ED 198 sub 5

Department of Treasury and Finance

The Treasury Building
21 Murray Street, HOBART, Tas 7000
GPO Box 147, HOBART, Tas 7001 Australia
Telephone: (03) 6233 3100 Facsimile: (03) 6223 2755
Email: secretary@treasury.tas.gov.au Web: www.treasury.tas.gov.au

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
MELBOURNE VIC 8007

Dear Mr Stevenson Kevin

EXPOSURE DRAFT 198
REVENUE FROM CONTRACTS WITH CUSTOMERS

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to respond to the Australian Accounting Standards Board's Exposure Draft 198 *Revenue from Contracts with Customers*.

HoTARAC supports the objectives of this Project and a principles-based approach. In particular, HoTARAC supports the development of a single revenue recognition model and agrees that an entity should apply the following principles:

- recognise revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration it receives, or expects to receive, in exchange for those goods or services (Paragraph 2);
- recognise revenue when it satisfies a performance obligation by transferring a promised good or service to a customer, as evidenced by the transfer of control of that good or service (Paragraph 25); and
- measure revenue as the amount of the transaction price allocated to a satisfied performance obligation (Paragraph 34).

HoTARAC notes that the Exposure Draft addresses many of the issues raised by respondents to the Boards' 2008 Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*. However, HoTARAC has concerns with some aspects of the proposal and offers detailed comments and suggestions in the Attachments.

These concerns primarily relate to:

- the proposed indicators of control (Question 3);
- the need to reflect customer credit risk in the initial measurement of revenue (Question 5);
- how the proposal would apply to perpetual contracts (Question 1);
- how the proposal would apply to onerous social benefit contracts (Question 18);
- the extent of the proposed disclosures (Question 10);
- whether the proposal would apply to revenue arising from permits and royalties that are not intellectual property; and
- the proposed accounting for warranties (Question 15).

Please contact David Laidley on (02) 9228 4759 or Robert Williams on (02) 9228 3019 from New South Wales Treasury if you would like to discuss any of the matters raised by HoTARAC.

Yours sincerely

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

21 September 2010

Encl

Contact: Sarah Woods
Phone: (03) 6233 5097
Our Ref: 10/118137 SW/DT

ATTACHMENT A

DETAILED COMMENTS ON EXPOSURE DRAFT ED198 *REVENUE FROM CONTRACTS WITH CUSTOMERS*

HoTARAC offers the following comments and suggestions, arranged in the order that the topics appear in the Exposure Draft. The responses commence with observations on introductory and scoping matters. The issues of greatest concern are asterisked (★).

Introduction and scope

Scope

The Exposure Draft specifies the accounting for revenue arising from contracts with customers (Paragraph 1), whereas the present IAS 18 *Revenue* deals with all revenue, regardless of whether it arises under a contract or from a customer. HoTARAC notes that the ED, in restricting itself to revenue from contracts with customers, fails to address some broader revenue recognition issues. The ED therefore misses an opportunity that is unlikely to arise again in the future.

The ordinary activities of many entities, particularly public sector entities, give rise to significant non-contractual revenues from taxes, fines, fees and grants. Contract-based revenues are often insignificant. HoTARAC suggests that there is a need to articulate the principles to be applied to the revenues that do not arise from contracts with customers.

Definition of contract

The ED defines a contract as an agreement between two or more parties that creates enforceable rights and obligations (Appendix A). It also notes that contracts can be written, oral or implied by the entity's customary business practice (Paragraph 9).

HoTARAC agrees in principle with the proposed definition of contract but notes that "customary business practice" would not necessarily be enforceable and therefore may not imply the existence of a contract as defined in the ED.

HoTARAC also notes that (as acknowledged in Paragraph BC13) the proposed meaning of contract is inconsistent with the meaning given in Paragraph 13 of IAS 32 *Financial Instruments: Presentation*. While the ED envisages a contract as being enforceable, IAS 32 envisages it as usually being enforceable, which is more permissive. A transaction that gives rise to revenue and a receivable would therefore potentially be subject to two different definitions of contract. HoTARAC suggests that the meanings should be consistent. Even if the two definitions were substantively the same, their different wording suggests otherwise and could lead to confusion.

★ *Permits and royalties*

The goods or services within the scope of the ED include granting licences, rights to use and options (Paragraph 21(f)). Licensing refers to an entity's granting a customer the right to use, but not own, intellectual property of the entity. Intellectual property includes "other intangible assets" (Paragraph B31). IAS 17 *Leases* provides guidance on rights to use specified types of assets (Paragraph B32).

Apart from the reference to "other intangible assets" in Paragraph B31, the proposal only discusses and illustrates licences of intellectual property. It is therefore unclear whether the guidance would apply more broadly to revenue arising from permits and royalty arrangements involving rights other than intellectual property. Such arrangements might include driving licences, fishing permits, mineral exploration licences, mineral royalties and casino operating licences. HoTARAC also notes that some of these "other intangible assets" may not qualify for recognition under IAS 38 *Intangible Assets* due to their having no material cost to the entity (eg a fishing licence), being internally-generated (casino operating licence) or being a mineral exploration asset (mining licence).

HoTARAC considers that the requirements of the ED would and should apply to revenue arising from permits and royalty arrangements. These often have features similar to intellectual property licences and give rise to similar accounting issues. However, it would be helpful if the eventual Standard clarified whether such items are within its scope and included an Illustrative Example in its Application Guidance.

The *System of National Accounts 2008* examines accounting for licences and permits in detail. This may be of interest to the Boards in any further deliberations on this topic. For further information please see: http://unstats.un.org/unsd/nationalaccount/SNA2008.asp.

Grants

The proposal defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations" and defines transaction price as the "amount of consideration that an entity receives... from a customer in exchange for transferring goods or services..." (Appendix A).

HoTARAC considers that these definitions may capture grants obtained under an agreement requiring the entity to perform some specified activity, possibly for the benefit of a third party. This raises several issues:

- If the proposal is to apply to non-exchange transactions (such as grants), the definition of customer would need to be clarified, given that a grantor itself does not directly receive goods and services from the grantee.

- The concept of transfer of control of goods or services (Paragraph 25) may not easily apply in cases where the customer is a grantor. This might be overcome if the proposal were to define control from the entity's perspective rather than the customer's perspective (see comments on control).

- It is unclear whether a refund liability arising from a customer's right of return (Paragraph 37) is analogous to an obligation to repay a grant if its conditions are not met.

HoTARAC therefore requests the Boards to clarify whether the proposal is intended to apply to grants or other transactions where the parties do not make a fair value exchange. If the Standard is not intended to cover such transactions, they should be explicitly scoped out.

Substance

The ED requires an entity, when exercising judgement, to consider the terms of the contract and all related facts and circumstances (Paragraph 3). This appears to require the entity to consider the economic substance of the transaction and not merely its legal form, in accordance with Paragraph 35 of the *Framework for the Preparation and Presentation of Financial Statements*.

HoTARAC notes that consideration of all related facts and circumstances is consistent with the principles-based approach taken by the Boards. However, mentioning the matter only once and in the introductory section of the proposal, does not seem to give it the importance that might be expected in a principles-based standard.

Further, referring to facts and circumstances rather than economic substance over legal form raises questions as to whether they are equivalent concepts.

HoTARAC recommends that the concept of substance over form should be explicitly addressed in the proposal (if they are different concepts) or used instead of facts and circumstances (if they are equivalent concepts) and be given greater emphasis.

Recognition

Determining when to combine, segment or modify a contract

Question 1: Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether:

(a) to combine two or more contracts and to 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 separate contract?

No. HoTARAC considers that the proposed approach to contract segmentation and modification is arbitrary and insufficiently justified.

The Application Guidance is not helpful in this regard. For example, HoTARAC does not understand why a discounted price in a modified contract necessarily indicates price interdependency between original and modified contracts, as illustrated in Scenario 2 of Example 2.

The ED proposes that price independence would be determined, in part, by similar goods or services being regularly sold separately (Paragraph 15(a)) and by the absence of a significant discount in the contract (Paragraph 15(b)). HoTARAC considers that there needs to be more guidance on the meanings of "regularly" and "significant" as they are each open to differing interpretations.

Determining when a good or service is distinct

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?

No. HoTARAC suggests that the principle for determining whether a good or service is distinct should also reflect the customer's perspective.

HoTARAC supports the proposed condition (Paragraph 23(b)(i)) that goods or services could be sold separately. However, HoTARAC considers the condition should acknowledge that the good or service might be used with something that the customer itself creates.

HoTARAC disagrees with proposed condition (Paragraph 23(b)(ii)) requiring distinct goods or services to have a distinct profit margin. Although the proposal suggests that a profit margin is distinct if it is subject to distinct risks, HoTARAC considers that profit margins are just as much about pricing arrangements.

Further, HoTARAC considers that the conditions in Paragraph 23 may be inappropriate for not-for-profit (including public sector) entities that provide their goods and services to customers for nominal or no consideration, or on a cost recovery basis. The entities may be compensated by grantors that are separate from the customers. In such cases the entities may not "sell" their goods or services for a profit and may be unable to determine profit margins.

★ *Sufficiency of guidance on control*

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?

No. HoTARAC has concerns with the proposed guidance on control.

HoTARAC agrees with the general principle of recognising revenue when a contractual obligation is satisfied and the promised good or service is transferred to the customer's control. HoTARAC supports the description of control in Paragraph 26 as it is consistent with descriptions of control of an asset in IAS 38 *Intangible Assets* and also in IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers).*

However, HoTARAC has difficulty in understanding how this general principle can be practically applied when the proposed indicators of control (Paragraph 30) are not conclusive and do not explicitly illustrate the general principle. The indicators do not demonstrate the customer's "ability to direct the use of, and receive the benefit from, the good or service" being transferred. For example, in the case of work in progress, despite the Boards' intention to permit revenue recognition as and when work in progress comes under a customer's control, HoTARAC considers it would often be difficult to demonstrate that a customer has the ability to direct and receive the benefit from work in progress as required by Paragraphs 26 and B64. Moreover, HoTARAC considers that the indicators are open to differing interpretations and this could give rise to issues between preparers and auditors and to inconsistencies between entities. HoTARAC considers that the proposal could be clearer about when a performance obligation is satisfied, perhaps by giving relevant examples in the Application Guidance.

HoTARAC also notes that the proposed indicators of customer control, as set out in Paragraph 30, do not include having the significant risks and rewards of ownership of goods. Paragraph BC60 notes the reasons for rejecting risks and rewards in favour of control. Nevertheless, HoTARAC considers that a consideration of risks and rewards may be an indicator of control. The transfer of such risks and rewards is presently included in IAS 18 *Revenue* as an essential condition for revenue recognition in relation to the sale of goods and HoTARAC supports its retention, at least as an indicator. It is arguable that the entity having the risks and rewards of ownership of the goods may be relevant to a consideration of all related facts and circumstances, as required by Paragraph 3 of the ED. HoTARAC notes that the proposed new Standard on leases also considers risks and benefits as being relevant in determining whether a lessor should continue to recognise an asset (ED/2010/9, Paragraphs 28 and 29).

HoTARAC notes that control appears to be assessed from the entity's perspective in the defined terms (Appendix A) but from the customer's perspective in the body of the proposal (Paragraph 25). HoTARAC considers that it would be better to assess control from the entity's perspective rather than from its customer's perspective. It may not always be practicable to assess a customer's control and systems are more likely to be designed from the entity's, rather than its customers', perspective. Moreover, the entity that purchases the goods or services may differ from the entity that ultimately receives and uses them, thereby raising doubts about who is the customer and who has control.

Further, HoTARAC questions the appropriateness of using an input method for recognising revenue where there is continuous transfer of goods or services (Paragraph 33(b)). It does not appear logical to recognise revenue according to costs incurred, especially given the qualification expressed in the last sentence of Paragraph 33(b).

HoTARAC also suggests that the terminology adopted in the ED (Paragraphs 26 and 27) does not sit well when applied to services. HoTARAC considers that a customer obtains control of the output of a service rather than obtaining control of the service itself. Arguably the service provider controls the service while it is being provided. Perhaps the wording could be adjusted to reflect this.

Interaction with Financial Instruments Standards

Contractual rights or obligations within the scope of IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* are scoped out of the proposal (Paragraph 6).

However, HoTARAC notes that the boundary between the ED and IFRS 9 / IAS 39 is unclear as the ED deals with credit risk, financing and the presentation of receivables (Paragraphs 43, 45 and 66). Sometimes there are inconsistencies. For example, the customer-specific discount rate proposed for use in the transaction price in Paragraph 45 appears to be inconsistent with the market-based discount rate required in Paragraph AG64 of IAS 39.

HoTARAC also considers that the eventual Standard should clarify the circumstances when a contract asset changes into a receivable (where there is an unconditional right to the consideration).

Distinguishing performance obligations from liabilities and contract liabilities

The ED defines a performance obligation to be an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to a customer. It also defines a contract liability to be an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer (Appendix A).

The ED explicitly requires a liability to be recognised where the entity:

- receives a prepayment from a customer before satisfying a performance obligation (Paragraph 65);
- has an onerous performance obligation (Paragraph 54);
- has an obligation to give the customer a cash refund (Paragraph 37); and
- has an obligation to repurchase a product sold to a customer (Paragraph B52).

Yet the ED stops short of declaring a performance obligation to be a liability.

The enforceability of a performance obligation suggests that it is a liability in its own right. However, this is not clear from the ED. The Basis for Conclusions implies that a performance obligation may be a liability (Paragraph BC28).

HoTARAC considers that some contracts give rise to liabilities before any party has performed. For example, a long-term construction contract may impose an enforceable and unavoidable obligation on the entity at the commencement of the contract. The customer may have a right to sue for specific performance in the event of a breach. In such cases a liability might arise, at least conceptually, prior to the point contemplated in the ED.

HoTARAC considers that the proposal would be improved by clarifying:

- the distinction, if any, between a performance obligation and a liability; and
- the distinction between a performance obligation and a contract liability.

Further, HoTARAC notes that the justification for offsetting contract assets and liabilities is only contained in the Basis for Conclusions (Paragraph BC160), which will not be in the public domain once the eventual Standard is published. HoTARAC considers that significant matters of principle underpinning the proposal should be incorporated into the body of the proposal and the eventual Standard.

Onerous contracts vs onerous performance obligations

The ED proposes that an entity would recognise a liability and a corresponding expense if a performance obligation is onerous (Paragraph 54). Specified disclosures about such obligations are also proposed (Paragraphs 79 and 80).

Despite the arguments in Paragraph BC137, HoTARAC considers that assessing whether each individual performance obligation is onerous would be unnecessarily burdensome if the overall contract is not onerous. Current practice under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* only requires contracts, rather than parts thereof, to be assessed for onerousness. HoTARAC believes that financial statement users would primarily be interested in the outcome of the overall contract rather than the separate performance obligations therein.

Further, the requirement to separately assess each performance obligation for onerousness may necessitate the separate assessment of concurrent performance obligations that would otherwise be permitted to be aggregated for revenue recognition and measurement purposes under Paragraph 24. HoTARAC also notes that the ED's proposed disclosures on onerous performance obligations differ slightly from the disclosures presently required by IAS 37.

Separately, HoTARAC is unclear why requirements dealing with liabilities and expenses are proposed for a Standard on revenue instead of leaving them in IAS 37. HoTARAC does not support the proposal to deal with onerous contract liabilities and expenses in the Revenue Standard and would prefer to see no more than a cross reference to IAS 37 for all the principles and requirements for onerous contracts.

If the Boards decides to require onerousness to be assessed for each performance obligation, either the eventual Standard or IAS 37, should give guidance to clarify the accounting treatment applicable when a performance obligation is onerous but the contract itself is not. The guidance should also explain how to treat a contract that, as a result of changed circumstances or more information, ceases to be onerous.

Measurement

Estimating variable consideration

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 reasonably 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 proposed criteria in Paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

No. HoTARAC disagrees with the proposed criteria for estimating variable consideration.

While HoTARAC agrees that an entity should recognise revenue on the basis of a reasonable estimate of the transaction price, HoTARAC considers that the proposed two mandatory criteria for making a reasonable estimate are too restrictive. If an entity failed to meet one or both of the two proposed criteria it would be prevented from immediately recognising revenue in relation to a satisfied performance obligation. This may not be appropriate in the following cases:

- Lack of experience may not of itself prevent an entity from making a reasonable estimate based on other relevant facts and circumstances relevant to the transaction.
- An entity would also find it difficult to satisfy the proposed criteria when it commences a new type of activity in which it has no (or no access to other entities) experience. For example, the entity might sell specialised or unique goods for which there is no active market. There may be little likelihood of the customer failing to pay the agreed transaction price. Yet, because of the entity's lack of experience with the new transaction, it would fail the mandatory conditions for being able to estimate the transaction price.
- Despite receiving an advance payment from the customer and satisfying one of the performance obligations, an entity may be prevented from recognising revenue because the overall transaction price is uncertain.

HoTARAC considers that, in the absence of an entity's experience with such transactions, a reasonable estimate based on relevant facts and circumstances, including the contract price, perhaps with suitable disclosure, would be more decision-useful than recognising no revenue at all.

HoTARAC also notes that there is some ambiguity in Paragraphs 38 and 41. Paragraph 38 requires revenue to be recognised only if the whole transaction price can be reasonably estimated. However, Paragraph 41 indicates that the transaction price includes only the amount that the entity can reasonably estimate, suggesting that only part of the transaction price needs to be reasonably estimable. Example 18 also illustrates revenue recognition where only part of the transaction price can be reasonably estimated. Does Paragraph 38 only refer to the part of the transaction price that relates to the performance obligation in question? HoTARAC suggests that this ambiguity needs to be addressed. The approach in Paragraph 41 and Example 18 appears reasonable.

Further, HoTARAC considers that the guidance in Paragraph 40 is vague and therefore unlikely to be of much practical use in interpreting Paragraph 38.

HoTARAC is confused by the proposed guidance on measurement of a refund liability, set out in the second sentence of Paragraph 37. The refund liability is said to represent "the difference between the amount of consideration received and the transaction price." HoTARAC cannot see how a liability would arise in relation to consideration that has not yet been received.

★ *Customer's credit risk*

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?

No. HoTARAC disagrees with this proposal which contrasts with the present practice of recognising:

- the full invoiced amount as a receivable and revenue; and
- an expense and an allowance for doubtful debts for the doubtful portion.

HoTARAC considers that reflecting credit risk in the initial measurement of revenue introduces unnecessary complexity for most transactions and is likely to reduce transparency and confuse financial statement users. The proposed approach may also be subject to manipulation or uneven application because of different entities' varying ability or willingness to measure customer credit risk. Further, it would be more consistent to recognise both the initial and subsequent assessments of credit risk as an expense rather than offsetting the initial credit risk against revenue while treating subsequent changes separately from revenue.

HoTARAC also notes that the proposed approach appears to be inconsistent with the separate proposals for treating own credit risk on financial liabilities (ED/2009/12).

HoTARAC recommends that the present recognition approach be retained because it is simpler to adopt and provides relevant information.

Time value of money

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 implicit or explicit). Do you agree? If not, why?

Yes. HoTARAC agrees with this proposal.

Allocating the transaction price

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?

Yes. HoTARAC agrees with the proposal for allocating the transaction price to separate performance obligations but notes that it may be difficult to estimate stand-alone selling prices.

HoTARAC also considers that Paragraph 53 could be usefully clarified to emphasise that any subsequent change in the transaction price is to be allocated only on the basis of the initial (and not any subsequently changed) stand-alone selling prices.

Contract costs

Cost capitalisation

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?

Yes. HoTARAC agrees that the proposed requirements are operational and sufficient.

Specified costs

Question 9: Paragraph 58 proposes the costs that relate 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 liability recognised for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

Yes. HoTARAC agrees with the proposed costs as specified.

HoTARAC sees a possible ambiguity between Paragraphs 57 and 63. Paragraph 57 appears to envisage contract costs being recoverable from any customer in future whereas Paragraph 63 appears to envisage them being recoverable from a particular customer. HoTARAC suggests that the intention be clarified in the eventual Standard.

Disclosure

★ *Achievement of disclosure objectives*

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?

No. While HoTARAC agrees with the Boards' objectives it considers that disclosures such as those proposed in Paragraphs 77(a), 78 and 80 are excessive. They will be burdensome to prepare and may result in an overload of information that will not help users of the financial statements. Disclosures should be limited to those that are most relevant.

The proposed disclosures will be particularly difficult for entities having a large number of performance obligations or providing specialised or unique goods or services. Some disclosures are likely to be commercially sensitive, such as the maturity profile of remaining performance obligations.

HoTARAC is also unclear about the objective of Paragraph 76 as:

- Paragraph 75 already requires a detailed reconciliation from the opening to closing aggregate balances of contract assets and contract liabilities; and
- it is difficult to understand why either an opening or a closing balance of contract assets or contract liabilities would differ from what is included in the Statement of Financial Position.

Remaining performance obligations

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?

No. HoTARAC disagrees with the disclosure of the timing of remaining performance obligations.

Consider a water, gas or electricity utility that is a monopoly supplier with independently regulated prices. The entity is required by law to supply to all citizens who request its goods or services and to maintain that supply until the customer terminates or breaches the supply contract. The entity's experience indicates that most of its customer contracts have a life of 20 years. Effectively, each customer enters a contract of indeterminate duration for the continuous transfer of goods or services, terminable at the customer's option, and with an agreed price escalation mechanism.

In such circumstances, the transaction price allocated to performance obligations remaining at the end of the reporting period will not be readily determinable because of uncertainty as to the duration of the contract and the timing and amount of future price increases.

Further, if an entity has a long term contract that the customer may terminate without penalty, there is no certainty that future performance obligations will arise.

HoTARAC suggests that, where remaining performance obligations or related transaction prices are not reliably determinable or where the continuation of the contract is uncertain, the entity should be permitted to merely disclose the existence and nature of the contract and the reason why the performance obligation cannot be reasonably estimated. This approach may also be more practicable for entities having large numbers of such contracts.

If the proposed disclosure requirement remains in the eventual Standard, HoTARAC considers that, to be consistent with the revenue measurement requirements in Paragraphs 38 and 41, the amount of remaining performance obligations should only be disclosed if the transaction price, or a relevant part of the transaction price, can be reasonably estimated. However, the value of such a disclosure is questionable as it may be incomplete and not readily comparable with other entities disclosures. It is also likely to be onerous for entities with large numbers of contracts.

Disaggregation

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?

Yes. HoTARAC agrees with the proposed reasons for disaggregating revenue.

Effective date and transition

Retrospective application

Question 13: Do you agree that an entity should apply the proposed requirements retrospectively (ie 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 information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better?

Yes. HoTARAC agrees with the proposed retrospective application.

HoTARAC also agrees that a long transition period would ease the burden, especially on entities that have many complex or long-term contracts (Paragraphs BC232 and BC237).

Application guidance

★ *Additional guidance*

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?

No. HoTARAC considers that the application guidance would be usefully enhanced by examples illustrating how the proposals would apply to:

- perpetual contracts, discussed below;
- permits for other than intellectual property, previously discussed; and
- social benefit contracts, discussed below in response to Question 18.

HoTARAC notes that there is a tension between providing too much and too little application guidance. However, the proposed inclusion of 48 pages of Application Guidance in a principles-based proposal suggests that those principles are not clear enough.

Perpetual contracts

As discussed above in response to Question 11, some entities (such as water, gas and electricity utilities) supply goods or services under contracts of indeterminate duration, terminable at the customer's option, and subject to price increases determined by an independent regulatory body. Such contracts can run for several decades with an escalating transaction price. The supplier entity is often a monopoly and may be legally prevented from terminating the contract unless the customer defaults.

HoTARAC considers that the proposals would require such an entity to deal with this situation as a continuous transfer and to recognise revenue progressively at the current transaction price. This is probably no different from the present accounting where revenue is accrued as the goods or services are delivered.

Application Guidance for perpetual contracts, illustrating the impact of the proposals, would be helpful. Does the entity have one continuous performance obligation or a sequence of performance obligations? Should the contract be segmented based on each price escalation? How should the remaining performance obligations be determined for disclosure in accordance with Paragraph 78?

★ *Distinguishing initial defect warranties from subsequent fault warranties*

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 two 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?

No. A majority of HoTARAC members have concerns that the proposed distinction between quality assurance warranties (for initial defects), insurance warranties (for subsequent faults) and statutory warranties is unnecessary and too arbitrary. Each type of warranty protects a customer from a defective or faulty product. Arguably, all product defects and faults result from deficiencies in manufacture and merely take varying periods to emerge. HoTARAC considers that the timing of the emergence of the defect or fault should not necessitate differences in accounting. Moreover, how can it be demonstrated that a fault does not arise from a latent defect that was present at the time of sale?

HoTARAC considers that the discussion in Paragraph BC205 supports the view that the distinction among quality assurance warranties, insurance warranties and statutory warranties is arbitrary in most circumstances.

Further, the ED does not clearly illustrate the accounting for each type of warranty. It appears that each type results in revenue being deferred, albeit for different reasons. However, both cases appear to give rise to a contract liability for the unsatisfied performance obligations under the warranty. To this extent, the accounting seems to be similar and this calls into question the need to distinguish between each type.

HoTARAC considers that, if the distinction between quality assurance and insurance warranties is retained, the proposal could usefully be improved by clearly illustrating and contrasting the accounting entries for both types. Do both give rise to a contract liability? When would revenue be recognised under each? If the entity has a right to recover, repair, and resell the warranted product, should this be recognised as inventories or (as implied in Example 3) some other asset?

HoTARAC also observes that the Basis for Conclusions variously states that a quality assurance warranty is "not a performance obligation" (Paragraph BC198) but is "an unsatisfied performance obligation" (Paragraph BC202). HoTARAC considers that these references are ambiguous and that it would be better for Paragraph BC198 to state that the warranty is "not a separate performance obligation."

HoTARAC would prefer to see all warranties (and rights of return and repurchase agreements, discussed below) treated similarly and recognised separately from revenue, in accordance with IAS 37.

Statutory warranties

The proposal notes that a statutory warranty is not a performance obligation (Paragraph B18) and the Basis for Conclusions suggests that a statutory warranty would be accounted for as a quality assurance warranty (Paragraph BC205) which may affect the recognition of revenue.

However, HoTARAC notes that some entities may take the view that a warranty arising under statute does not arise under a contract and would therefore be outside the scope of the proposal. In such circumstances, the warranty obligation would fall within the scope of IAS 37 which would require the entity to recognise an expense and a provision, instead of deferring revenue. HoTARAC also notes that the ED does not propose to amend IAS 37 in this regard.

This will potentially result in divergent accounting for warranties, depending on whether the warranty is viewed as arising under contract or statute.

Further, where a contract refers to a statutory warranty it will be unclear whether to apply the eventual Standard or IAS 37.

HoTARAC recommends that the eventual Standard should clarify whether statutory warranties are regarded as arising under contract.

As stated above, HoTARAC would prefer to see all warranties treated similarly and recognised separately from revenue, in accordance with IAS 37.

Rights of return and repurchase agreements

The proposal requires an entity to account similarly for a customer's separate rights to:

- require the entity to repurchase a product under a repurchase agreement; or
- return a product for a full refund (Paragraphs B52 and BC71).

In both of these cases, the customer obtains control of a product and has the option of returning it. The entity initially recognises revenue for the transferred goods and a refund liability for the expected returns (Paragraphs B9 and BC71).

HoTARAC suggests that the proposal needs to be clarified to deal with several matters:

- The proposal requires an entity to recognise a refund liability for sales that are expected to be returned. However, it is not clear whether the refund liability is a performance obligation or a financial liability. It appears to be the latter, which is outside the scope of the proposal.

- It is not clear why the entity would not recognise revenue for the full transaction amount, given that:
  - the performance obligation to transfer the product to the customer is satisfied;
  - control of the product passes to the customer (Example 3 and Paragraph BC70);
  - the refund liability does not meet the definition of a performance obligation (Appendix A); and
  - the customer has absolute discretion over whether to return the product.

- The proposal notes that the sale of a product under a contract that gives the customer either a right to return it or an option to require the entity to repurchase it, transfers control of the product to the customer (Example 3 and Paragraph BC70). Inventory is derecognised when the product is initially transferred to the customer. However, the proposal regards a customer's exercise of its right of return of a product to be a failed sale (Paragraph BC190). This description is questionable as arguably a failed sale would not involve transfer of control of the inventory to the customer.

- Where a customer has a right to return a product and obtain a full refund, the Basis for Conclusions purports to distinguish between an entity's obligation under the "return right service" (Paragraph BC189), which is not recognised, and the entity's "obligation to refund amounts" (Paragraph BC191), which is recognised. The distinction, if it exists, is not well articulated and needs to be explained more clearly. Perhaps these two obligations are in fact the same obligation: to accept returned goods and give a refund. Further, the argument for not recognising a return right service as a performance obligation is not convincing. In reasoning that, in many cases, the number of returns is expected to be a small percentage of total sales (Paragraph BC193), the proposal applies probability as part of recognition instead of it being applied as part of measurement (Paragraph 35).

Inconsistent treatment of a right of return and a quality assurance warranty

HoTARAC also notes some inconsistencies between the proposals for quality assurance warranties and rights of return.

The proposal aims for consistency of treatment for products subject to a quality assurance warranty and products subject to a right of return (Paragraph BC202). However, defective products subject to a quality assurance warranty are recognised as inventories while products subject to a right of return are not. Why is there a difference? What treatment prevails if a customer exercises its right of return after a defect, covered by a quality assurance warranty, emerges? HoTARAC notes that items expected to give rise to quality assurance warranty claims will not be recognised as revenue or reductions in inventory, despite their being in the physical possession of customers. This will make stocktaking more complicated because the entity's general ledger will reflect more items than are physically on hand.

Further, what is the difference between a refund liability arising from a customer's right of return (Paragraph 37 and Example 3) and an unsatisfied performance obligation, presumably a contract liability, arising under a quality assurance warranty (Example 4)?

Distinguishing exclusive licences from non-exclusive licences

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?

Yes. A majority of HoTARAC members agree with the proposed distinction between exclusive and non-exclusive licences.

Licences treated as sales

The ED proposes that a licence shall be considered to be a sale if it gives an exclusive right to use intellectual property for substantially all of the property's economic life (Paragraph B33).

HoTARAC agrees that such an arrangement would transfer control of the intellectual property to the licensee and should therefore be treated as a sale. However, HoTARAC observes that the potential difficulty in determining the economic life of some intellectual property may mean that a sale might only be recognised if the licence was granted in perpetuity.

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?

Yes. HoTARAC agrees with the proposed application of the revenue model to certain asset sales.

Not-for-profit entity issues

Question 18: Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organisations)? If so, which requirements and why?

Yes. HoTARAC considers that the proposal fails to meet the needs of not-for-profit (including public sector) entities in the following circumstances:

- non-contractual revenues, discussed under Scope;
- grants, discussed above;
- determining when a good or service is distinct, discussed above; and
- onerous social benefit contracts, discussed below.

★ *Onerous social benefit contracts*

HoTARAC considers that the proposed onerous contract requirements (Paragraphs 54-56) should not apply where a not-for-profit entity intentionally provides goods or services at less than cost. Public sector or other entities often contract to provide goods or services at non-commercial prices to fulfil social or charitable objectives. Sometimes the entity receives a government grant to fund (or partially fund) the revenue shortfall.

HoTARAC notes that Paragraph 77 of IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* deals with this issue by explicitly scoping out social benefit contracts from the onerous contract requirements that would otherwise apply. Those onerous contract requirements are similar to those proposed in the ED.

Consider the case of a not-for-profit railway entity that operates in a price-regulated market and only recovers 40 per cent of its costs from its customers through its customer contracts. The entity recovers the remaining 60 per cent of its costs from the Government by way of a (non-exchange) social benefit contract. Some of the ticket revenue from customers is received up to a year in advance of the provision of services. The ED would view customer contracts as onerous and would require the entity to recognise an expense and a liability for each.

Depending on its terms, and subject to the comments on Grants above, the contract with the Government might also be viewed as onerous as the Government does not pay for the full cost of the goods or services the entity provides. Despite the fact that the entity will make no overall loss on the services it provides, the customer contracts (and possibly the contract with the Government) will have to be treated as onerous. This does not appear to be a sensible outcome.

If the customer and Government contracts were considered together, the entity's costs would not exceed its revenues. It is therefore questionable whether the entity has any substantive onerous performance obligations. Do facts and circumstances override the onerous contract requirements in this situation?

For the above reasons, HoTARAC considers that the onerous contract requirements in the ED are inappropriate for contracts that are part of a social benefit or charitable arrangement and recommends that the eventual Standard should adopt the IPSAS 19 approach and scope out onerous social benefits.

In any case, the eventual Standard should give guidance to entities in this situation.

ATTACHMENT B

COMMENTS ON AASB SPECIFIC MATTERS

Not-for-profit and public sector entity issues

(a) Are there 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?

Yes. As mentioned in response to Question 18, HoTARAC considers the proposals in the Exposure Draft give rise to several issues for not-for-profit, including public sector entities.

HoTARAC is also uncertain about the impact the proposals may have on the AASB/FRSB Project on *Income from non-exchange transactions.*

Usefulness

(b) Overall, would the proposals result in financial statements that would be useful to users?

Based on its responses to the specific questions in the ED, HoTARAC is not certain that the proposals would result in useful information for users of financial statements.

Best interests of the economy

(c) Are the proposals in the best interests of the Australian and New Zealand economies?

Based on its responses to the specific questions in the ED, HoTARAC is not certain that the proposals are in the best interests of the Australian economy. HoTARAC offers no comment in respect of the New Zealand economy.

Reduced disclosure requirements

(d) Should any of the proposed disclosures be considered for exclusion from the reduced disclosure requirements?

Yes. HoTARAC considers that Paragraphs 75, 76, 79 and 80 should be excluded from the reduced disclosure requirements.

Implications for GAAP-GFS harmonisation

HoTARAC considers that the revenue recognition and measurement proposals in the ED conflict with how revenue would be recognised, measured and presented for GFS purposes. For example, for GFS purposes, the full amount of the transaction price would be recognised as revenue up front, disregarding any customer credit risk and any potential obligation to provide a refund to the customer. Unlike the proposal in the ED, GFS would only recognise such risk or obligation when it actually arises. Hence, this would give rise to additional reconciliation differences between GAAP, based on the ED, and GFS.

HoTARAC also notes that recent revisions to the System of National Accounts in relation to accounting for licences may, if adopted in Australia, give rise to future GFS convergence issues. Some licences may be treated as taxes for GFS purposes (see for example SNA 2008, paragraph 17.35).