AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

24 September 2010

Mr. Kevin Stevenson
Australian Accounting Standards Board
PO Box 204
Collins Street West VICTORIA 8007

Dear Mr Stevenson,

ED 198 'REVENUE FROM CONTRACTS WITH CUSTOMERS'

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above and a copy of the ACAG response to the International Accounting Standards Board in relation to Exposure Draft 2010/6 'Revenue from Contracts with Customers'.

The views expressed in this submission represent those of all Australian and New Zealand members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
ACAG Financial Reporting and Auditing Committee

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ED 198 'REVENUE FROM CONTRACTS WITH CUSTOMERS'

ACAG provides the following comments in response to specific questions raised by the AASB.

The AASB would particularly value comments on whether:

(a) 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; and

ii. public sector entities;

ACAG is not aware of any significant implications for GAAP/GFS harmonisation, but believes it is important that the AASB consider this project when reviewing the proposals.

ACAG recommends that the AASB consider the possible GST implications of any proposed changes.

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

ACAG believes that the proposals would result in financial statements that are more complex and possibly difficult to understand for the following reasons:

- revenue may be based on estimates of probability for certain outcomes
- recognising contract assets and liabilities could mean additional transactions being recorded without providing any benefit to the users
- disclosures are complex and very detailed
- disclosure requirements are open to interpretation and further guidance should be included to help maintain the comparability of financial statements
- differences between entities in splitting and combining contracts and identifying performance obligations could lead to less consistency
- there is a risk that moving away from substance over form will encourage entities to write contracts to achieve certain accounting outcomes
- revenue for management reporting purposes could differ from revenue for financial reporting purposes, for example in the construction industry.

The costs for prepares and auditors are likely to be significant. Accounting systems and processes will need to be modified to capture all the required information. The proposals move to a 'form over substance' approach that may result in additional legal costs to determine whether a contract exists, whether a transfer has occurred, whether the entity has met performance obligations and to rewrite contracts to meet accounting requirements.

Also accountants and auditors will need a greater understanding of both the legal requirements of specific contracts and of the business itself leading to increased compliance costs.

(c) **the proposals are in the best interests of the Australian and New Zealand economies; and**

Whilst the proposals appear sound in theory, ACAG is not convinced they are beneficial due to the practical concerns and the possible implementation costs mentioned above.

(d) **any of the proposed disclosures should be considered for exclusion from the reduced disclosure requirements.**

Notwithstanding the comments above, ACAG recommends the AASB consider excluding the following from reduced disclosure requirements:

- contracts with customers (para 73 of the ED)
- disaggregation of revenue (para 74)
- reconciliation of contract balances (para 75-76)
- performance obligations (para 77-78).

This is based on the assumption that the users of the financial statements for entities that are not publicly accountable would be in a position to demand this specific information.

Applicability to the Not-For-Profit and Public Sectors

The ED proposes a framework for accounting for revenue from contracts with customers that could be adapted for use by Not-For-Profit (NFP) and Public Sector entities. However, aspects of the requirements and guidance may not be appropriate for these sectors. For example:

- for the purposes of the ED, '**A contract exists if ... the contract has commercial substance (i.e. the entity's future cash flows are expected to change as a result of the contract) ...**' (para 10(a) of the ED). NFP and Public Sector entities may be able to avoid accounting for revenue in accordance with the requirements of the ED by arguing their contracts with customers do not have commercial substance, even though the contract is expected to affect future cash flows.

- it is unclear whether statutory revenue from exchange transactions will be within the scope.

- determining whether two contracts should be treated as a single contract, or whether a single contract should be treated as more than one contract, is based on whether consideration or price is interdependent (paras 12 to 16). In the NFP and Public Sectors contracts may be interdependent based on criteria other than price.

- for the purposes of identifying performance obligations, a good or service is distinct if '**... it has a distinct profit margin – a good or service has a distinct profit margin if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service**' (para 23(b(ii)). NFP and public sector entities provide goods or services that are subject to distinct risks and for which they can separately identify the resources needed to provide them, but there may be no profit margin.

- satisfaction of performance obligations being linked to future cash flows (para 27) may not be relevant in the NFP sector and further guidance is needed.

Recognition of performance obligations and commitments

Performance obligations are, in substance, similar to commitments and the proposed disclosures for performance obligations (paragraph 78 of the ED) are similar to disclosures currently required for commitments (paragraph Aus138.6 of AASB 101).

We understand that the AASB is proposing to remove paragraph Aus138.6 of AASB 101 as part of the Australian and New Zealand Harmonisation. If this does not occur, there is the potential for an entity to include the same commitment as both an expenditure commitment and a performance obligation. AASB should ensure users of financial statements can easily differentiate between performance obligations and expenditure commitments and the information is not misleading.

Other Comments

The proposals will create more timing differences with the recognition of contract assets and liabilities. This could complicate the tax records that must be maintained and increase the complexity of the reconciliation of tax to accounting profit.

ACAG AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL

24 September 2010

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Chairman,

ED/2010/6 'REVENUE FROM CONTRACTS WITH CUSTOMERS'

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above.

The views expressed in this submission represent those of all Australian and New Zealand members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
Chairman
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ED/2010/6 'REVENUE FROM CONTRACTS WITH CUSTOMERS'

Recognition of revenue (paragraphs 8–33)

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

(a) to combine two or more contracts and account for them as a single contract;

(b) to segment a single contract and account for it as two or more contracts; and

(c) to account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

ACAG believes that the practical application of this principle may be problematic.

In practice, applying these requirements could reduce the comparability of the financial statements because entities may account for similar contracts in different ways. Slight variations in the terms of a contract could result in different accounting treatments for transactions that may have a similar substance.

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?

ACAG believes that entities should be required to identify separate performance obligations, but do not believe it is necessary to identify and separately accounting for the goods and services provided. This level of disaggregation appears to be excessive and as discussed in paragraph 24, may not provide a different result.

Non-refundable upfront fees – para B27-B30:
The ED requires an entity to recognise a non-refundable upfront fee over the period that the entity expects to provide the relevant service to the customer. It is unclear how the ED intends entities to account for an up-front fee that relates to a service the entity expects to provide for an indefinite time period, for example, a joining fee for a gym which allows a customer to continue their gym membership indefinitely. ACAG recommends the IASB provide guidance on how to determine an appropriate time period over which to recognise such revenue.

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?

ACAG agrees with the proposal that a performance obligation is satisfied when the customer obtains control of the good or service and notes that the proposal should be easier to apply than the current approach of using the transfer of 'risks and rewards'. However, there is a risk that it will lead to a loss of substance over form, with entities structuring transactions and contracts to achieve desired accounting outcomes. To help mitigate this risk, ACAG suggests that the transfer of risks and rewards of ownership could be included as an indicator of control.

ACAG does not believe the guidance is sufficient for determining when control has been transferred to a customer. The guidance in paragraph 27 of the ED is confusing because it indicates that the transfer of control of the good or service is related to the customer's ability to obtain substantially all of the potential cash flows from the good or service. This assumes the customer is another for-profit commercial entity and does not consider customers that are end users of goods or services. For example, a retail consumer does not obtain cash flows from having gained control of food or electricity.

ACAG also believes the use of the term 'asset' to describe the good or service (paragraph 27-29 of the ED) makes the guidance difficult to understand. The meaning of the term 'asset' for the purpose of the ED is different to the definition in the Conceptual Framework. It also assumes that the customer is a for-profit entity and not an end user. A retail customer would purchase the good or service for the purpose of consumption and would not consider the good or service an asset.

Measurement of revenue (paragraphs 34–53)

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?

ACAG agrees that an entity should recognise revenue on the basis of estimates. It is inevitable that measurement of revenue will require some estimation and the use of reliable estimates does not undermine the reliability of the measurement of revenue (refer paragraph 86 of the Conceptual Framework).

Variable consideration:

However, ACAG disagrees with the proposal that revenue should be measured at the probability-weighted amount of consideration the entity expects to receive (para 34 and 35) because it introduces a degree of subjectivity and guess work that will decrease the usefulness of the information in the financial statements. Such an approach would make revenue more susceptible to earnings management and fraud.

ACAG believes that applying the proposals will result in revenue recognition that does not represent the pattern of revenue being earned but instead represents the changes to probabilities and other management assumptions. This issue is highlighted in Example 19 whereby revenue recognised at each stage is based on management judgement, which continues to alter during the consulting period. These changes in assumptions result in revenue being recognised in a way which does not truly represent the timing and amounts of actual revenue earned.

Increased subjectiveness in measuring revenue will make it more difficult to obtain objective audit evidence to support judgements, assumptions and probabilities used to estimate revenue.

ACAG also notes that allowing entities to recognise variable revenue is inconsistent with the recognition of contingent assets under IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. An entity cannot recognise a contingent asset unless the realisation of income is virtually certain because it may result in recognition of income that may never be realised (refer para 31- 35 of IAS 137). This is inconsistent with the proposals in the ED, which allows contingent revenue to be recognised, even if that revenue may never be realised.

Consideration payable to the customer:

A refund liability (para 37 of the ED) is very similar to a provision under IAS 37, that is, a liability of uncertain timing or amount (para 10 of IAS 37). However, it is not clear whether the measurement of the refund liability at the probability-weighted amount of consideration the entity expects to refund to the customer (para 37 of the ED) will differ materially from the best estimate of the expenditure required to settle the present obligation (para 36 of IAS 37). ACAG recommends the IASB consider how the requirements of IAS 37 and the ED will interact.

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, ACAG prefers the approach where collectability is not reflected in the amount of revenue earned. Credit risk is more correctly related to the value of any asset.

The impacts of credit risk on the entity are currently addressed adequately by impairment testing of receivables at each reporting date (para 58 of IAS 39 'Financial Instruments: Recognition and Measurement') and in disclosures required by paragraphs 36-38 of IAS 7 'Financial Instruments: Disclosures'.

ACAG believes that reflecting credit risk in the transaction price would introduce greater subjectivity and complexity to the measurement of revenue and would not improve the usefulness of information. In some cases it may be difficult to assess a customer's credit worthiness at the time of a sale especially for new customers.

ACAG also believes the revenue recognised under the proposal may not accurately reflect the actual consideration received. For example, an entity believes there is a 50% probability of receiving a final contract payment of CU1000 because of the customer's credit risk. As a result, they recognise CU500 over the relevant period. If the entity does receive the full payment, the additional CU500 received is not recognised as revenue (para 43 of the ED), even though it is earned as part of fulfilling the performance obligation.

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?

Yes, ACAG agrees with the proposal to reflect the time value of money in the measurement of revenue.

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, ACAG agrees with the proposal in paragraph 50.

Contract costs (paragraphs 57–63)

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, ACAG agrees with the proposal in paragraph 57. However, the costs of implementing systems to capture all relevant contract costs may outweigh the benefits. The information required by this proposed standard is very different to what is required under current accounting standards such as IAS16 'Property, Plant and Equipment'.

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, ACAG agrees with the proposal in paragraph 58.

Disclosure (paragraphs 69–83)

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, ACAG does not believe the proposed disclosure requirements will achieve the stated objective. Although paragraph 70 of the ED expresses the principle that entities must present disclosures at a level of detail relevant and understandable for users of the financial statements, the actual disclosures will be complex and difficult to understand.

We are not convinced that categorising revenue is particularly useful. Users are more likely to be interested in the sensitivity of any assumptions made and the financial impact of movements in these assumptions.

ACAG also notes it will be difficult for entities to keep track of all the information required for the disclosures. For example, sophisticated databases will be required to record the terms, duration and other details of all performance obligations and contracts to be able to provide the disclosures required by paragraph 75-78 of the ED. Accountants will require a far more detailed knowledge of contracts and performance obligations to be able to provide accurate disclosures and auditors will need a greater understanding of the client's business and transactions than previously.

ACAG believes that the additional cost of applying the disclosure requirements is not justified because they do not provide more relevant and understandable disclosures.

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?

Yes, ACAG agrees with proposed disclosure requirements regarding remaining performance obligations.

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?

No, ACAG believes this information may duplicate segment disclosures required by IFRS 8 'Operating Segments'.

Effective date and transition (paragraphs 84 and 85)

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 trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

Yes, ACAG agrees with applying the proposed requirements retrospectively to preserve meaningful comparatives. In saying that, it would be beneficial for entities to lock in their assumptions and estimates in the year preceding the effective date to ensure they do not have the benefit of hindsight when determining their comparative data.

Also the IASB should consider an effective date that allows adequate time for entities to implement systems to meet the requirements of the proposed standard.

Application guidance (paragraphs B1–B96)

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?

ACAG believes the application guidance is sufficient to assist an entity to apply most principles. However, as discussed in the response to question 2, we recommend more guidance on how to account for non-refundable upfront fees.

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?

Yes, ACAG agrees with the proposals.

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, ACAG agrees with this proposal.

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, ACAG agrees with this proposal.

Other Comments:

Scope
It is not clear how non-contractual royalties and dividends on investments, other than from associates or subsidiaries, are to be accounted for. Previously these types of income were accounted for under IAS 18 'Revenue' but the ED does not address how they will be accounted for or which standard will apply to them when IAS 18 is withdrawn.

Overlap and Inconsistency with other Standards

IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'

The proposed definition of, and measurement basis for, onerous performance obligations (paragraph 55 of the ED) does not appear to be consistent with those in the current IAS 37 or those proposed as part of the IASB project on amendments to IAS 37 for accounting for onerous contracts. Having different accounting treatment for similar liabilities will result in financial statements that are confusing for users and difficult for entities to prepare.

ACAG also noted inconsistencies between the ED and IAS 37 with regard to refunding liabilities and recognition of contingent revenue, as discussed in our response to question 4.

Management Information

There has been a movement toward financial reporting being more consistent with management reporting, for example IAS 8 'Segment Reporting'. The ED focuses on reporting according to the legal form of contracts and transactions. In comparison, management is likely to demand information about the substance of the contracts and transactions to make decisions and assess performance. The proposals in this ED may result in less meaningful and useful information for the users of financial statements in particular industries.