

[date] October 2010

Sir David Tweedie
Chairman
The International Accounting Standards Board
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Dear David

EXPOSURE DRAFT ED/2010/6 *Revenue from Contracts with Customers*

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*.

Key concerns

The FRSB's primary concerns with the Exposure Draft are as follows:

- The concepts underpinning the Exposure Draft.
- The proposal to base revenue recognition on the physical transfer of goods or services to customers rather than on the transfer of rights and obligations.
- The lack of consistency between the proposals in the Exposure Draft and other International Financial Reporting Standards (IFRSs) or other proposals presently under consideration, including the creation of a separate measurement basis for liabilities that are similar in nature.
- The lack of consistency between the proposed standard and the application guidance as well as the extent of mandatory application guidance proposed for a principles-based standard.
- The volume of mandatory guidance proposed for what is intended to be a principles-based standard.
- The degree of complexity that the Exposure Draft might introduce.
- The onerous and excessive amount of disclosures proposed.

The concepts underpinning the Exposure Draft

The Exposure Draft appears to be a mixture of concepts apparently included to combine and justify existing practice in various parts of the world. The proposed model seems to be derived as the only practical way to achieve desired pre-determined outcomes.

Although the objective of the IASB's revenue project was to develop a standard on revenue, the Exposure Draft addresses accounting for contracts with customers more than accounting for revenue. If the focus of the project is indeed revenue, then the FRSB considers that the proposals should be refocused on revenue from contracts (rather than contracts *per se*). The FRSB is also unclear whether income other than contracts with customers should be classified as gains, or whether other sources of revenue are possible.

Revenue recognition based on physical transfer of goods or services

The FRSB is concerned that the Exposure Draft still places too much emphasis on the physical delivery of a good or service which could result in inappropriate timing of revenue recognition under long-term contracts. The proposals in the Exposure Draft seem to particularly affect construction contract accounting in a way that could unnecessarily delay revenue recognition but without any indication of the problem that the IASB is attempting to solve.

The emphasis in the Exposure Draft on the physical delivery of a good or service ignores the rights of the customer which may arise before delivery and the rights (and obligations) of the supplier that arise as specialised assets are constructed. If valuable materials are committed to production or construction the supplier will have a right before delivery, such that the customer cannot terminate the contract without penalty. Likewise, the customer would have a right to require the supplier to finish the good in question.

The focus on physical delivery of goods or services inappropriately forces an entity to account for separate performance obligations based on sales of analogous physical goods and services. Rather, the focus should be on the creation of rights and satisfaction of obligations under the contract itself.

In particular the FRSB has concerns with the following paragraphs of the Exposure Draft:

- Paragraph 21(g) suggests that a contractor provides a good or service as the contractor performs contractually agreed tasks (arguably, every step in a contract could be a contractually agreed task and therefore give rise to recognition of revenue). However, paragraph 22 then restricts revenue recognition by referring to criteria unrelated to the rights and obligations under the contract i.e. criteria for identifying goods and services that are physically distinct.
- Paragraph 25 ties the transfer of control of a good or service to a customer to the physical delivery of the good or service rather than to the rights and obligations arising under the contract.
- Paragraph 30 includes a list of indicators that control of goods or services has transferred to a customer. However, what has not been identified is the underlying principle for identifying when control has transferred.

- In paragraph 30, the indicators that control of goods or services has transferred to a customer were interpreted differently by different members of the FRSB raising concerns that application in practice 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 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 application of paragraph 33(a) and (b) hinges on ones definition of 'output methods' and 'input methods'. If work in progress were considered an output, an entity could justify using the percentage of completion method.
- Para 30(a) states that an indicator that the customer has obtained control of a good or services is that the customer has unconditional obligation to pay. This obligation could arise ahead of goods and services being transferred to the customer.

Lack of consistency between the Exposure Draft and other standards or proposals

The FRSB considers that any proposals should be consistent with current proposals to amend other IFRSs, for example, in respect of leases and insurance contracts. Any exceptions must be justified in the basis for conclusions. The FRSB considers that inconsistencies between the Exposure Draft and other proposals arise in the following areas:

- The proposed approach to accounting for warranties and rights of return.
- The proposed accounting for contract costs.
- The proposed approach to measurement uncertainty.
- The proposed approach to assessing whether or not control has transferred to the customer.

Inconsistent approach to accounting for warranties and rights of return

The proposals in respect of warranties and rights of return are inconsistent with accounting for such items elsewhere in other IFRSs or IASB projects and result in information that is not useful to users.

The approach to accounting for rights of return and warranties proposed in the Exposure Draft appears to lack an appropriate underlying principle. The justification for the differing approach to rights of return, warranties for latent defects and warranties for faults is the measurement thereof rather than the nature or substance of the underlying transaction.

The FRSB considers that an entity's obligation to accept returned goods and refund the customer's consideration should be a performance obligation. A standalone guarantee (like an insurance contract) is treated as a revenue generating activity. Consistently, warranties or return rights embedded within a contract with a customer should be treated as a performance obligation.

Treating rights of return as options to unwind a transaction where the customer does not actually have control over the right of return would require an entity to defer the recognition of any revenue arising from the contract until the right of return has expired. Such an approach inappropriately implies that the contract with the customer has not resulted in anything of substance. Reporting revenue in this manner would provide users with misleading information.

Example 14 of the illustrative examples in the application guidance of the Exposure Draft illustrates the potential for spurious results to be reported when combining a probability-weighted estimate of outcomes with a 'failed sale' approach to rights of return proposed in the Exposure Draft. We elaborate on our concerns in our response to question 15 of the IASB's questions for respondents set out in the appendix to this letter.

Proposed accounting for contract costs - potential inconsistent approach to accounting for internally generated intangible assets

The proposals regarding accounting for contract costs 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 certain contract costs differently, it would be more appropriate to make that change by amending IAS 38.

Inconsistent approach to measurement uncertainty

The proposals regarding the circumstances in which an entity has the necessary experience to be able to reasonably estimate the transaction price and therefore recognise revenue, is inconsistent with the IASB's approach to measurement uncertainty elsewhere (for example in the financial instruments project) and could create an inappropriate accounting outcome.

The proposals in paragraphs 38 and 39 could give rise to a situation where an entity, having met a milestone in a contract, is still unable to recognise revenue because the entity does not know what the ultimate contract revenue will be. The entity would not recognise revenue but would continue to recognise a liability for any consideration received even though it may be clear that the performance obligation has been satisfied. This results in bias in the financial statements. Also, this approach is inconsistent with the approach to measurement uncertainty in the IASB's financial instruments project where an entity is required to measure instruments at fair value based on estimates except in exceptional circumstances.

Inconsistent approach to measurement of liabilities similar in nature

The FRSB is concerned that the Exposure Draft would create yet another measurement basis for liabilities different from measurement of similar liabilities under other IFRSs. If the IASB proceeds with its proposals, there would be:

- Revenue liabilities: a liability under the proposed standard on revenue from contracts with customers, measured at transaction price and not consistent with the measurement basis in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- Onerous contracts: an onerous contract liability measured differently from liabilities under IAS 37.

- Provisions for non-financial liabilities, measured under IAS 37.
- Financial liabilities measured at fair value.

Inconsistent approach to assessing whether or not control exists

Paragraph 27 of the Exposure Draft states that the customer's ability to direct the use of a good or service refers to the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities. It is unclear why the remaining useful life of the asset is relevant when control is assessed at a point in time, not at a point in time and for a specified period. Considering the useful life of the asset potentially is in conflict with the approach taken in other IASB projects such as the conceptual framework project, the consolidation project and the leases project. It is also unclear whether the second part of the sentence 'or to consume the asset in the customer's activities' is intended to modify the first part of the paragraph or to deal with different circumstances.

Inconsistent application guidance and excessive amount of mandatory application guidance

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. In our response to question 14 of the IASB's questions for respondents set out in the appendix to this letter, we explain our concerns with particular illustrative examples in the proposed application guidance.

Also, the FRSB questions whether a proposed standard supplemented by up to 50 pages of mandatory application guidance is indeed a principles-based standard.

Degree of complexity that the Exposure Draft may introduce

Including a customer's credit risk in measurement of revenue

The FRSB is concerned about the practical difficulties of factoring a customers' credit risk into the measurement of revenue. Existing practice would not be to take credit risk out of the contract price unless there is evidence of failure. If the measurement of revenue includes the customers' credit risk accounting for most credit sales will be affected. The resulting change will be confusing, complex and, for most entities, costly to apply.

Use of probability-weighted estimates

The FRSB considers that it may be extremely complex and costly to measure amounts using detailed probability-weighted averages of all possible outcomes. As such, the proposed approach to dealing with measurement uncertainty would create: (i) considerable compliance cost; (ii) overly complex reported amounts (that do not equate to actual or expected outcomes); and (iii) tension between reporting entities and their auditors. Measurement at the most likely amount is preferred and provides users with the most relevant and useful information.

The onerous and excessive amount of proposed disclosures

The FRSB considers the disclosures proposed by the Exposure Draft to be both onerous and excessive. In our response to questions 10, 11 and 12 of the IASB's questions for respondents, set out in the appendix to this letter, we explain our concerns with particular illustrative examples in the proposed application guidance.

Responses to questions for respondents

The FRSB's responses to the specific questions for respondents to the Exposure Draft are provided in the appendix to this letter.

If you have any queries or require clarification of any matters in this submission, please contact me.

Yours sincerely

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Appendix – FRSB’s responses to specific questions for respondents raised in the Exposure Draft

Recognition of revenue (paragraphs 8-33 of the Exposure Draft)

Question 1

Paragraph 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?

1. The FRSB does not agree with the outcome of the proposals as illustrated in scenario 2 of example 2 in the proposed application guidance. The FRSB considers that adjusting reported revenue due to a subsequent agreement to provide further services at a lower price inappropriately distorts reported revenue providing users of financial statements with information that is misleading.
2. In scenario 2 of example 2, it is concluded that the price negotiated for a further 3 years of service is dependent upon the price agreed for the first 3 years of service. Consequently, the entity is required to account for the agreement for a further 3 years service together with the original contract for the first 3 years of service. The entity therefore is required to recognise the cumulative effect of the contract modification as a reduction to revenue in year 3 and, for the further 3 years of service, recognise revenue at the stand-alone selling price that would otherwise be charged for those services.
3. The FRSB considers that revenue should be reported at the amounts agreed with the customer for each year of service. Therefore, in years 1 to 3, revenue of \$100,000 should be reported, being the price agreed for each year of service. In years 4 to 6, \$40,000 should be reported, being the price agreed for each of the further 3 years of service. To adjust reported revenue to \$40,000 in year 3 and \$80,000 per year for years 4-6 attempts to report ‘relative revenue’ (i.e. revenue relative to what might be charged in the market for the same or similar services). The FRSB considers that distorting reported revenue in this manner provides users with misleading information and undermines the usefulness of reported revenue in predicting an entities future cash flows.
4. The mere fact that the service provider is agreeing to provide an existing client with discounted services is not sufficient to justify combined accounting for the both the agreement for the first 3 years of service and the second agreement for a further 3 years of service. Such an approach fails to recognise the possibility that the service provider may offer its existing preferred clients with preferential rates compared to new or other clients.

Question 2

The boards propose that an entity should identify the performance obligation 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?

5. The FRSB does not agree with the proposals. Refer to the cover page of this comment letter for the FRSB's comments in regards to these proposals and particularly in relation to recognition of revenue under long-term contracts.

Question 3

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

6. The FRSB does not agree with the proposals and related application guidance. The FRSB is concerned that the Exposure Draft still proposes to base revenue recognition on the physical transfer of goods or services to customers rather than on the transfer of rights and obligations. This is particularly in relation to long-term contracts. The FRSB is also concerned at the potential for inconsistent application of the proposals in practice. Refer to the cover letter of this comment letter for the FRSB's detailed comments in this regard.

Measurement of revenue (paragraphs 34-53 of the Exposure Draft)

Question 4

The boards proposed that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposed criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

7. The FRSB is concerned that the proposals in paragraphs 38 and 39 of the Exposure Draft regarding the circumstances in which an entity has the necessary experience to be able to reasonably estimate the transaction price and therefore recognise revenue, are inconsistent with the IASB's approach to measurement uncertainty elsewhere (for example in the financial instruments project) and could create an inappropriate accounting outcome. Refer to the covering letter for the FRSB's detailed comments in this regard.

8. In addition, the FRSB considers that the following paragraphs are too prescriptive for what is intended to be a principles-based standard:
- a. Paragraphs 38 and 39 regarding the circumstances in which an entity's experience is relevant in estimating the transaction price.
 - b. Paragraphs 48 and 49 regarding consideration payable to the customer.

Question 5

Paragraph 43 proposed 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?

9. The FRSB is concerned about the practical difficulties of factoring a customer's credit risk into the measurement of revenue. Existing practice would not be to take credit risk out of the contract price unless there is evidence of failure. If the measurement of revenue includes the customer's credit risk accounting for most credit sales will be affected. The resulting change will only be confusing, complex and, for most entities, costly to apply.

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?

10. The FRSB agrees that, where the effect is material, the amount of promised consideration should be adjusted to reflect the time value of money.

Question 7

Paragraph 50 proposed 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?

11. The FRSB agrees that the transaction price should be allocated to performance obligations identified within a contract on the basis of the entity's selling price (estimated if necessary) of the individual goods or services underlying those performance obligations. The proposed approach will provide the most reliable decision-useful information for users.

Contract costs (paragraphs 57-63 of the Exposure Draft)

Question 8

Paragraph 57 proposed 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, IAS 16 or IAS 38), 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?

Question 9

Paragraph 58 proposes [specifies] the costs that related directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liabilities recognised for an onerous performance obligation.

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

12. The FRSB considers that the proposals could 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 certain contract costs differently, it would be more appropriate to make that change by amending IAS 38.

Disclosure (paragraphs 69-83 of the Exposure Draft)

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 that the proposed disclosure requirements will meet that objective? If not, why?

13. The FRSB considers the disclosures proposed by the Exposure Draft to be both onerous and excessive. In particular the FRSB is concerned with the following proposed disclosure requirements:
- a. Disclosure of detailed reconciliations of contract balances is excessive (paragraphs 75-76 of the Exposure Draft). It seems that the IASB has concluded that disclosure is required of complete reconciliations of all major balances in balance sheets but without providing appropriate justification for such a blanket approach to determining disclosure requirements.
 - b. Disclosure of detailed information about performance obligations is excessive (paragraph 77 of the Exposure Draft). In addition, the detailed information required to be disclosed could be considered commercially sensitive.

- c. The proposed disclosures in paragraphs 81 to 83 of the Exposure Draft in respect of significant judgments in the application of the proposed standards are excessively detailed and potentially duplicate the disclosures required by IAS 1 *Presentation of Financial Statements* regarding judgements made in the process of applying the entity's accounting policies and information about sources of estimation uncertainty.

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?

14. The FRSB disagrees with the proposals. Entities are already required to disclose the portion of assets and liabilities expected to be recovered or settled: (i) no more than twelve months after the reporting period; and (ii) more than twelve months after the reporting period (in accordance with IAS 1 *Presentation of Financial Statements*). This existing classification provides users with appropriate and useful information.

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?

15. The FRSB disagrees with the proposed level of disaggregation for disclosure. This level of disaggregation would result in excessively detailed disclosures.

Effective date and transition (paragraphs 84-85 of the Exposure Draft)

Question 13

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

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

16. The FRSB agrees with the IASB's intention that the proposed requirements should be applied to all contracts in existence during any reporting periods presented. However, the proposed transition requirements do not make it clear that this is the intention. Simply stating that full retrospective application is required could be interpreted as requiring application of the proposed standard to all previous periods and including contracts in existence prior to reporting periods presented. The FRSB recommends that the IASB make its intention clear in the transitional provisions.

Application guidance (paragraphs B1-B96 of the Exposure Draft)

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

17. 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. Set out below are the concerns the FRSB has with specific examples.
18. Also, the FRSB questions whether a proposed standard supplemented by up to 50 pages of mandatory application guidance is indeed principles-based.

Example 11 – Construction contract

19. In illustrative example 11 it is simply stated that the customer obtains control of the material and equipment as they are delivered. This is not particularly useful as the question in practice will be, how is it determined that control has passed to the customer? The FRSB recommends providing in the example the rationale for this conclusion.

Example 18 – Management fees based on an index

Example 19 - Consulting services with a performance bonus/penalty

20. The FRSB does not agree with the outcome illustrated in example 18. In example 18 it is concluded that the entity cannot recognise as revenue any portion of the variable consideration due to the uncertainty arising from the wide range of possible outcomes.
21. The FRSB considers that the proposals in paragraphs 38 and 39 of the Exposure Draft regarding the circumstances in which an entity's experience is relevant in estimating the transaction price are too prescriptive and therefore give rise to a situation where an entity, having met a milestone in a contract, is still unable to recognise revenue because the entity does not know what the ultimate contract revenue will be. This gives rise to bias in the financial statements and is inconsistent with the approach to measurement uncertainty taken by the IASB in other projects.

22. In both example 18 and example 19, the FRSB considers that measurement at the most likely amount is preferred and would provide users with the most relevant and useful information. The FRSB considers that may be extremely complex and costly to measure amounts using detailed probability-weighted averages of all possible outcomes. As such, the proposed approach to dealing with measurement uncertainty would create: (i) considerable compliance cost; (ii) overly complex reported amounts (that do not equate to actual or expected outcomes); and (iii) tension between reporting entities and their auditors.

Example 20 – Customer credit risk

Example 21 – Customer payment in arrears

23. The FRSB strongly disagrees with example 20.
24. Firstly, the FRSB is concerned about the practical difficulties of factoring a customers' credit risk into the measurement of revenue. If the measurement of revenue includes the customers' credit risk accounting for most credit sales will be affected. The resulting change will only be confusing, complex and, for most entities, costly to apply.
25. Secondly, presumably other customers would buy the same product of CU1,000 cash (i.e. the customer in the example does not pay extra for the extended credit for 30 days) there is no justification for recognising revenue at less than \$1,000. Surely the "loss" is due to the financing activity (i.e., extending credit for 30 days). Therefore this should be an IAS 39/IFRS 9 issue and should be recognised as a financial instrument impairment loss. Even if one accepts the proposals as illustrated in example 20, it is unclear how the entity would account for the "gain" of CU100 in the event of the customer paying the full consideration. If the "gain" is interest income it would be interest at an astronomical rate of 133%. If the "gain" is additional revenue, deferring recognition until payment is inconsistent with the proposals in the Exposure Draft since recognition as revenue would not coincide with the transfer of control of the good to the customer.
26. Thirdly, the FRSB considers that, if the IASB proceeds with the example 20 and example 21 (customer payment in arrears), example 20 and 21 should be combined to provide a more realistic and useful example.

Example 22 – Customer payment in advance

27. The FRSB considers that requiring an entity to recognise interest expense on revenue received in advance is excessively pedantic and therefore, unlikely to be accepted in practice.

Example 23 – Slotting fees

28. In example 23 it is concluded that, although the product placement service is not sold separately (i.e. without related products), the service is distinct because it has a distinct function and a distinct profit margin. It is unclear how it was concluded that the product placement service has a distinct profit margin when the product placement service is intertwined with the purchase and sale transaction for the goods in question. The FRSB recommends providing in the example the rationale for this conclusion.

Example 24 – Sales incentive

29. In example 24 it is concluded that, if the manufacturer issues the coupons before it transfer the product to the retailer, the manufacturer would recognise revenue at the transaction price less the maximum discount provided by the coupons. The FRSB's considers that it is unclear why the timing of the issue of the coupons by the manufacturer affects the accounting by the manufacturer. Whether the manufacturer issues the coupons prior to or after transferring products to the retailer, the substance of the issuing of the coupons does not change and, therefore, the accounting for such coupons should be the same regardless of when the coupons are issued. The FRSB considers that example 24 provides a perfect structuring opportunity for the manufacturer to manipulate the timing of revenue recognition.

Example 25 – Estimating the stand-alone selling price of an option for additional goods or services

30. The FRSB considers that example 25 is difficult to follow. The FRSB recommends that each step required to be undertaken in accordance with the proposed standard be explained in more detail.

Example 27 – Maintenance services with a renewal option

31. The FRSB considers the proposed approach illustrated in example 27 to be too complex and costly to apply, and therefore, is unlikely to be accepted in practice. The FRSB considers that it may be extremely complex and costly to measure amounts using detailed probability-weighted averages over multiple years. As such, the proposed approach would create: (i) considerable compliance cost; (ii) overly complex reported amounts that do not equate to actual or expected outcomes diminishing the usefulness of reported amount for users; and (iii) tension between reporting entities and their auditors.

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?

32. The FRSB does not agree with the proposed distinction between the type of product warranties and rights of return.
33. The proposed approach to accounting for rights of return and warranties appears to lack an appropriate underlying principle. The justification for the differing approach to rights of return, warranties for latent defects and warranties for faults is the measurement thereof rather than the nature or substance of the underlying transaction. In addition, in some cases, it is doubtful whether or not, in practice, it would be beneficial or even possible to distinguish between repair under

warranty of latent defects and repair under warranty of defects that arise subsequent to the sale of goods.

34. The FRSB considers that an entity's obligation to accept returned goods and refund the customer's consideration should be a performance obligation. A standalone guarantee (like an insurance contract) is treated as a revenue generating activity. Consistently, warranties or return rights embedded within a contract with a customer should be treated as a performance obligation.
35. Regarding rights of return, the FRSB considers that treating rights of return as options to unwind a transaction would require an entity to defer the recognition of any revenue arising from the contract until the right of return has expired. Such an approach inappropriately implies that the contract with the customer has not resulted in anything of substance. Reporting revenue in this manner would provide users with misleading information. The gross revenue amount provides useful information to users as a key indicator of economic activity. If this amount is not provided in the financial statements, users will lose a vital piece of information.
36. Example 14 of the illustrative examples in the application guidance of the Exposure Draft illustrates the potential for spurious results to be reported when combining a probability-weighted estimate of outcomes with a 'failed sale' approach to rights of return and warranties proposed in the Exposure Draft. In example 14 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 then entity accounted for the entire sale at 100% of its value and then accounted for the written put option separately. Users are more concerned with the most likely amounts. Particularly where there is only a limited number of discrete outcomes, the most likely obligation reflects management's expectations and represents an actual possible outcome.

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 it satisfies that obligation when the customer is able to use and benefit from the licence.

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

37. The FRSB considers that the distinction between exclusive and non-exclusive rights to use of software is artificial. In the case of both exclusive and non-exclusive rights, the FRSB considers that performance obligation to be the requirement to provide the good for the customer to enjoy over a period in quiet access. Whether the right is exclusive or non-exclusive, the right to use does not differ from the customer's viewpoint (except maybe in value in the case of a rare right). The proposals appear to create an unnecessary and inappropriate distinction much like the distinction between an operating and a finance lease that the IASB is attempting to eliminate in its project on lease accounting.

Consequential amendments

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?

38. The FRSB agrees with the proposals. The accounting for revenue or similar items should be consistent across all standards as far as possible.

Non-public entities

Question 18 [FASB only]

Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organisations)? If so, which requirements(s) and why?

39. If the proposed standard were to be applicable to non-public entities, the FRSB's expectation is that little, if any, modification would be appropriate. This is because the proposed standard specifies the accounting for revenue arising from contracts with customers which are primarily exchange transactions rather than accounting for revenue from non-exchange transactions such as some forms of government grant or donations.

Other issues

40. The FRSB is concerned that paragraph 29 of the Exposure Draft sets a precedent for accounting for repos ahead of the IASB completing its derecognition project. Paragraph 29 states that, when assessing whether a customer obtains control of an asset, an entity shall consider any related arrangements entered into at or near the same time as or in contemplation of the contract. This would imply that repurchase agreements entered into at or near the same time as or in contemplation of a sale agreement would preclude derecognition of the asset and recognition of revenue.

41. The FRSB is concerned that paragraph 47 of the Exposure Draft suggests that consideration would have to be paid before it could be accrued. Paragraph 47 states that, if a customer contributes goods or services to facilitate the fulfilment of a contract, an entity must first assess whether it obtains control of the contributed goods or services. If so, the entity accounts for the contributed goods or services as non-cash consideration. This paragraph implies that an entity could ignore a contractual receivable until goods are received when the transfer of control is not usually the trigger for accrual.