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Dear Bruce

**ITC 18 Request for Comment on IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers**

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on its Invitation to Comment on the IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers ITC 18 (the DP).

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies and businesses, and this submission has benefited with input from our clients, Grant Thornton International which will be finalising a global submission to the IASB, and discussions with key constituents.

Although both the FASB and the IASB are already addressing some of the issues in separate projects, this is such a crucial area that a joint approach is needed. We support the project and agree there is a compelling case for change.

A single model is a good aspiration but not at the expense of decision-usefulness. Although this looks like a good starting point, there is still a lot of work to do to develop a workable solution to many practical issues, such as measurement, variable or contingent consideration and some long-term contracts.

In addition to the problems noted, the recognition models in IAS 11 (based on activity) and IAS 18 (based on transfer of control and risks/rewards) are very different and the boundary between them (the buyer having the ability to specify or change the major structural elements) is unsatisfactory. We note that for many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the boards' proposed model would differ from present practice. For example:

- entities that at present recognise revenue for construction-type contracts as activity progresses would recognise revenue during construction only if the customer controls the work in progress as it is constructed.
- in present practice, entities sometimes account for similar contractual promises differently, e.g. some warranties and other post-delivery services are accounted for as cost accruals rather than as 'deliverables' in or 'components' of a contract. In the proposed model, entities would account for those obligations as performance obligations and would recognise revenue as they are satisfied.
- more entities would estimate the stand-alone selling prices of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer, even if there is no objective and reliable evidence of the selling price of the undelivered items.
- at present, entities sometimes capitalise the costs of obtaining contracts. In the proposed model, costs are capitalised only if they qualify for capitalisation in accordance with other standards.

Our detailed comments on the IASB's questions in the DP and comments requested by the AASB are contained in Appendix 1.

If you require any further information or comment, please contact me.

Yours sincerely  
GRANT THORNTON AUSTRALIA LIMITED



Keith Reilly  
National Head of Professional Standards

## Appendix

### **(a) Response to IASB Questions**

#### **Question 1**

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not?

If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

- We agree a single model is desirable and is worth striving for. The individual rights and obligations within a contract are very fact specific but are expected to be closely interdependent. This interdependency suggests that the proposed 'change in the net contract position' is a good starting point. Treating the contract as the unit of account will help to achieve consistency in the consideration of all the rights and obligation under the contract.

#### **Question 2**

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why.

What alternative principle do you think is more useful in those examples?

- The summary of preliminary views highlights three types of contract that the Board are currently questioning the usefulness of the proposed model for: financial instruments in the scope of IAS 39 or SFAS 133; insurance contracts in the scope of IFRS 4 or SFAS 60; and leases in the scope of IAS 17 or SFAS 13 (DP.S11). Are there other examples where the current proposals may not provide decision-useful information?
- (i) Long-term contracts? If there is no continuous transfer, an entity that performs work under a contract will not recognise revenue until final delivery. Also, the contract terms that establish continuous transfer may have very limited practical or economic effect. For example, a customer might have a legal entitlement to take the work to date and change supplier, but it will very often be commercially unattractive to do so (especially if there is a cancellation penalty). We will get dissimilar accounting for contracts that may be substantively similar - is this an acceptable outcome?

- (ii) Licensing agreements - what is the unit of account (the right itself or the underlying IP) for assessing control and what is the role of use restrictions in determining whether control has passed?

### Question 3

Do you agree with the boards' definition of a contract? Why or why not?

Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

- The proposed definition of a contract appears reasonable and should be suitable to apply in most cases. It does not obviously rely on specific contract law in any particular jurisdiction but it will rely on judgement in determining what is enforceable. However, are some 'contracts' that are not enforceable at law (e.g. betting contracts) and for which revenue could not therefore be recorded (this is perhaps a definition point) or are there scenarios in which revenue arises but there is no contract?
- Another point to consider is whether there will be problems over deciding when a contract comes into being. It is for example commonplace in professional services to undertake substantial work before signing an engagement letter. Is the definition broad enough to capture the period prior to finalisation of contract?

### Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not?

If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

- Partly. The definition itself revolves around transfer of an asset. The application guidance in the DP then takes a very broad view of an asset in this context - including things we don't normally consider to be asset. For example, the Boards acknowledge that making the definition operational involves thinking about services as assets even though we wouldn't normally do so. As another example, in a warranty arrangement (which may generate revenue without any provision of services) is an 'asset' really 'transferred' simply as a result of time passing. Similarly, under IFRIC 13, we currently record revenue if the customer loyalty awards (to which revenue has been allocated) expire. Is expiry equivalent to transfer of an asset? It almost seems like an attempt to force asset/liability language into the model rather than state a clear principle that will drive the application.
- Also, the identification of additional consideration may be a useful indicator that a right of return is an additional service but it is not clear this should be an essential criterion (it should not be).
- See also comments under Q5

**Question 5**

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not?

If not, what principle would you specify for separating performance obligations?

- The proposal to recognise separate performance obligations based on the timing of transfer of promised assets to the customer is a reasonable approach but it is not particularly useful in distinguishing whether we have (i) one obligation that take time to deliver, or (ii) more than one performance obligation satisfied at different times. To identify 'performance obligations' we must identify the 'promised assets' and then decide if there is more than one 'asset'. This is not easy when the term asset is used so loosely in this context but suggesting an alternative is not easy. For example:
  - A5 suggests that an 'asset' for this purpose is anything that could be sold separately
  - in a continuous transfer model, the asset is an infinitely divisible portion of the WIP in a stand-ready type arrangement such as a warranty the asset transfer is simply the passage of time (although we question whether this is really a service type arrangement or is it more appropriate to treat it like an insurance contract or option-type arrangement (e.g. in a sale with right of return).

**Question 6**

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

- As mentioned immediately above, although the wording of the example in 3.34-42 (rights of return) is not totally clear, there seems to be sufficient support for the characterisation as a performance obligation. However, it may be more useful and persuasive to describe the obligation as a written option. This fits better with the asset terminology used in defining performance obligations.

**Question 7**

Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

- Yes but not sure it helps with practical issues on volume rebates (is 'rebate' a performance obligation attaching to each sale, or only to the sales that takes the volume to the target level).

**Question 8**

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not?

If not, please suggest an alternative for determining when a promised good or service is transferred.

- The proposal to concentrate on transfer of control is not only more consistent with the Boards' relevant Frameworks but is more straightforward to apply than a mixed model requiring transfer of control plus risks and rewards. However, it will be important to define control carefully as it currently has a number of meanings in IFRS - e.g. in IAS 18 control is not defined but is perhaps associated with managerial involvement; in IAS 27 it's about power to take decisions and in IAS 39 it's about practical ability to sell the asset. In the DP, the Toolco examples at 4.11 et seq seem to take a 'legally enforceable rights' view which seems broadly the same as legal title.
- There will be a need for clear application guidance to help distinguish 'activities' from 'transfer' in the context of transfer of control in services and stand-ready type arrangements.
- Further guidance may be needed for licensing agreements: what is the unit of account (the right itself or the underlying IP) for assessing control and what is the role of use restrictions in determining whether control has passed?

#### **Question 9**

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

- Linking the timing of revenue recognition to satisfaction of performance obligations seems to be a very reasonable approach for many situations. However, does it work for long-term contracts where there is no continuous transfer (see earlier comments)?

#### **Question 10**

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- a Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?
- b Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?
- c Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not?  
If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.
- d Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not?  
If so, please provide examples and describe the measurement approach you would use.

- For those familiar with using a multiple-element approach under IFRIC 13 *Customer Loyalty Programmes*, and to some extent IAS 11 *Construction Contracts*, the proposed approach will be reasonably familiar.
- In response to the individual sub-questions:
  - a Yes, but this will not always be straight-forward (especially for variable, performance based fees and contingent fees).
  - b Yes - this is consistent with the current approach and that in IAS 37 and is unlikely to cause problems in the majority of cases where the time taken to deliver all elements of the contract is not significant and there is little variability in outcomes.
  - c The proposed approach may create volatility in the margins recognised for the different elements if there is a higher level of variability in outcomes. What measurement approach(es), if any, would provide a more consistent approach for these more variable contracts as well as the simpler contracts?
  - d Will the model work for continuous transfer type contracts?

**Question 11**

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- a Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?
  - b In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.
- a) Yes.
    - b) In some industries, this will be controversial because these costs may be substantial (and so should be disclosed) but there is no obvious conceptual basis for capitalising them.

**Question 12**

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not?

If not, on what basis would you allocate the transaction price?

- The initial allocation of the overall contract transaction price to the various elements based on estimations of stand-alone selling process is expected to have a major impact on many transactions under US GAAP and will accelerate the timing of revenue recognition substantially in some cases, where much more judgement will be required.
- The expression of the principle may need some refinement. For example, a warranty provided as part of a sale of goods should be 'valued' based on the stand-alone selling price of the warranty if possible. The current language could be read as requiring reference to the stand-alone price of the repair/replacement service to which the warranty conditionally entitles the holder.

### **Question 13**

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

- Yes. In practice, estimates can be made using internal pricing information - even if an entity does not actually sell different elements separately, they usually still have internal costing information for the different elements and can apply a desired margin to each element to reach a reasonable estimate of selling price.

### **(b) Response to Specific AASB Questions**

- a Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
  - i not-for-profit entities;
  - ii public sector entities;
- We are not aware of any regulatory issues that may effect the implementation of the proposals
- b Whether overall, the proposals would result in financial statements that would be useful to users;
  - Subject to our earlier comments we believe that the proposals will result in financial statements that would be useful to users; and
- c Whether the proposals are in the best interests of the Australian economy.
  - Subject to our earlier comments we believe that the proposals are in the best interests of the Australian economy.