Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through email (commentletters@ifrs.org)

22 October 2010

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft of *Revenue from Contracts with Customers*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

Overall, we support many of the broad principles in the Exposure Draft. However, we believe that some principles, especially transfer of control for services and continuous transfer, need to be clarified to make them operational across all types of revenue contracts with customers and to ensure that the resultant pattern of revenue recognition properly reflects the economic substance of each arrangement.

We also find much of the application guidance useful. However, we consider that further work is needed to some of the examples to set out realistic or more challenging fact patterns and explain the implications of those fact patterns for the accounting treatment. Furthermore, we believe it is important that the board considers whether there is sufficient guidance in the Exposure Draft on transactions covered by interpretative guidance that is to be withdrawn (e.g. sales of real estate, customer loyalty programmes and barter transactions). We believe that these areas for improvement must be addressed before issuing the final standard because sufficiently developed application guidance is critical in ensuring the effectiveness of a principles-based revenue standard.

We are aware that this project is an important part of the MOU with the FASB and that for this reason it is being progressed ahead of conceptual discussions surrounding revenue and the broader concept of income. Whilst we understand the importance of achieving a common standard with US GAAP, we continue to believe that the conceptual debate is important and that this standard should not have the effect of pre-empting that debate. We also note that the IASB and the FASB continue to work on a number of projects that have transactions that are similar to those addressed in the Exposure Draft, or are based around a concept of control or expected values (including leases and insurance contracts). We believe that it is important to ensure consistency in application to economically similar transactions across all of these projects.

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Further details of our views are set out in the Appendix to this letter in the form of responses to the consultation questions which you have raised. If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/AW/jn

Comments on the IASB Exposure Draft of *Revenue from Contracts with Customers*

Recognition of revenue (paragraphs 8-33)

<u>Question 1</u>

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?

We agree with the substance over form approach based on price interdependence to combine or segment legal contracts to identify a "contract" for the purposes of this proposed standard and to account for contract modifications.

However, since the criteria for segmenting contracts (paragraph 13) and identifying distinct performance obligations (paragraph 23) appear similar, we consider that more clarification is needed to explain the differences between the two concepts i.e. to explain the possible accounting consequences of segmenting at the contract level as opposed to identifying separate performance obligations within a single contract (e.g. so far as allocation of variable consideration and discounts is concerned).

<u>Question 2</u>

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?

While we agree in principle that each promised good or service should be accounted for as a separate performance obligation only if it is distinct, we find it hard to pin down the intended meaning of "distinct" and how it would be identified in practice, particularly for companies in the construction, software and franchising industries. For example, "similar", "distinct profit margin" and "distinct risks" are not clearly articulated in paragraph 23 and Examples 8 and 11 in Appendix B give insufficient information on the basis for the conclusions reached (see also our response to question 14). Also, although when-and-if available software is specifically mentioned in paragraph 21(d) as an example of a good or service, it is unclear as to whether or not such software would be considered as distinct and so whether the promise to deliver such software "when and if available" would be a separate performance obligation.

Therefore, we consider that in order to operationalise the principle it would be necessary to include more explanatory guidance and enhanced examples as an inappropriate upfront division of a contract into separate performance obligations would appear to have far-ranging consequences for revenue recognition later on.

In particular, we consider that Example 11 relating to the construction industry needs to be reconsidered as we are not convinced that it is appropriate to encourage entities to identify separate performance obligations within one contract when the construction company, as the main contractor for the job, will perform a key contract management role to ensure the coordination of all the works and cover the overall project risk to provide the integrated construction services for which the customer has contracted. We consider that in such cases when there is interdependency in the execution of all the construction activities in achieving the project outcome, the delivery of the project as a whole to the customer should be treated as one single performance obligation for which revenue is recognised during the period of construction as and when the customer accepts that contract activity has taken place for which the customer has an unconditional obligation to pay (as discussed further in our response to question 3).

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?

We do not find the proposed guidance sufficient for determining when to recognise revenue arising from contracts for services or for goods which are produced to the customer's specification and take an extended period of time to complete. In particular, we find that the indicators set out in paragraph 30 are inconsistent with or inadequate when attempting to apply the principle, as it is articulated in paragraphs 25-27, to such arrangements.

Our impression of the standard is that, although the principle discussed in paragraph 25-27 is based solely on a transfer of control evidenced by the customer's ability to use the asset, the indicators and guidance in paragraphs 30 to 33 and the application guidance to the Exposure Draft seem to be based more on an earnings-based model for revenue recognition. That is, in the case of services or goods which are produced to the customer's specification and take an extended period of time to complete, revenue would be recognised as and when the entity has carried out a stage of work which unconditionally entitles the entity to payment for work done to date, even though at that time the good or service may be incomplete (and therefore is literally incapable of being "used" by the customer as described in paragraph 26-27 at that moment). We consider that describing such situations as a "continuous transfer of control" adds to the confusion as conceptually this implies that a transfer has not been completed or that there has not been a proper cut-off of a distinct performance obligation.

In terms of how to address this apparent inconsistency: we support the direction that the indicators and guidance in paragraphs 30 to 33 and the application guidance have taken on the timing of revenue recognition and believe that the resultant pattern of revenue recognition properly reflects the economic substance of the arrangement from the perspective of the seller and thus gives rise to decision-useful information about the seller's performance.

We therefore consider that it is paragraphs 25-27 that need to be amended by the boards, rather than paragraphs 30 to 33, to ensure that the principle discussed in these paragraphs is clearly consistent with revenue being recognised while work is in progress in cases where the goods or services are only partially complete and therefore cannot be "used" by the customer, but work being carried out is directly to the customers' specification, and the customer has an unconditional obligation to pay for the work done to date, for example through accepted progress billings. We consider that this is an appropriate basis on which to recognise revenue in respect of such activities, as it results in revenue being recognised when the entity has performed under the contract and the customer has accepted that such performance has occurred and that they have an obligation to pay for it. Without such consistency of principle and guidance, it will be very hard to ensure a proper and consistent application of the standard other than in the most straightforward of cases.

We consider that any more fundamental attempt to apply the concept of "transfer of control" to revenue recognition for contracts for services and custom-built items and thereby change current practice should be deferred until the meaning of "control" and the concept of what economic activity "revenue" is intended to portray have been addressed at the Conceptual Framework level and on a consistent basis across IFRSs.

Measurement of revenue (paragraph 34-53)

<u>Question 4</u>

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?

Yes, we agree with recognising revenue on the basis of a reasonably estimated transaction price and consider that the guidance on how to determine whether a price can be reasonably estimated, as set out in paragraphs 38 to 42, is sensible and pragmatic. We have noted that such wording is inconsistent with the proposals in the exposure draft on leases, which requires that contingent rentals and expected payments under term option penalties and residual value guarantees are only included as part of the right to receive lease payments if they can be *measured reliably,* and in certain other standards. In this regard we would recommend that both projects align any requirements re estimates of variable amounts using consistent terminology.

However, we have concerns at the requirement in paragraph 35 that the transaction price should be the "probability-weighted amount of consideration that a customer expects to receive". While we agree that measuring the transaction price at a probability-weighted amount is appropriate for a large population of similar sales, we do not consider that it provides decision-useful information to use this statistical method for individual sales and it is unclear to us how this requirement interacts with the requirements in paragraphs 38 to 42 for the revenue to be "reasonably estimated".

For example, where an entity has sold a good and based on past experience considers that there is an 80% chance that this customer will exercise its right of return and obtain a full refund, we do not consider it provides decision-useful information to record revenue at 20% of the sales price as this does not represent a reasonable estimate of future cash flows based on past experience.

We consider that the approach taken in the ED on leases to determining the length of the lease term provides an appropriate measurement basis when estimating revenue in the case of small populations and where the transaction is subject to discrete outcomes (for example, either a sale has occurred or the customer receives a full refund, or an additional lump is receivable if and when a certain milestone is reached). We would consider such an approach provides decision-useful information and intuitively is consistent with the guidance in paragraphs 38 to 42 on making reasonable estimates.

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?

We agree that the customer's credit risk should not be a factor which determines whether revenue should be recognised, once control over a good or service has passed to a customer.

However, we believe that the amount reported as revenue should be based on the transaction price agreed in the contract and that any amount recognised in the statement of comprehensive income arising from an assessment of a customer's credit risk, or changes in that assessment, should be separately disclosed from the amounts recorded as revenue. We consider that this provides more decision useful information to users of the financial statements than netting the two amounts. We also consider that such presentation reduces complexity for the preparer of the financial statements, as generally information on receivables, and any valuation allowances related to doubts over recovery of those receivables, is maintained in separate ledgers from the sales information and by a separate team within the accounts function.

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?

We agree with the principle that time value of money should be taken into account when determining the transaction price. However, we believe further clarification is needed to explain:

- *when* it would be applied i.e. whether the phrase "if the contract includes a material financing component (whether explicitly or implicitly)" in paragraph 44 refers only to when financing is involved in excess of normal credit terms or to whenever the effect of discounting is material irrespective of the length of normal credit terms? Likewise, to clarify whether it refers to all situations where payment is received in advance and the impact of discounting would be material (including those situations where the advance payment was agreed upon only as a result of concerns over credit worthiness of the customer, or to cover start up activities which do not meet the definition of a separate performance obligation) or only those where the intent of the arrangement was to provide financing for the entity, for example during a period of extended production;

- *how* the requirement to consider credit risk in determining the discount rate should be applied to cash received in advance from a customer (paragraph B84)? i.e. to identify whose "credit risk" should be taken into account; and

- whether non-refundable advance payments received in a foreign currency should be regarded as monetary or non-monetary items in accordance with IAS 21 i.e. whether the revenue recognised in such cases should be based on the spot rates prevailing at the date that the advance payment was received or based on the spot rates prevailing at the date the revenue is recognised?

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, we generally agree with the proposals in paragraph 50. However, we ask the boards to re-consider the decision to prohibit the residual method as an alternative basis of allocation (paragraph BC125) as the requirement to estimate stand-alone selling prices of all performance obligations, including those satisfied in the first accounting period in which the contract was entered into, even if unobservable directly, seems unnecessarily onerous.

With respect to the allocation of subsequent changes to the transaction price (paragraph 53), as an entity would already be segmenting contracts and further breaking down a single contract into separate performance obligations under the current proposals, as previously mentioned in our response to Question 1 above, we believe that there may be situations where it would not faithfully represent the economics of the contract to require such an allocation to be performed across all performance obligations at the contract level.

For example, a contract which bundles sale of equipment and subsequent servicing may fail to meet the contract segmentation criteria due to an overall discount for agreeing to buy the bundle. However, such a contract may also include variability, for example based on the number of maintenance hours or due to indexed increases in parts and/or labour costs of the subsequent servicing activities. In such cases allocating the transaction price changes to both the already delivered equipment and the subsequent servicing seems counter-intuitive.

Hence, we suggest that paragraph 53 should allow more judgment, such that if subsequent changes to the transaction price are clearly related to one or more specific performance obligations within a contract (e.g. subsequent servicing in the above example), then the allocation of those changes should be limited to those performance obligations. This will also reduce the complexity for the preparer in terms of how to maintain their accounting systems to record such variations.

Contract costs (paragraphs 57-63)

<u>Question 8</u>

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?

In general, we support the proposals in respect of cost recognition. However, in our view, and consistent with our comments on the Discussion Paper, we continue to believe that the recognition of costs incurred as a result of successful sales and/or non-refundable deposits should be matched with the revenue that they generate in order to give rise to decision-useful information.

For example, a sales commission may become payable at the time of exchange of contracts on a property development, even though the entity will not recognise such revenue until a later time when control over the property passes to the customer. Typically the commission is either subject to claw-back on a failed sale, or, if not subject to claw-back, would economically be covered by the entity taking an initial non-refundable deposit from the customer at the time of the contract exchange. Either way, given paragraph 59(a) there does not appear to be a mechanism under the proposals by which the commission cost can be deferred and matched with the directly related revenue. In our view, recognising the commission as of a different date than the revenue would not reflect the economics of this transaction.

<u>Question 9</u>

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?

We agree with the costs specified.

However, it is not clear to us why the boards have proposed to assess costs already incurred (i.e. contract costs) at the contract-level (paragraphs 57 – 63) but to assess costs to be incurred (i.e. costs directly related to satisfying onerous performance obligations) at the individual performance obligation level (paragraphs 54 – 55). In our view, onerous contract provisions should be assessed at the contract level as this is consistent with the price interdependency principle set out in paragraph 13. We therefore do not support the proposal in paragraph 55. If this proposal remains, we consider that the different basis for assessing costs could cause confusion and therefore it is important that a clear example is included which illustrates the interaction between these two sets of requirements.

In addition to our comments above on Questions 8 and 9, we believe that contract costs and onerous provisions should be addressed as consequential amendments to the relevant standards (i.e. IAS 2, IAS 37 or IAS 38) rather than as a separate part of the revenue standard.

Disclosure (paragraphs 69-83)

<u>Question 10</u>

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?

We support the disclosure requirements with the following exceptions:

(i) Given the very broad definition of "contract" in this standard (i.e. which includes virtually every interaction with customers that generates revenue or will generate revenue in the future) we consider that the reconciliation of opening and closing contract assets and liabilities, as is required by paragraphs 75-76, to be excessive. In this regard we consider that information disclosed in the statements of comprehensive income, financial position and cash flows should be sufficient information on revenue and contract assets and liabilities, without explicitly reconciling the information as proposed in paragraphs 75-76.

(ii) Likewise, we have concerns over the broad scope of the disclosure requirements set out in paragraph 77, as it appears that the boards are requesting detailed information on all the products and services offered by the entity and the terms (including payment terms) on which the entity does business with its customers.

We consider that the information in the financial statements in respect of these matters should be limited to that which would be disclosed in a description of the entity's accounting policies under paragraph 117 of IAS 1, (or in any additional disclosure on where judgement was required in applying those policies, as is required to be disclosed under paragraph 122 of IAS 1), and in the qualitative and/or quantitative discussion in respect of how the entity is exposed to credit risk and manages that risk (as is required to be disclosed under paragraphs 33 to 38 of IFRS 7).

We therefore consider that paragraph 77 should be re-drafted to be in the form of a reminder of these other requirements and their relevance to the entity's contracts with customers. Any additional information on the terms on which the entity does business with its customers, if provided at all, should be provided in management discussion & analysis commentary, rather than in the financial statements.

(iii) We do not support the forward looking proposals set out paragraph 78 for the reasons explained in our response to question 11 below.

(iv) We consider the requirements set out in paragraphs 79-80 concerning onerous contracts to be excessively detailed and, as mentioned in our response to question 9, we consider that in general onerous contract provisions are dealt with more appropriately in IAS 37 and would therefore already be covered by the disclosure requirements in that standard, which we consider are adequate.

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?

Mandatory forward looking information in financial statements which focuses on the timing of future cash flows is typically limited to those transactions which expose the entity to liquidity risk or other going concern uncertainties. We therefore do not consider that the proposed disclosure requirement concerning unfulfilled contracts is appropriate as it effectively asks the entity to disclose management information from its order book, even when such contracts and are not onerous do not otherwise represent potential cash outflows.

Instead, we believe that such forward looking information as is required to be disclosed under paragraph 78, if provided at all, should be provided in management discussion & analysis commentary, rather than in the financial statements, and should be placed in the context of a discussion of the prospects of the business for the foreseeable future (which would include information about sales plans and trends in general relating to the entity's goods and services, rather than focusing only on existing contracts).

<u>Question 12</u>

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, we agree as it provides decision-useful information to users of the financial statements.

Effective date and transition (paragraphs 84 and 85)

<u>Question 13</u>

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.

We understand the importance of ensuring comparability and hence preserving trend information (paragraphs BC231 – BC232) and so agree with the boards' decision to reject *prospective* application (paragraph BC234). However, we also strongly believe that, as noted by the boards (paragraph BC 232), *retrospective* application will cause major operational problems for entities, despite the long lead time between the revenue standard's issuance and effective date. As a compromise, we would recommend allowing entities to apply the revenue standard on a *limited retrospective* basis. For example, similar to the approach taken to business combinations, the requirements of the new standard would only be required to be applied by the entity to contracts entered into after a certain date, or, similar to the approach taken to the Amendments to IAS 17, the restatement would be limited to the opening balances at the start of the current period i.e. with respect to contracts with customers which remain unfulfilled at that date. If the requirement is kept for full retrospective adoption then we consider that entities should be permitted an extended lead time to allow for re-analysis of past data and systems changes necessary to collate such information.

Furthermore, we would request that early adoption is permitted for <u>all</u> entities, not just for first-time adopters as is currently discussed in BC238, to create a level-playing field for all entities.

Application guidance (paragraph B1-B96)

<u>Question 14</u>

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?

We find much of the application guidance useful. However, we consider that further work is needed to some of the examples to set out realistic and/or more challenging fact patterns and to explain the implications of those fact patterns for the accounting treatment.

For example, in Example 11 (paragraph B43) the fact pattern includes the statement "the customer obtains control of those materials and equipment as they are installed", as if this is a question of fact, rather than a conclusion drawn against the principles set out in paragraphs 25-27. Consequently there is no explanation as to how this conclusion was reached in this fact pattern, and it is not self-evident from the other facts how this fits with the explanation in paragraphs 25-27 as the construction activity was expected to last for 3 years i.e. presumably the customer is not able to "use" these materials and equipment until the facility construction is completed (NB see also our response to question 3 in respect of concerns over the inconsistency between paragraphs 25-27 and the concept of "continuous transfer" while construction is in progress).

In addition, in example 3 (paragraph B12) the fact pattern chosen to illustrate the requirements relating to refund liabilities is simplified such that the calculation of the number of items expected to be returned ("3 items") is both the most likely outcome and also the probability weighted average of "25% x 1 item + 25% x 5 items + 50% x 3 items". By choosing a simple fact pattern which leads to a whole number for the "expected" calculation, this example fails to illustrate clearly that if the calculation had resulted in the "expectation" that e.g. 3.5 items would be returned, then the refund provision would be for 3.5 items, even though this is a physically impossible outcome (NB see also our response to question 4 where we express concern over the application of the probability weighted calculation to a small population of items).

Similarly, set out below are more examples of unanswered questions that arose during our review of the examples in Appendix B, which led us to conclude there is currently a lack of clarity in the examples on certain key determinative factors which may hinder the consistent application of the principles:

- What are the "distinct risks" for site preparation and site finishing in Example 11 (as previously mentioned in our response to Question 2)? (the example simply states "The entity identifies distinct risks for site preparation and site finishing" and it remains unclear why these activities should be singled out from all the other activities that will be covered by the single contract to design and build the facility. Note also that as per our answers to questions 2 and 3 we are not convinced that in the fact pattern outlined in example 11 it would be appropriate for the main contractor to view the construction of this facility as anything other than a single performance obligation for which revenue is recognised during the period of construction as and when the customer accepts that contract activity has taken place for which the customer has an unconditional obligation to pay. In order to illustrate the identification of separate performance obligations within a single contract a different fact pattern should be chosen, for example, the construction of two facilities under a single contract or a build and operate contract).

- What was it about the terms of the contract re deliverables in Example 19 that justify recognising the revenue "evenly over the six months"? (the example simply states "because those services are provided evenly…").

- Why does paragraph B21 use the concept of *control* when determining whether an entity is acting as a *principal* but in paragraph B22 uses the concept of *risks and rewards* when determining whether an entity is acting as an *agent*? What sort of situation is paragraph B21 referring to when it refers to the intermediary "obtaining control" over the goods? How closely must the end-user be linked to the goods or services in order to be able to assert that the intermediary has no "control" over the goods as they pass through their hands? These paragraphs seem contradictory and in view of this difference, we believe that illustrative examples are needed to demonstrate how this determination should be made in practice.

- Are normal payment (billing) terms still a relevant criteria for recognising bill-and-hold sales? This is an important criteria in IAS 18.IE1(d)) but it has not been mentioned in the list in B60, or elsewhere (paragraphs B58 – B62).

- In example 15: is the right of the customer to physically take possession of the part-completed equipment essential to the conclusion or would the unconditional obligation to pay and customer specific design features be sufficient? (this example leaves this key question unanswered, by having a less controversial fact pattern where the customer has both the right to take the WIP and the unconditional obligation to pay for it).

Furthermore, we believe that it is important that the boards consider whether the revenue standard adequately covers the transactions in the interpretative guidance which are to be withdrawn (paragraph 86) e.g. real estate, customer loyalty programmes and barter transactions in IFRIC 15, IFRIC 13 and SIC 31 respectively.

We believe that these areas for improvement must be addressed before issuing the final standard because sufficiently developed application guidance is critical in ensuring the effectiveness of a principles-based revenue standard.

<u>Question 15</u>

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?

We agree with the proposed distinction between the types of product warranties in principle but we believe that it may be difficult at times to make this distinction in practice. However, we noted that the methodology described in paragraph B15 for deferring the revenue related to the products' components that are expected to be replaced in the repair process is inconsistent with the principles set out in the main body of the standard concerning identifying separate performance obligations (since the components to be replaced in the repair process will not generally meet the definition of a separate performance obligation). Furthermore, in addition to deferring this revenue for the replacement part, it would appear necessary for the entity to also consider the onerous contract requirements in IAS 37 in order to recognise the liability to cover the additional costs of repair i.e. the labour costs to be incurred when carrying out the repair work free of charge.

Therefore, overall, we consider that the approach set out in paragraph B15 regarding the replacement of a part arising from a latent defect as a revenue generating activity is unduly complex and burdensome for reporting entities.

As an alternative, we consider that the cost of carrying out repairs of latent defects under warranties (both replacement parts and labour) should be regarded as part of the cost of the item sold, measured following the principles of IAS 2 and IAS 37. Under this view, accruals or provisions for repair costs would be recognised at the time of sale and charged to cost of sales, rather than deferring revenue.

<u>Question 16</u>

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 license 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?

We find it difficult to distinguish between an exclusive and a non-exclusive right because the meaning of each is not clearly articulated in the Exposure Draft. For example, if an entity grants a licence in a single jurisdiction (while licences in other jurisdictions can be granted to other parties), has the entity sold an exclusive right or a non-exclusive right? It appears that the answer depends on the level at which the transaction is viewed and so is highly judgmental.

Instead of developing separate guidance in the revenue standard on licensing and outright sales versus "right to use", we believe that there should be greater conceptual consistency between the revenue standard and the accounting by lessors under the replacement of IAS 17. In this regard we encourage the boards to ensure that the project teams of the revenue and leases projects work together on this issue.

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, we agree.

- End -