

MEMORANDUM

DATE: 26 August 2010

TO: MEMBERS OF THE FINANCIAL REPORTING STANDARDS BOARD

FROM: CLIVE BRODIE
SENIOR PROJECT MANAGER – ACCOUNTING STANDARDS

SUBJECT: COMMENT LETTER ON IASB EXPOSURE DRAFT *CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING: THE REPORTING ENTITY*

Purpose

1. The FRSB is asked to:
 - a) confirm the key issues to be raised in its comment letter on the International Accounting Standards Board (IASB) Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*;
 - b) approve the draft comment letter (agenda item B3.2) due to the IASB by 22 October 2010; and
 - c) agree on a process for finalising the comment letter – the comment letter is due before the next FRSB meeting on 27 & 28 October.
2. This memo includes:
 - a) a list of the key comments to be raised in the FRSB's comment letter on the IASB's Exposure Draft;
 - b) in the appendix, an extract from the minutes of the AASB/FRSB join meeting in July 2010; and
 - c) staff's proposed next steps.

Key issues to be raised in the FRSB's comment letter

3. At the joint AASB/FRSB meeting in July 2010 meeting the FRSB agreed that the following key comments would be raised in its comment letter:
 - a) The Exposure Draft is a mixture of concepts apparently included to combine and justify existing practice in the US and the rest of the world.
 - b) In some instances, the examples accompanying the Exposure Draft seem to conflict with the principles in the Exposure Draft. This would perpetuate the same issue that is currently experienced with the illustrative examples in IAS 18 *Revenue*.
 - c) If the focus of the project is indeed revenue, then the IASB needs to refocus its proposals on revenue from contracts ((rather than contracts *per se*).
 - d) Any proposals should be consistent with current proposals to amend other accounting standards. Any exceptions must be justified in the basis for conclusions.
 - e) The IASB's proposals focus on the wrong asset as a basis for revenue recognition – the physical transfer to customers of a good or service. Rather, the focus should be on the creation of rights and satisfaction of obligations under contracts with customers. Because of this problem, the Exposure Draft's proposals may result in inappropriate accounting for revenue under long-term contracts.
 - i. Although the IASB responded to the Boards' and others' comments on this problem in their submissions on the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, the changes made have not overcome the problem.

- ii. In paragraph 30 of the ED, the list of indicators that control of goods or services has transferred to a customer does not identify the underlying principle for identifying when control has transferred.
- iii. The indicators that control of goods or services has transferred to a customer provided in paragraph 30 of the Exposure Draft were interpreted differently by different Board members, indicating the indicators are ambiguous and raising concerns that their application may be inconsistent.
- iv. The apparent prescriptive nature of paragraph 30 of the Exposure Draft contrasts with the non-prescriptive nature of the subsequent and related paragraphs (paragraphs 32-33 of the Exposure Draft). The indicators that control has been transferred to a customer provided in paragraph 30 of the Exposure Draft could be interpreted strictly and therefore limit the use of the percentage of completion method for revenue recognition with the continuous transfer of goods or services. However, if an entity qualifies to use the percentage of completion method, paragraphs 32-33 are non-prescriptive, allowing almost any approach to recognising revenue with a continuous transfer of goods or services.
- f) The Exposure Draft would create yet another measurement basis for liabilities under International Financial Reporting Standards (IFRSs). A case should be made by the IASB for measuring liabilities to customers by reference to the cost of relieving or extinguishing that obligation.
- g) The proposed approach to accounting for rights of return, options and warranties appears to lack an appropriate underlying principle. Also, the proposals in respect of warranties and options are inconsistent with accounting for options elsewhere (such as the IASB's tentative decisions in its derecognition project) and result in information that is not useful to users.
- h) Including in the measurement of revenue the customers' credit risk is confusing and complex.
- i) The proposals regarding accounting for contract costs appear to be in conflict with IAS 38 *Intangible Assets* by allowing the capitalisation of internally generated intangible assets. If it were appropriate to treat those costs differently, it would be more appropriate to amend IAS 38.
- j) The disclosures proposed are excessive.

Questions for the FRSB

- 4. *Does the FRSB agree with staff's summary of the AASB's/FRSB's key comments above?*
- 5. *Does the FRSB have any comments in respect of the draft comment letter – agenda item B3.2?*

Next steps

- 6. The comment letter is due to the IASB on 22 October which is before the next FRSB meeting on 27 & 28 October. Comments are due to the FRSB by 8 October.
- 7. Staff will update the comment letter for the discussion at this meeting. Thereafter, staff suggests that the updated comment letter be reviewed and finalised by a subcommittee of the FRSB.

6 Revenue: Consider preliminary views on IASB Exposure Draft

- 6 Consider memo from Clive Brodie: Revenue: Consider preliminary views on IASB Exposure Draft ED/2010/6 *Revenue Recognition in Contracts with Customers*
- 6.1 Note memo from Clive Brodie: Summary of IASB Exposure Draft *Revenue Recognition in Contracts with Customers*
- 6.2 Note memo from Clive Brodie: Assessment of impact of the IASB's proposals on current practice
- 6.3 Note FRSB comment letter on IASB Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* – 16 June 2009
- 6.4 Note AASB comment letter on IASB Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* – 19 June 2009
- 6.5 Note IASB Exposure Draft ED/2010/6 *Revenue Recognition in Contracts with Customers*

The AASB and FRSB (the Boards) discussed the IASB's Exposure Draft and members commented that:

- The Exposure Draft is a mixture of concepts apparently included to combine and justify existing practice in the US and the rest of the world. The IASB has arrived at the proposed model as the only practical way to achieve desired pre-determined outcomes.
- In some instances, the examples accompanying the Exposure Draft seem to conflict with the principles in the Exposure Draft. Part of the concern with IAS 18 *Revenue* is that the accompanying illustrative examples are inconsistent with the principles in IAS 18. If the IASB proceeds with the Exposure Draft and related application guidance it will perpetuate the same concern. The Boards questioned whether an exposure draft supplemented by up to 50 pages of application guidance is principles-based.
- The Exposure Draft seems to be more about accounting for contracts than accounting for revenue even though the project objective was to establish a standard for revenue. If the focus of the project is indeed revenue, then the IASB needs to refocus its proposals on revenue from contracts (rather than contracts *per se*).
- Any proposals should be consistent with current proposals to amend other accounting standards, for example, in respect of leases and insurance contracts. Any exceptions must be justified in the basis for conclusions.
- The IASB's proposals focus on the wrong asset as a basis for revenue recognition – the physical transfer to customers of a good or service. Rather, the focus should be on the creation of rights and satisfaction of obligations under contracts with customers. Because of this problem, the Exposure Draft's proposals may result in inappropriate accounting for revenue under long-term contracts.
 - Although the IASB responded to the Boards' and others' comments on this problem in their submissions on the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, the changes made have not overcome the problem.

- In paragraph 30 of the ED, the list of indicators that control of goods or services has transferred to a customer does not identify the underlying principle for identifying when control has transferred.
- The indicators that control of goods or services has transferred to a customer provided in paragraph 30 of the Exposure Draft were interpreted differently by different Board members, indicating the indicators are ambiguous and raising concerns that their application may be inconsistent.
- The apparent prescriptive nature of paragraph 30 of the Exposure Draft contrasts with the non-prescriptive nature of the subsequent and related paragraphs (paragraphs 32-33 of the Exposure Draft). The indicators that control has been transferred to a customer provided in paragraph 30 of the Exposure Draft could be interpreted strictly and therefore limit the use of the percentage of completion method for revenue recognition with the continuous transfer of goods or services. However, if an entity qualifies to use the percentage of completion method, paragraphs 32-33 are non-prescriptive, allowing almost any approach to recognising revenue with a continuous transfer of goods or services.
- The Exposure Draft would create yet another measurement basis for liabilities under International Financial Reporting Standards (IFRSs). If the IASB proceeds with its proposals, there would be at least four (*see below*) types of liabilities with different measurement bases under IFRSs:
 - a liability under the Standard on revenue from contracts with customers, measured at transaction price (not consistent with the measurement basis in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*);
 - an onerous contract liability (not consistent with the measurement basis in IAS 37);
 - provisions, measured under IAS 37; and
 - financial liabilities.
- A case should be made to the IASB for measuring liabilities to customers by reference to the cost of relieving or extinguishing that obligation.
- The proposed approach to accounting for rights of return, options and warranties appears to lack an appropriate underlying principle. Also, the proposals in respect of warranties and options are inconsistent with accounting for options elsewhere (such as the IASB's tentative decisions in its derecognition project) and result in information that is not useful to users. For example, in example 14 in the Exposure Draft, an entity sells an asset and grants the customer the option to return the asset and receive a refund. The entity estimates that there is a 50% probability that the asset will be returned. Therefore, the entity recognises 50% of the transaction price as revenue. Recognising half the transaction price does not provide the user of financial statements with meaningful revenue information. It would be more useful if the entity accounted for the entire sale at 100% of its value and then accounted for the written put option separately.
- Including in the measurement of revenue the customers' credit risk is confusing and complex.

- The proposals in paragraph 57 of the Exposure Draft regarding accounting for contract costs are confusing. The proposals appear to be in conflict with IAS 38 *Intangible Assets*. IAS 38 prohibits the capitalisation of internally generated intangible assets. Paragraph 57 of the Exposure Draft however may allow the capitalisation of some internally generated intangible assets. If it were appropriate to treat those costs differently, it would be more appropriate to make that change by amending IAS 38.
- The disclosures proposed are excessive.

The Boards agreed the following:

- The comment letters should set out the conceptual concerns the Boards have with the Exposure Draft. The comment letters should also set out the necessary changes that should be made to the proposals at a practical level if the IASB proceeds with the main proposals in the Exposure Draft.
- AASB and FRSB staff would prepare a joint issues paper summarising the key issues to be raised in the Boards' comment letters for consideration at each Board's next meeting.