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Ref: DAH

24 September 2010

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

Email: standard@asb.gov.au

Dear Mr Stevenson

ED 198: Revenue from Contracts with Customers

Our comments and recommendations regarding ED 198 are provided in this submission. Responses to the specific questions as requested by the AASB and IASB are provided in the attachment on pages 3-6.

Pitcher Partners is an association of independent firms operating from all major cities in Australia. Our clients come from a wide range of industries and include listed and non-listed disclosing entities, large private businesses, family groups, government entities and small to medium sized enterprises.

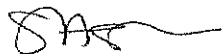
In summary, we hold the following views which are described further in the attachment:

- We firmly believe that financial reporting should reflect the commercial substance of a transaction as presented in contractual arrangements. We do not concur with the proposed approach to combine contracts as this treatment does not have regard to the factors which prompt delivery of performance obligations in separate legal agreements (IASB Q1). Where there are contractual terms and conditions that require all performance obligations to be delivered as anticipated before the full contract price can be demanded, a stand-alone basis for revenue recognition should not be permitted (IASB Q7).

- We consider that the discussion and requirements on credit risk are somewhat convoluted. (IASB Q5). We consider that credit risk will be addressed through the terms and conditions for contractual payments. The standard should clearly address and differentiate the reporting requirements where contractual obligations require a customer to make progress payments to fund performance delivery and/or address credit risk (which is often prior to delivery of the performance obligation), and the recognition of revenue when a performance obligation has been completed.
- We consider that adjustments for the time value of money should only be made where a contract explicitly includes a financing component (IASB Q6).
- We consider that disclosures of remaining performance obligations should be limited to circumstances where the entity is compelled to satisfy performance obligations under an onerous contract only (IASB Q11).
- We are concerned that the discussion relating to “exclusive” and “non-exclusive” licences is not meaningful and does not anticipate how the sale/rent/lease of intellectual property might evolve in the (short-term) future. We consider that the accounting requirements for the licence of intellectual property should follow the rights and obligations described in the contract transferring rights. (IASB Q16)
- We consider that the level of detail in the nature and extent of information to be provided to users in the proposed disclosure requirements will result in “information overload” and consequently is unlikely to be useful. We do not believe that increased complexity in financial statements is in the best interests of the Australian or New Zealand economies.

Please do not hesitate to contact me if you wish to discuss further any matters arising from this submission.

Yours sincerely



S. DIANNE AZOOR HUGHES
Partner

AASB Specific Matters for Comment

- (a) *Regulatory issues that may impact the implementation of the proposals relating to not-for-profit entities and public sector entities*

No comment.

- (b) *The proposals result in financial statements that would be useful to users*

We consider that the level of detail in the nature and extent of information to be provided to users will result in “information overload” and consequently is unlikely to be useful.

We are concerned that certain proposals do not reflect the commercial reality of the transactions as negotiated between a willing buyer and seller. Further the disclosures anticipated will add to the complexity of financial statements and to the compliance burden for preparers.

- (c) *Proposals in the best interests of the Australian and New Zealand economies*

We do not believe that increased complexity in financial statements is in the best interests of these economies.

- (d) *Proposed disclosures should be considered for exclusion from the reduced disclosure requirements.*

We consider that the following disclosures are required and all others should be excluded:

Para 69(b) – significant judgements

Para 74 – disaggregation of revenue

Para 77(c) – significant payment terms

Para 79 – onerous performance obligations

IASB Questions for Respondents

Question 1: Principle relating to price interdependence

We generally concur with the principle as described in paragraphs 12-19 regarding the segmentation of contracts, and contract modifications. However, we have concerns regarding the requirements to combine two or more contracts and account for them as a single contract (as described in paragraph 13). We also consider that the “substance over form” requirements of paragraph 13 are inconsistent with other international financial reporting standards, which require due consideration of the legal form of a transaction.

We firmly believe that financial reporting should reflect the commercial substance of transactions. Although contract *prices* may be interdependent, other factors in performance obligation may be significantly different. For example, where performance obligations are deliberately delivered in separate contracts to recognise differences in the risk-reward relationship, it may be inappropriate to account for them as a single contract, whether or not the criteria in paragraph 13 are met.

We consider that determination that “the contracts are negotiated as a package with a single commercial objective” (paragraph 13(b)) does not recognise the commercial reality that requires the performance obligations to be scoped into legally separate agreements.

Recommendation: The discussion in paragraph 13 should be presented as matters to be considered rather than as an explicit requirement. The financial reporting should reflect the commercial reality as presented in contractual agreements.

Question 2: Principle to determine when a good or service is distinct.

We concur with the principle as described in the draft standard.

Question 3: Determining when control of a promised good or service has been transferred to a customer.

We have no significant concerns with the proposed guidance in paragraphs 25-31. However we consider that it would be preferable to include most of this discussion as application guidance, rather than in the main body of the standard.

Question 4: Estimation of transaction price

We agree that an entity should recognise revenue on the basis of an estimated transaction price and concur with the proposed criteria in paragraph 38.

Question 5: Reflection of the customer’s credit risk

We concur with a view that revenue should not include anticipated losses but consider that the discussion around customer credit risk is somewhat convoluted.

Although it may be reasonable to presume that prices are adjusted for credit risk, credit risk is more likely to be addressed through terms and conditions of payment rather than adjustment of the contract price. For example, the size and timing of progress payments on (say) a construction contract are more likely to be required *before* the performance obligations are completed, if the customer is considered to be a high credit risk.

Recommendation: The standard should clearly address and differentiate the reporting requirements where contractual obligations require a customer to make progress payments to fund performance delivery and/or address credit risk (which is often prior to delivery of the performance obligation), and the recognition of revenue when a performance obligation has been completed.

Question 6: Adjustments to reflect the time value of money

Adjustments to reflect the time value of money may be necessary for consistency with other International Financial Reporting Standards. However, we consider that the contract price and required timing for payments throughout the period of the contract implicitly reflect the time value of money as determined through the commercial negotiations to agree these issues.

Recommendation: Adjustments for the time value of money should only be made where a contract explicitly includes a financing component.

Question 7: Allocation of transaction price to separate performance obligations in a contract in proportion to the stand-alone selling price of goods/services underlying each performance obligation

Although we generally concur with this principle we are concerned that the requirement provides opportunity to manipulate the timing of recognition of revenues and profits. In certain circumstances, the “unbundling” of performance obligations will not recognise the synergies and efficiencies that arise through a combined product/service delivery. An arbitrary allocation based on stand-alone prices ignores the commercial basis for the transaction.

Further, entitlement to the full contract price may be dependent on fulfilment of *all* contractual obligations to completion. In some contracts the performance of all contractual obligations may not be certain in the early stages of performance delivery. Therefore a pro-rata allocation of profit based on stand-alone prices may result in revenues and profits being recognised in the early stages, and losses in the later stages of contract delivery. This requirement has the potential to ignore the commercial reality of an agreement.

Recommendation: Financial reporting should reflect the commercial substance of transactions. Where there are contractual terms and conditions that require *all* contractual obligations to be delivered as anticipated before the full contract price can be demanded, a stand-alone basis for revenue recognition should not be permitted.

Question 8: Contract costs

We concur with the proposed requirements on accounting for the costs of fulfilling a contract and consider that they are operational and sufficient.

Question 9: Costs relating directly to a contract and recognition of an additional liability regarding an onerous performance obligation

We generally concur with these proposals.

Question 10: Help users of financial statements understand the amount, timing and uncertainty of revenues and cash flows.

We consider that the nature and extent of information provided will result in “information overload” for users, with too much detail in extensive note disclosures. Further, where the recognition and measurement of revenues and profits is not consistent with the way a business is managed, and is not in accordance with the legal form of contractual obligations, there is scope for considerable misunderstanding of future expectations. Consequently the disclosures are unlikely to help users understanding of these issues but may contribute to confusion in the intended meaning.

Question 11: Disclosure of remaining performance obligations beyond one year

We consider that these disclosures are onerous. Further, where it is normal practice to modify contract prices or performance obligations as a contract proceeds, these disclosures are not necessarily meaningful.

Recommendation: Disclosures of remaining performance obligations should be limited to circumstances where the entity is compelled to satisfy performance obligations under an onerous contract only.

Question 12: Disclosure of disaggregated revenue

We concur with disclosures of disaggregated revenue based on the broad categories included in paragraph 74.

Question 13: Retrospective application

We consider that retrospective application is onerous and impracticable. Considerable work would be needed to compile data in the format required for contracts that are now completed, with minimal benefit to preparers or users.

Recommendation: The draft standard should require prospective application only.

Question 14: Application guidance

We consider that the application guidance is sufficient to make the proposals operational.

Question 15: Product warranties

We concur with the distinction between the different types of product warranties and the proposed accounting for each type.

Question 16: Licence of intellectual property

We generally concur with the guidance provided, although we question whether it is needed.

Following the requirement to identify and recognise intangibles in business acquisitions (in previous revisions to IFRS 3) there has been considerable activity in the legal profession in Australia to provide a legal form to support the rights attaching to an intangible. We are therefore concerned that the discussion relating to “exclusive” and “non-exclusive” licences is not meaningful and does not anticipate how the sale/rent/lease of intellectual property might evolve in the (short-term) future.

Recommendation: The accounting requirements for the licence of intellectual property should follow the rights and obligations described in the contract transferring rights.

Question 17: Gain or loss on sale of non-financial assets

We concur with the proposed accounting for disposals of non-financial assets.

Question 18: Non-public entities

No comment



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

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 preparers 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.