that the same is true in relation to exclusive rights for intangible assets. We therefore agree that in relation to exclusive rights, revenue should be recognised over the term of the licence.

120 Conversely, when an entity sells a non-exclusive right it can sell the same right again and again. Therefore, many customers can have exactly the same right. Accordingly, the entity would not have any performance obligation related to providing something to the customer that no one else can use – in other words, the ability to prevent other entities from directing the user of, and receiving the benefit from, a good or service does not apply in this case. The entity, therefore, does not have any unsatisfied performance obligations when the customer controls the good or service – that is when the customer is able to use and benefit from the license.

<u>Alternative 2</u>

121 EFRAG does not agree with the proposal, because we believe that a distinction should not be made between exclusive and non-exclusive licenses for two reasons:

(a) we do not think that exclusivity captures whether or not a performance obligation remains to be satisfied by the entity after the customer is able to use a licence. We think the factor to be considered is whether continuous involvement exists;

(b) it could be difficult to determine to what degree exclusivity exists.

122 In the view of EFRAG, the ED focuses on whether or not an entity is facing opportunity costs when granting a right to use an intangible asset and the customer is receiving something that no one else can use. If a right is exclusive, an entity cannot grant the same right to another entity and at the same time the customer is receiving something that no one else can use. However, in the view of EFRAG, whether the entity has granted a customer an exclusive or non-exclusive right does not by itself affect the nature of the performance obligation that an entity has in relation to the contract after the customer is able to use and benefit from the licence. In relation to an exclusive right, it is argued in the basis for conclusion to the ED that an entity would have a performance obligation because the right that the entity is providing is constrained for a period of time – as the entity cannot grant a similar right to more than one customer at the same time.

123 We understand that the IASB is linking the existence of a performance obligation to the entity's opportunity costs, and we do not think that such a link should be made. In our view, an entity has a performance obligation if it has a continuous involvement with the contract after the customer is able to use a licence that cannot be separated from the licence agreement – for example, if the entity will have to defend a trademark or would have to provide related services to the customer in order to meet its obligation under the contract. In many cases we think that continuous involvement and exclusivity would go hand-in-hand. However, there are situations where this is not the case and in these situations we think that the focus should be on the continuous involvement as this would capture whether or not a performance obligation remains to be satisfied after the customer is able to use a licence.

Alternative 3

124 EFRAG thinks that 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. Accordingly, we do not think that this is the right point in time to answer question 16.

Question to constituents

125 Which of the alternatives (Alternative 1 to 3) do you prefer?

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?

Notes to EFRAG's constituents

126 *IAS 16 and IAS 38 refer to the current IAS 18 Revenue in relation to accounting for disposals of tangible and intangible assets. IAS 18 will be withdrawn once the new Revenue standard becomes effective. It is therefore proposed that the recognition and measurement principles of the proposed revenue model should also apply in accounting for gains or losses on the sale of some non-financial assets.*

EFRAG agrees with the proposal.

127 EFRAG agrees that if IAS 18 *Revenue* is replaced by a new standard on revenue recognition, 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 this new standard.

APPENDIX 2

Additional issues

1 In addition to the questions raised in the ED, EFRAG would like to make some comments in relation to the definition of stand-alone selling price and the distinction between a contract asset and a receivable.

Stand-alone selling price

Notes to EFRAG's constituents

2 *The ED defines 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.*

EFRAG overall agrees with the definition of a stand-alone selling price. However, for the avoidance of doubt, we think that it could be clarified in Appendix A of the ED that the stand-alone selling price is the price at which the entity would sell that good or service if it was sold separately to that particular customer.

3 EFRAG has debated what the reference to the entity's stand-alone selling price might mean in certain circumstances. For example, we think that in many cases a stand-alone selling price would depend on the customer, so it is necessary to decide whether to account for this 'customer' effect. EFRAG think that the stand-alone selling price should be referring to the price that the entity would have charged the customer, if that particular customer—and not any other customer—would buy the good or service separately. We think so because in many cases it is likely to be impossible to estimate a stand-alone selling price without taking the customer into account. For example, we think that the stand-alone selling price of a carport would be different if it is ordered by a customer where the entity is already carrying out a construction, and therefore has its equipment on the site, than if it is ordered by another customer.

4 We think that the ED takes the 'customer' effect into consideration in the definition of a stand-alone selling price. However, we suggest that this point is clarified in the definition included in Appendix A. This could, for example, be done by defining stand-alone selling price as "the price at which the entity would sell that good or service if it was sold separately to *that* particular customer".

Distinction between a contract asset and a receivable

Notes to EFRAG's constituents

5 *The ED defines a contract asset as an entity's right to consideration from a customer in exchange for goods or services transferred to the customer. However, when the entity has an unconditional right to consideration, a receivable shall be recognised. A right to consideration is unconditional when nothing other than the passage of time is required before payment of that consideration is due.*

EFRAG notes that the proposed definition of a contract asset is not different from the definition of a financial asset in paragraph 11 of IAS 32, as IAS 32 does not require the contractual right to be *unconditional*. The ED introduces an additional criterion for the definition of a receivable – the requirement for the right to consideration to be unconditional. It is not clear how this requirement interacts with the requirements in IAS 32 and how this proposal could be made operational.

6 EFRAG notes that the proposed definition of a contract asset is not different from the definition of a financial asset in paragraph 11 of IAS 32, as IAS 32 does not require the contractual right to be *unconditional*. The ED introduces an additional criterion for the definition of a receivable – the requirement for the right to consideration to be unconditional. It is not clear how this requirement interacts with the requirements in IAS 32 and how this proposal could be made operational.

APPENDIX 3

An alternative model for revenue recognition

1 Under the ED, even in periods when an entity has been very busy on activities carried out pursuant to contracts with customers and where the entity has acquired irrevocable rights to consideration subject to continued performance, no revenue is recognised for the following types of contracts:

(a) construction-type contracts under which the asset under construction is not transferred to the customer on a continuous basis;

(b) contracts for services where there is no continuous delivery (in other words, when the service is delivered after a period of activity by the seller).

2 We do not think this will result in decision-useful information. We think that an entity, that has progressed towards satisfying a performance obligation under such contracts, should report an increase in net assets that shows that it is 'better off' than another entity, that has not performed any work under a contract.

3 We will therefore suggest an alternative model for revenue recognition, which we believe would result in decision-useful information *in all circumstances* within the scope of the ED.

4 Under this alternative model, revenue should reflect the activity carried out by an entity pursuant to a contract with a customer. That is, revenue should be recognised as an entity progresses towards the fulfilment of a performance obligation. However, the following conditions should exist before revenue is recognised:

(a) A contract with a customer must be concluded, and the entity must have performed pursuant to that contract, i.e. made progress in fulfilling its performance obligations under the contract;

(b) The contract must be such that the entity, as it progresses towards fulfilling its performance obligation, holds an irrevocable right to consideration, subject to continued performance. This right may be stipulated in the contract itself, stem from law or from law enforcement practices. In other words, the customer must be obliged, in one way or another, to pay for any work completed to date, as long as the entity performs under the contract.

5 We think that an irrevocable right to consideration would generally exists in relation to:

(a) contracts for the delivery of customer-specific assets; and

(b) contracts for the delivery of assets of significant unit value and that are sold pursuant to small numbers of orders per year and/or of which manufacturing lead time (from order to delivery) is significant.

Under these contracts, risks inherent in launching manufacturing generally command that a contract with a customer and the irrevocable right to consideration subject to performance is secured before the production of the asset commences.

6 The conditions mentioned in paragraph 4 also imply that an entity should have a reasonable assurance that it will perform under the contract before revenue can be recognised.

7 According to the IASB framework, revenue arises because there have been certain increases in the net assets of the entity. In the alternative model it is considered that, as an entity carries out activity pursuant to a contract with a customer, the entity progressively builds up the asset (good or service) that it ultimately (or continuously) is to transfer to the customer. Revenue measures that progression.

8 The alternative model would use many of the concepts developed in the IASB's ED. For example:

(a) 'a contract' should be defined either in the way IAS 32 defines it or in accordance with the ED;

(b) the total amount of revenue recognised on a contract should equal the transaction price of that contract;

(c) if a contract comprises more than one distinct performance obligation, those performance obligations should be treated as separate performance obligations and accounted for separately. For this purpose, the criteria for unbundling performance obligations should be as set out in the ED considering comments suggested by EFRAG;

(d) performance obligations and contract assets would be measured under the alternative model in accordance with the ED;

(e) the carrying value of a performance obligation should be re-measured only as proposed in the ED;

(f) the requirements for, and treatment of the satisfaction of performance obligations will be identical to the ED;

(g) the measurement of progress would be made using the guidance available in the ED on how to measure revenue arising from continuous transfer of revenue.

9 As the alternative model uses many of the concepts developed in the IASB's ED, it also differs from the model of IAS 11 in that it results in more unbundling than paragraphs 8 and 9 of IAS 11 would require. Under the alternative model, a contract that covers a number of assets that are transferred to the customer at different points in time and that could be sold separately would be separated into discrete performance obligations that are accounted for individually.

10 However, contrary to the model proposed in IASB's ED, the satisfaction of a performance obligation would not be the event that would trigger revenue recognition under the alternative model. Despite this difference, we think that revenue recognition under the model proposed in the ED and this alternative model will often coincide. This is because an entity often does not receive an irrevocable right to consideration before control of goods or services passes to the customer and because the time span of some contracts is short. In a cash sale, for example, when a customer buys things in a supermarket, the alternative model

would not result in a different timing of revenue recognition because the time span of the transaction is so short.

11 Also, although the transfer control of goods and services does not trigger revenue recognition under the alternative model, transfer of control is considered as an important economic event that would be appropriately depicted by transfers within the statement of financial position. At the time control transfers, the entity would derecognise the asset it has been building up to the finalisation stage. It would recognise instead, either a contract asset or a receivable, as defined in the ED. As a result, information regarding the transfer of control will also be disclosed under the alternative model.

12 Information provided to users would however not be limited to depicting transfers of control of assets between suppliers and customers. The income statement would convey supplementary information – i.e. how the activity of the entity throughout the period generates revenue and profit pursuant to contracts with customers. This information would prove to be more useful to users in determining sustainable streams of future cash flows. Also, the statement of financial position would show inventory for which no irrevocable right to receive payment contingent on continuous performance separately from inventory (work in progress) for which such a right exists.

13 To illustrate the proposed model, consider the following example. An entity is producing an asset and the contract provides for an irrevocable right to consideration as the work progresses, subject to continued performance. The entity uses 100 cu of inventory and 90 cu of labour to produce the good that is sold for 440 cu. The good is 50 percent finalised at the end of the year and the entity applies the mile-stone method to recognise revenue and the entity has just reached a milestone at the end of the year.

During production (before a milestone is met):		
Dr Inventories (salaries)	90	
Cr Salary payable		90
Dr Inventories (goods)	100	
Cr Payables		100
When a milestone is met:		
Dr Work in progress at sales value	220	
Cr Revenue		220
Dr Costs of sales	190	
Cr Inventory		190

14 It follows that when a milestone is met, a reclassification from inventory to ‘Work in progress at sales value’ through ‘Revenue’ and ‘Costs of sales’ takes place.

15 The IASB has expressed the following concerns with an activities model:

(a) it would be a significant change to existing standards;

(b) revenue recognition would not be based on accounting for the contract – but would be based on increases in an entity’s assets (conceptually, an activities model does not require a contract with a customer for revenue recognition, although revenue recognition could be deferred until a contract exists);

(c) it would be counterintuitive to many users to recognise revenue when the customer has not received any goods or service; and

(d) there would be potential for abuse (an entity could produce inventory and thereby accelerate revenue recognition).

16 We do not agree with these concerns in respect of the alternative model suggested in this appendix. Firstly, we do not think that the alternative model represents a significant change to existing standards if IAS 11 or the paragraphs dealing with rendering of services of IAS 18 are considered as the reference point.

17 Secondly, we do not think that the alternative model would result in more abuse than the model proposed by the ED. Revenue recognition would follow the ED's proposals for revenue recognition when control is transferred on a continuous basis. Accordingly, there would be no more room for abuse under the alternative model under those circumstances. In addition, the conditions the alternative model requires to be present before revenue is recognised would prevent an entity from accelerating revenue recognition by producing inventory. Also, we do not think that preventing abuse should be the leading consideration in developing accounting standards.

18 Thirdly, we believe that this model would avoid that very similar economic situations would be treated differently. Consider an example:

Entity A is producing subway carriages. It has received an order worth 10 cu. A subway carriage is fairly unique and can only be used by the customer. In addition all conditions that we believe are necessary before revenue can be recognised are met. At year-end entity A has produced half a subway carriage.

Entity B is producing train carriages. It has received an order worth 10 cu. A train carriage is fairly standardised although the customer can choose from a series of options in power, colours and sittings. In addition, all conditions that we believe are necessary before revenue can be recognised are met. At year-end entity B has produced half a train carriage.

Under the model proposed in the ED, Entity A would recognise revenue of 5 cu and Entity B would not recognise any revenue. We fail to see how the two situations described above differ in economic terms.

Questions to constituents

19	Are there issues that you would see in applying the proposed alternative model? If so, how could the model be further developed?