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

Our Ref.: C/FRSC

Sent electronically via email commentletters@ifrs.org and director@fasb.org

13 March 2012

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

Dear Sirs,

IASB Exposure Draft of *Revenue from Contracts with Customers* (as issued in November 2011) – FASB File reference No. 2011-230

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 and our comments on other areas in the Exposure Draft are set out in the Appendix for your consideration.

Overall, we continue to support many of the broad principles in the Exposure Draft and find that the application guidance is easier to understand and more helpful. However, we believe that some of the principles, especially around satisfaction of performance obligations over time, need to be clarified and/or reconsidered in order for the proposed standard to be applied properly and consistently across different types of contracts with customers, including those commonly found in the construction and real estate industry as well as the telecom industry.

Specifically in respect of pre-sales of individual apartments within a larger development, our constituents have expressed serious concerns about whether these proposals are operable and whether they are consistent with the principle of the standard to recognize revenue when or as the entity satisfies a performance obligation. In our detailed response to question 1 we have explained these concerns and noted a number of matters for which further clarity is required. We consider that if our proposals for simplifying the calculations and narrowing the concept of "right to payment" in respect of these apartment sales are not accepted by the boards, then the standard should instead clearly scope out sales of individual apartments within property development projects controlled by the developer from any assessment under paragraph 35 and therefore require such contracts to be automatically assessed under paragraph 37 on the basis that the performance obligation is satisfied "at a point in time".

In respect of the telecom industry and other industries with service plan arrangements with customers and/or other contingent income which depends on a customer's end customer, we consider that the role of "contract options which do not contain a material right" and the constraint on the recognition of revenue which is not "reasonably

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assured" need to be given greater prominence at steps 2 and 3 respectively, so as to reduce confusion and inappropriate revenue recognition at the later steps of allocating and recognising revenue.

However, we do not support the proposal to assess onerous contracts at the performance obligation level. Instead, we consider that provisioning for onerous contracts is an issue relating to the timing of recognition of non-recoverable costs and should continue to be dealt with in IAS 37 rather than in the proposed revenue IFRS.

Also, we would like to encourage the IASB and the FASB (the boards) to re-consider:

(a) the disclosure requirements and transitional provisions, so as to achieve an appropriate balance between the benefits to users and the costs to entities of preparing and auditing that information; and

(b) the location of the "costs to fulfill" requirements so as to maintain a logical structure of the IFRS literature and to avoid unnecessarily amending existing requirements and literature structure which have served IFRS users well.

Further details of these comments and recommendations are contained in the attached Appendix. 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/WC/jn

Encl.

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APPENDIX

Hong Kong Institute of CPAs

IASB Exposure Draft of *Revenue from Contracts with Customers* (as issued in November 2011)

<u>Part A: responses to specific questions set by the IASB</u>

<u>Question 1</u>

Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

We are grateful that the boards have re-considered the principles for recognising revenue over time in this Exposure Draft and we consider that the approach set out in paragraph 34, to first consider whether any of the "transfer over time" criteria are met, will greatly assist in providing clarity and consistency of application.

However, we feel there are aspects of paragraphs 35 and 36 which may still cause some confusion and need to be reconsidered in the final standard so that the boards' intent is clear and the requirements are capable of consistent application. Further details of our concerns are as follows:

Structure of paragraph 35

During outreach activities in Hong Kong we gained a greater understanding of why there appears at first sight to be duplication or overlap between the four different ways in which a performance obligation can be regarded as being satisfied over time. We understood that the intent is to assist readers in finding at least one of the scenarios which clearly speaks to their fact pattern, even though there may be one or more of the other scenarios which also is relevant.

We agree with the logic of this approach but are concerned that paragraph 35 is unnecessarily complex. In particular, currently readers appear confused by the "one or more" approach in paragraph 35(b) and are unsettled when a transaction meets one scenario but appears to fail paragraph 35(b)(iii) so far as payment terms are concerned.

We consider that the structure of paragraph 35 can be considerably simplified without changing the intended scope of activities where it is appropriate to recognize revenue over time. Specifically, we strongly recommend the following changes:

(a) Paragraph 35(b)(i) would be far less confusing if it were moved to be part of 35(a) (for example it would remove the need to try to explain how the "does not create an asset with alternative use" test is always satisfied for paragraph 35(b)(i) because for such activities "there is no asset created at all" (which explanation seems to leave many still confused and unsettled).

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(b) Paragraph 35(b)(ii) should be deleted, with further guidance, including the example of transportation services (as per paragraph BC97) being included instead to provide clarity over how such services fall under the "over time" criteria (our concerns in respect of paragraph 35(b)(ii) are explained more fully below).

For example, after making the above changes paragraph 35 would read as follows:

35 An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognises revenue over time if at least one of the following two criteria is met:

(a) the entity's performance creates or enhances an asset (whether goods or services) that the customer controls as the asset is created or enhanced or that the customer simultaneously receives and consumes. An entity shall apply the requirements on control in paragraphs 31-33 and paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or

(b) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36), the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised. The right to payment for performance completed to date does not need to be for a fixed amount. However, the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

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In our view, this provides a clearer structure to paragraph 35 in that:

- part (a) of paragraph 35 would then be covering assets clearly under the control of the customer at the time the work is done, including improvements to assets owned by the customer (such as renovation works) and services consumed by the customer immediately when rendered (such as time spent by security personnel or other seconded staff); while

- part (b) of paragraph 35 would contain a single set of criteria, all of which must be met, to cover the less obvious situations where revenue recognition is appropriate over time even though physically the supplier appears to be still exercising some control (in the practical sense of the word) over the product or service.

No alternative use to the entity

We expect that in most cases the application of paragraph 35(a) will be consistent with current IFRS accounting under IAS 11 or IFRIC 15. However, we expect that the outcomes will not necessarily be the same as current practice when applying paragraph 35(b) and it is therefore critical that the scope and intended application of paragraph 35(b) is articulated as clearly as possible to avoid confusion and potential diversity in practice.

In this regard, the concept of "no alternative use to the entity" is fundamental as the gate-keeper to considering even the possibility of recognising revenue over time. However, we find that readers of paragraph 35 are unsure how this relates to criteria (b)(i) and (ii) and readers of paragraph 36 are unsure over the extent to which legal form should take precedent over substance. In this regard, we would recommend the following:

(a) As discussed above, we recommend that paragraph 35(b)(i) is moved to be part of 35(a) and paragraph 35(b)(ii) is deleted in order to provide a single set of criteria in paragraph 35(b), all of which must be met before an entity can recognize revenue over time under paragraph 35(b).

(b) The following aspects of the assessment of whether an asset has alternative use to the entity need to be more clearly evident from paragraph 36 and/or in further application guidance or examples (these recommendations are based in part on our understanding of the boards' intent gained from outreach activities in Hong Kong):

- The assessment of whether an entity could "contractually or practically" readily divert the asset to another customer should consider the ability of the entity *while the contract is live*. That is, it is not relevant to this assessment what the entity could do with the asset after the customer cancelled or otherwise defaulted on the contract.

- "Redirect the promised asset to another customer" may also be evidenced by the entity's ability to re-direct assets from another customer to the project in question i.e. it includes the right of substitution.

- "Practically" refers to the practical ability of the entity to physically substitute or re-direct the work in progress without the customer being aware of the change – if the entity can do this in practice then this indicates that any clause in the contract which purports to prevent this is non-substantive and should be disregarded when making the assessment.

- This assessment takes place at the contract inception but considers the period of activity for fulfilling the performance obligation and the entity's ability during that time to substitute or re-direct the partially completed products to others (in this regard an illustrative example would be useful discussing how, for example, customisation of a standard commercial airplane towards the end of production (such as the type of seats or exterior markings) would not be sufficient to indicate that the entity was practically unable to redirect the airplane during

construction.

- The assessment looks to the single performance obligation as a whole and therefore the asset being created would not fail the "no alternative use to the entity" test simply because it was being constructed using parts which could have had an alternative use in other projects.

- In order to recognise revenue over time both the "no alternative use" test and all of the other criteria in 35(b) need to be met (assuming that 35(b)(i) and 35(b)(ii) are deleted as recommended above) – therefore in cases where it is unclear whether or not the contractual terms preventing re-direction of the WIP are substantive (for example, in the case of ship building, or a manufacturer with limited ability to work on more than one order at a time), if all the other criteria in 35(b) are met then the entity should presume that the contract terms in this regard are substantive and that therefore the asset being created has no alternative use to the entity.

Clarity of paragraph 35(b)(ii)

In our comments above, we recommend deleting paragraph 35(b)(ii) as readers find that paragraph confusing and, when fully understood, it appears to only have application to situations such as transport services. The comments below explain this concern more fully and suggest alternative wording for paragraph 35(b)(ii) in case the boards reject our recommendation to replace it with guidance and an illustrative example.

We have noted that there is considerable confusion over whether or not paragraph 35(b)(ii) applies to the construction of tangible items. We believe this confusion arises because the meaning of 35(b)(ii) seems rather obscure, especially as the 2nd and 3rd sentences do not seem to flow properly. That is, both sentences are telling the reader to ignore certain features of the arrangement, but they work to opposite purposes (the second sentence serves to narrow the applicability of this criterion whereas the 3rd sentence serves to widen it) and therefore the words "in addition" at the start of the 3rd sentence are misleading. We also find that IN24, which gives readers the impression that 35(b)(ii) is just about "someone else not having to re-do the work", adds to the potential confusion around this paragraph.

As noted above, we consider that paragraph 35(b)(ii) adds unnecessary complexity as we consider that paragraph 35(b)(iii) is sufficiently broad to cover situations where it is appropriate to recognise revenue over time. We therefore strongly recommend that paragraph 35(b)(ii) is deleted and that additional guidance, including the example relating to transportation services in paragraph BC97 is included instead.

However, if the boards decide to retain paragraph 35(b)(ii), then we recommend that the order of ideas in paragraph 35(b)(ii) is reversed so that it reads, for example, as follows:

"(ii) another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. In evaluating this criterion, an entity may disregard potential

limitations (contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity. However, the entity shall not presume that another entity fulfilling the remainder of the contract would have the benefit of any asset (for example, work in progress), presently controlled by the entity."

In addition, if paragraph 35(b)(ii) is retained, then we would request that the additional guidance supporting this paragraph be included to make clear that in practice, so far as construction of physical assets is concerned, if the activity failed to meet any of the other tests in paragraph 35, then it must by definition mean that the WIP is still under the control of the entity and that therefore the activity would also fail paragraph 35(b)(ii) because of the requirement to ignore the developer's WIP (i.e. as per the 3rd sentence in the above re-ordered wording).

Practical application of paragraph 35(b)(iii) to pre-sales of apartments within multi-unit developments

In Hong Kong, construction and pre-sale of real estate (e.g. apartments in multi-level, multi-unit residential developments) is quite common. Currently and with due regard to IAS 18 and IFRIC 15, revenue from pre-sales of apartments within multi-level, multi-unit buildings are recognised at a single point in time i.e. on completion of the whole building, rather than continuously over time. However, we anticipate that the requirements of paragraph 35(b)(iii) could be met in certain circumstances in Hong Kong, in particular where on signing the pre-sale contract the buyer pays 100% of the purchase price (for example, in order to take advantage of an early-bird discount offer from the developer) as these contracts are non-cancellable except in the event that the developer fails to complete the property.

As a result, it appears that the proposals, if finalized, would change long-established practice in Hong Kong by requiring developers in Hong Kong to apply different accounting models on an apartment-by-apartment basis for units within a single apartment block, depending on the pattern of payment, and to recognise revenue on some of those units before the building is complete. We have noted that there are mixed views in Hong Kong as to whether such a change in accounting policy is a welcome development or whether it introduces unnecessary complexity for property developers who offer a choice of payment terms to their customers for what is essentially an identical product. There is also concern amongst constituents that recognizing revenue over time for the development of apartment blocks is inconsistent with the notion of transfer of control, as it is clear under the law that the property developers' obligations to the customer are only satisfied when the development is complete.

If such an accounting change is to be introduced it is therefore important that the requirement is articulated as clearly as possible and that the required estimates and accounting systems implications are practicable for developers developing a large number of projects, with many thousands of apartments, at any given reporting date. It is also important that revenue is only recognized when, at the reporting date, it is reasonably assured, and that any reversals of revenue as a result of "failed sales" from customer default are minimized. In this regard, we consider that the proposals lack clarity concerning the methodology for measuring revenue "over time" and the meaning

of the phrase "right to payment for performance", as explained further below:

Lack of clarity concerning the methodology for recognizing revenue over time

In this regard, while we note that Example 7 (in paragraph IE6) illustrates clearly that the proposed standard intends to permit recognition of revenue on an uncompleted apartment where the criterion in paragraph 35(b)(iii) is met, the standard is not clear on how "performance completed to date" should be estimated in such cases and therefore leaves some fundamental questions unanswered, specifically:

(a) Should the "performance completed to date" be assessed with reference to the land component and the building component separately or combined? and

(b) Should the "performance completed to date" be specific to the apartment in question or should it be assessed with reference to the building as a whole? For example, if the 20th floor penthouse has been pre-sold in return for 100% non-refundable cash payment and so far only the 5th floor from the ground up has been built, what is the "performance completed to date" so far as the sale of the 20th floor penthouse is concerned?

In our view, in order for property developers to be able to operationalise paragraph 35(b)(iii) to apply to individual sales contracts on an apartment-by-apartment basis, the answers to the above questions would need to be as follows:

(a) When the sales contract is for an individual apartment within an uncompleted property development which is otherwise under the control of the developer (as is commonly the case), then the undivided share of the interest in the land and common areas which is attributable to that the ownership interest in that apartment is not distinct from the ownership interest of the apartment itself. The sales contract therefore contains a single performance obligation relating to the sale of the apartment and the undivided interest in the common areas.

(b) When assessing the "performance completed to date" for a single apartment within a property development, the assessment should be made for the building as a whole. For example, in the case of the 20th floor penthouse of a building which is currently only 5 floors high at the reporting date, revenue would be recognised on the sales contract for the penthouse based a percentage for the building as a whole (for example, the percentage may be computed on a ratio of manhours of labour undertaken to date on the building compared to manhours to complete the whole building, which might result, for example in a 35% completion ratio by the time the foundations are complete and the 5th floor is reached).

If the standard were to make clear that the answers to these two issues are as set out above, then this would considerably remove the need to answer other common questions which have arisen concerning paragraph 35(b)(iii) such as (a) how to apportion the sales price of an apartment between an interest in land and buildings in an apartment development and (b) whether any partial stage payments should be attributed first to the land or on a pro-rata basis between land and buildings. Computing a single percentage for the building as a whole would also considerably simplify the computations required when assessing whether stage payments

receivable over the course of the remainder of the development activity are in fact sufficient to cover at least "performance to date" as measured under the standard.

If the boards do not agree that, for example, a 20th floor penthouse can be regarded as, for example, 35% complete, when the structure is only 5 floors high, and/or do not agree that for the undivided share of the land, the land should be regarded as a non-distinct part of the transaction, then we do not support the conclusion reached in Example 7 as we agree with our constituents that it would be impossible for them to apply the recognition over time principle on an apartment-by-apartment basis. Instead, we would request that the sales of individual apartments within property development projects controlled by the developer are clearly scoped out of any assessment under paragraph 35 and are therefore automatically assessed under paragraph 37 as being transferred "at a point in time" and that example 7 is amended accordingly.

Lack of clarity concerning the "right to payment for performance completed to date" criteria in paragraph 35(b)(iii)

In addition to the above concerns, we have noted confusion over the intended meaning of the entity's "right to payment for performance completed to date" criteria and believe that paragraph 35(b)(iii) needs to be clearer in this regard to ensure a consistent approach and minimize reversals of revenue as a result of "failed sales" of apartments due to customer default. In particular:

- it should be clearer that the right should survive cancellation by customer of the contract for reasons other than the entity's failure to perform as promised;
- it should be clearer that the right must also survive customer default under the contract and that the right needs to be substantive*;
- it should be clearer that the condition that "the entity must be entitled to a sum that is intended to at least compensate the entity for performance completed to date" must be met throughout the period until completion i.e. not just at the inception of the sales contract; and
- it should be clearer that the "reasonable profit margin" is measured as "a reasonable proportion of the expected profit margin under this contract". For example, if a developer expects to make a 20% margin on each apartment, then the compensation amount if the customer terminated the contract before construction is complete should be at least costs to date attributable to that apartment plus a 20% margin on those costs.

** For example, in Hong Kong a significant proportion of contracts take the form of a 10% payment on signing, may be another 10% at a later stage and 80-90% payment on completion of the building and exchange of keys to the apartment. There is no provision in the contract for the customer to cancel it (except in the case of default by the developer) but in practice the contracts become frustrated if the customer fails to pay the 90% on completion. In such cases of default the developer will generally still be in physical control of the apartment and legally has two choices of action open to them: (a) determine the contract (after giving 21 days notice of the default) or (b) sue*

the customer for specific performance of the contract.

If the developer determines the contract, the apartment legally belongs to the developer and they are free to decide whether to hold on to the apartment (for example for rental) or whether to re-market it either immediately or at some later date. So far as recovery from the buyer is concerned in the case of a determined contract, the buyer will forfeit the 10% deposit but will only be liable to compensate the developer for any loss of profits evidenced by a sale of the specific completed apartment within a specified period (usually 6 months) at a lower price (any profits on re-selling at above the original price will belong to the developer).

If the developer decides to sue the buyer for specific performance, this will require taking legal action through the courts. In practice, legal action to sue the customer for specific performance, or even pursue the buyer for loss of profits, is not commonly undertaken on a defaulting customer. This can be for various reasons, but generally because of one or more of the following reasons: the ease at which the developer can determine the contract and seek alternative buyers or tenants, the lack of financial ability of the buyer to complete the transaction, the legal costs and delays involved, and/or the possible adverse affects on the market for the remaining unsold flats in the development from the publicity associated with taking such an action.

We understand from outreach activities in Hong Kong that the boards' intention is that contracts where the seller's rights extend only to recovery of lost profits would fail paragraph 35(b)(iii); however this is not clear from the wording as the wording only refers to a customer being able to terminate the contract. It is also not clear whether legal rights of specific performance can be ignored, if it is not common that the developer pursues those rights effectively (i.e. whether it is acceptable to view such rights as non-substantive). The wording therefore needs to be improved to cover such default scenarios to ensure that the requirements are applied consistently and to ensure that instances of reversals of revenue recognition from "failed sales" from customer default, where the apartment reverts to inventory as "unsold", are minimised. In this regard, we consider that the developer should not take into account any non-substantive rights to force specific performance (for example, those as we have described above) when assessing their "right to payment" as a justification for recognizing revenue before the property is completed.

<u>**Question 2**</u>

Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

We agree with the proposed requirement in paragraph 69 that amounts to which the entity is entitled under a revenue contract but are assessed to be uncollectable should be presented as a separate line item adjacent to the revenue line item, and that any

subsequent changes in that estimate should be presented in the same line item as the original estimate. We consider that there is an important informational link between the sales revenue and the amount of income lost through inability to collect from customers, which speaks to the quality of the sales activity.

However, we are concerned at the additional complexity that could arise from the assertion in paragraph 69 that IFRS 9 is applied "on initial recognition" of the receivable and that "any difference" between the measurement of the receivable under IFRS 9 and the amount of revenue recognised is presented in profit or loss. This wording appears to raise the possibility that at the time of initial recognition of revenue and a trade receivable a further computation would be necessary, if the amount of revenue recognised for the satisfaction of the performance obligation was different from the amount of the fair value of the trade receivable, other than for reasons relating to collectability of the amount to which the entity was entitled.

For example, if market interest rates have changed between (a) the date the transaction price was determined and allocated to performance obligations (which presumably is at contract inception under steps 3 and 4 of the model) and (b) initial recognition of the revenue and receivable under step 5, paragraph 69 could be read as implying that the trade receivable should be measured under IFRS 9 on initial recognition using the more up-to-date market interest rates, resulting in a day-one difference compared to the revenue recognised. Similarly, the wording in paragraph 69 raises doubt over whether (a) the practical expedient in paragraph 60 concerning the time value of money or (b) the requirements of IFRS 9 to measure initially "at fair value" take precedent, especially given the requirements of paragraph 11 to look to other standards first.

We believe that this implied full application of IFRS 9's "fair value on initial recognition" policy introduces unnecessary complexity. Instead, we believe the revenue standard should take precedent over IFRS 9 by driving the initial recognition of the receivable at the amount to which the entity is entitled as computed under the revenue standard. The IFRS 9 requirements on assessing collectability would then be applied under the amortised cost model after the moment of initial recognition and at each reporting date. We believe that paragraph 69 should be amended to make this application principle clear to avoid unnecessary confusion and debate on this issue.

Question 3

Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the

amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

Yes, we agree with the proposed constraint on the cumulative amount of revenue recognised and consider that the indicators are relevant. However, we have a number of concerns as to the manner in which this concept is dealt with in the exposure draft which we believe unnecessarily adds to the complexity of the proposals and may result in confusion and diversity in practice. These concerns are as follows:

Application of the "reasonably assured" concept to contingent revenue

We note that paragraph 85 is very clear that, with respect to licensing of intellectual property, when an additional amount of consideration varies based on the customer's subsequent sales of a good or service, the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (i.e. as the sales occur). We strongly believe that this is not an exception but rather is an important principle which should not be limited to the licensing of intellectual property but should be extended to other types of transactions where the additional revenue will only arise as a result of positive actions by the customer, which actions the customer is not contractually obliged to take.

For example, we would agree with the upfront recognition of trailing commissions in example 14 (in paragraph IE13) to the Exposure Draft <u>only if</u> the fact pattern was to specify that the insurance contract would roll over automatically unless the policyholder notified the insurance company of his/her wish to terminate the contract. Otherwise, <u>if</u> each annual policy renewal required positive confirmation from the policyholder to prevent the policy lapsing, then to be consistent with paragraph 85 we believe that commission revenue arising from the renewal should not be recognised by the insurance agent until the positive confirmation has been given by the policyholder.

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We also note that the inclusion of the "reasonably assured" concept *after* step 5 can result in anomalies when recognising revenue progressively over time. Consider the following example:

- Entity A provides services to its customer, say customer B. According to the contract, the consideration includes (a) a fixed fee of 1,200 and (b) a contingent bonus element of 800, receipt of which is not considered "reasonably assured" in accordance with paragraph 85 until the project nears completion, but, in accordance with paragraph 55(b), is considered to be the most likely outcome from the outset.

- Revenue is recognised based on the percentage of completion method.

According to paragraph 50, the "transaction price" for the above transaction is 2,000 as this is the amount the entity expects to be entitled to. According to paragraph 49 this "transaction price" should be recognised as the performance obligation is satisfied, and the constraint in paragraph 81 only applies if the cumulative amount of revenue recognised to date is not reasonably assured. Applying these two paragraphs to the above fact pattern would seem to imply that when the % of completion is below 60% revenue will be recognised based on an appropriate % of 2,000, such that when the

project is 60% completed, cumulative revenue of 1,200 will have been recognised. However, no further revenue can be recognised for work done beyond 60% completion until the uncertainty surrounding the bonus is resolved. This means that revenue and profit would be recognised at a faster rate over the first 60% of the contract than in the rest of the project. In our view this is inappropriate; in our view in the above fact pattern the constraint should have operated to exclude the bonus from any measure of performance until the bonus becomes reasonably assured. On this basis, revenue recognised at 60% completion should only have been 60% of the fixed fee of 1200 i.e. 720.

To address the above concerns, we believe that the boards should expand paragraph 85 beyond licensing of intellectual property to identify more broadly how the "reasonably assured" concept is to be applied in the case of contingent consideration, and that the concept needs to be moved to be part of step 3 of the core principle regarding determining the transaction price. In this regard, we request that the boards make a clear distinction in step 3 between a transaction price that is reasonably assured vs. not reasonably assured, with the latter potential revenue <u>not</u> being including in any amount of transaction price to be allocated or recognised until the uncertainty is resolved.

We further recommend that the boards make clear that a variable element of the transaction price *shall not* be regarded as reasonably assured if the additional revenue that would arise on the resolution of the uncertainty directly depends on actions of a customer or the customer's customer, which actions that other party is not obliged to take under the terms of the contract. This is irrespective of how likely it is that the customer (or the customer's customer) will take that action (this would serve to exclude sales by customers arising from the licensing of intellectual property as per paragraph 85 but would also have broader application, for example, to exclude commissions to be earned by insurance agents on renewals of insurance policies where the policy will lapse without the customer signing the renewal notice each year). Amendment to the trailing commission example in paragraph IE13 would be necessary to illustrate the two different scenarios of (a) the policy rolls another year unless the customer cancels and (b) the policy lapses unless the customer renews each year.

Distinguishing between variable revenue which is subject to a "reasonably assured" constraint and additional revenue which arises as and when a customer exercises an option which does not contain a material right

The definition of "transaction price" in paragraph 50 appears to be drawn broadly to include any amount of consideration that the entity expects to receive under the contract in exchange for transferring promised goods or services, including the expected amount of variable revenue. In practice, particularly in the telecoms industry, there is considerable confusion over how this should be interpreted with respect to the variable features of a term service plan, for example the per minute call or data charges that will arise if the customer uses the phone or other data connection beyond "minimum" levels specified in the plan as being covered by a fixed charge. For example:

- Some may believe these amounts are "variable revenue" on the basis that the "performance obligation" is to provide 24/7 connectivity over an identified period

(e.g. 2 years), but accept that the "reasonably assured" constraint needs to be considered before recognising revenue allocated on a relative stand-alone selling price basis under paragraph 71 for example, to up-front handsets.

- Others may see each call or connection as a separate "performance obligation" priced at its stand-alone price, which nevertheless needs to be considered when allocating revenue on a relative stand-alone selling price basis under paragraph 71 (and, again, the constraint in paragraph 81 may need to be considered after some of the revenue expected to arise from these calls is allocated, for example, to up-front handsets).

- Others may identify these amounts as additional revenue received from the exercise of options which do not contain a material right and hence are excluded from the "transaction price" altogether, and only recognised as revenue as and when the call or data connection is made in accordance with paragraph B22. Given this, no amounts would be allocated from the future pay-per-usage charges to be recognised as sales revenue from the sale of handsets, irrespective of how probable those charges were.

Of the three views above, we understand that the third view, to take revenue only as and when the calls or data connections are made irrespective of their predictability, is the correct form of accounting and we note that this is illustrated in example 23 (in paragraph IE20). However, as the discussion on customer options is not mentioned in the main body of the standard, and furthermore, many would not characterise the usage of a phone or internet connection in accordance with a basic service plan as a form of "exercise of customer options for additional goods or services" we are concerned that this third view and consequently example 23 will be easily overlooked when applying the 5 steps.

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We believe that it is important for the discussion of step 2 in the standard (i.e. paragraphs 23 to 30) to include a clear discussion of the question of how "contract options which do not contain a material right" fit into this model, so that the reader of those requirements is able to understand that such pay-per-usage features of deals with customers do not give rise to present contractual performance obligations within the meaning of step 2 and therefore the revenue that the entity may become entitled to if the customer were to exercise those options in the future does not form part of the transaction price identified and allocated at step 3. We believe such a clear discussion on this issue, together with a reference to the example in paragraph IE20, could make a significant contribution towards facilitating implementation of the proposals and removing any doubt over whether, for example, income from call minute charges is a recognition or measurement issue and whether any of it should be allocated and recognised as revenue for "sale" of a handset at the start of the plan period.

Question 4

For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

Consistent with our response to question 9 on the first exposure draft, we believe that the proposed scope of the onerous test (i.e. at the individual performance obligation level) does not reflect the economic substance of the contract, especially if the overall contract is profitable, and information at this disaggregated level does not provide meaningful disclosures to users of the financial statements. We have also received further comments from our constituents which express concern at the confusion caused by including requirements relating to onerous contracts in the revenue standard, when the issue relates more appropriately to the assessment of whether the entity is incurring costs or carrying assets which are not recoverable. For example, they have expressed concern that a bank may provide a range of services to its customers, such as cheque books, access to internet banking, credit cards, cash machines, with a range of sources of income, include fees and interest income, and that it would not be practicable to analyse the operating costs relating to such relationships at the separate performance obligation level to determine whether any of the performance obligations are “onerous”.

In our view, the current requirements in IAS 37 function well and could easily cope with the withdrawal of the contract loss provisions that are in IAS 11 without a material change to the level of provisions that are recorded. Our strong preference is therefore to continue to apply the current requirements in IAS 37 to contracts with customers, including those contracts which are currently under the scope of IAS 11.

However, if the boards decide instead to continue with the current proposals, then our comments on those proposals are as follows:

As per paragraph D21, rights and obligations arising from contracts with customers are to be completely scoped out of IAS 37. Given this, we believe that the proposed requirements for onerous provisions in the Exposure Draft are inadequate as they do not clearly cover performance obligations that an entity satisfies at a single point in time.

For example, a car manufacturer enters into an agreement to produce and sell 50 cars in 3 years’ time. The manufacturer does not have any raw materials on hand at the time of entering into the contract and does not intend to purchase those materials until the production commences in one year’s time. In the meantime, the price of steel dramatically increases resulting in the unfulfilled performance obligations becoming onerous. Under the current IAS 37 the manufacturer would be required to book an onerous contract provision in the first year. However, as the Exposure Draft is silent on this issue, there is no inventory to be impaired under IAS 2, and all revenue contracts are to be scoped out of IAS 37, it seems that under the revised requirements an

onerous provision would not be necessary or even permitted. In our view, this would not be appropriate accounting for such a scenario.

We understand from outreach activities in the region that the boards consider that the above scenario would be covered by the last 2 sentences of IAS 2 which read as follows:

"Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts. Such provisions are dealt with under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*."

We do not consider that these sentences in IAS 2 are an adequate response to this issue as these sentences, as originally written, are simply reminding the reader that this is an issue covered by IAS 37. Since it is proposed that the scope of IAS 37 will exclude all revenue contracts, this "reminder", if it is noticed at all, will only serve to confuse the reader as to which text takes precedence: the last two sentences of IAS 2.31 (which is a guidance paragraph written many years ago) or the recently amended bold paragraph in IAS 37 setting out its scope? We consider that instead the scope paragraphs in IAS 37 should set out more clearly that revenue contracts satisfied "at a point in time" will still need to be assessed under IAS 37.

We also do not agree with the relief from providing for onerous performance obligations when control is transferred continuously over time spanning a period of less than one year, as we have concerns that this may lead to non-recognition of material onerous elements for less-than-one-year contracts which straddle over two financial reporting periods and therefore lead to a material distortion of the statement of financial position and profit or loss for that period. We believe that it is sufficient relief for the assessment for onerous contract provisions to be made only as of the reporting date in respect of unfulfilled performance obligations: this would serve to avoid the need to consider separate recognition of onerous contract provisions for situations where the performance obligation is satisfied in the same reporting period as the date on which it first became onerous.

Also, we would note that if the boards decide to proceed with assessing onerous provisions at the individual performance obligation level and recognizing an expense for such losses, even when the overall contract is profitable, this could in some cases be conceptually inconsistent with requirement in paragraph 94 to recognize an asset for the incremental costs of obtaining a contract with the customer if the entity expects to recover those costs. For example, an entity may sell a machine at a loss in return for securing future sales of replacement parts at a profit. We therefore request that, if the boards continue to require assessment of contract losses at the performance obligation level, paragraph 86 should be modified to allow an entity to regard the loss on an individual performance obligation as an incremental cost of obtaining the contract (i.e. to be assessed for capitalization, amortization and impairment in accordance with paragraphs 94 to 103) if the loss-making obligation is identified at contract inception.

Finally, we would request that the requirements in paragraph 86 are clear that the "performance obligation" in question is the performance obligation identified <u>after</u> considering all of the requirements and guidance in paragraphs 23 to 30, in particular

after deciding whether to take advantage of the the practical expedient stated in paragraph 30.

Question 5

The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports (In the IASB exposure draft, see paragraph D19 in Appendix D). The disclosures that would be required (if material) are:

- **The disaggregation of revenue (paragraphs 114 and 115)**
- **A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)**
- **An analysis of the entity's remaining performance obligations (paragraphs 119–121)**
- **Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)**
- **A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfil a contract with a customer (paragraph 128).**

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

We consider that certain aspects of the above disclosure requirements are excessive even for annual reports. We further have concerns in principle about the expansion of IAS 34 to include disclosures designed for annual reports. Further details of our concerns are as follows:

So far as the annual financial statements are concerned, our comments are as follows:

- We believe that similar to the approach taken in IFRS 7 and 8, the "disaggregation of revenue" disclosure requirement (paragraphs 114 – 115) should focus on the disaggregation that the entity itself uses internally. To require further disaggregation, particularly on a large variety of different bases as listed in paragraph 115, would impose excessive systems burden on preparers and additional audit effort.

- We also believe that the tabular reconciliation as required under paragraph 117 is unduly complex as it appears to extend beyond a reconciliation of movements in the contract balances, to be a full reconciliation between revenue recognized in the income statement and the contract balances on the balance sheet. For example, as per example 19 in paragraph IE17, it would apparently be necessary to include

cash retail sales in this reconciliation even though these have no connection to contract assets and liabilities. This further begs the question as to whether, for example, a department store chain would need to separately analyse sales between cash sales and credit card sales? To produce such information, particularly on a consolidated basis, could result in excessive cost and effort on the part of preparers and their auditors. In this regard, and consistent with our response to question 10 on the first exposure draft, we consider that the information already required to be 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 full revenue information in the income statement to "contract balances" in the statement of financial position as is proposed in paragraph 117.

- Consistent with our response to question 11 on the first exposure draft, we still do not consider that the proposed disclosure requirement concerning unfulfilled performance obligations is appropriate as it effectively asks the entity to disclose management information from its order book, even when such contracts are not onerous and do not otherwise represent potential cash outflows (i.e. the "obligations" here are fundamentally different from other "obligations", such as pension obligations or reinstatement obligations). Instead, we believe that such forward looking information, if to be disclosed 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).

So far as the interim report is concerned, rather than adopting a piecemeal approach to revising IAS 34 as done through these proposed disclosure requirements in the revenue standard, we believe that constituents' interests would be better served if the boards take a holistic review of IAS 34. In the meantime, we consider that disclosures should only be required when they are significant to an understanding of the changes in the entity's financial position and performance since the end of the last annual reporting period similar to IAS 34.15.

Question 6

For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset (In the IASB exposure draft, see paragraphs D17, D22 and D26 in Appendix D). Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

Yes, we agree that the proposed control and measurement requirements relating to contracts with customers are equally relevant to transfers of non-financial assets that are not an output of an entity's ordinary activities, similar to IAS 16.69.

Additionally, we believe that the Exposure Draft should be expanded to adequately cover all of the requirements which it intends to replace, for example:

- paragraph 64 as currently worded does not adequately cover the measurement of the transferred item of property, plant and equipment upon initial recognition compared to IFRIC 18.12 – 13; and

- there is only limited guidance in paragraphs 9(e) and 14(a) on the question of exchanges of non-monetary items and this does not seem adequate to replace the more detailed guidance in SIC 31 on barter transactions involving advertising.

We consider that specific examples in the Implementation Guidance and/or additional guidance in appendix B are necessary to ensure that diversity in practice does not develop around these issues. Furthermore, we understand based on outreach activities in Hong Kong that the proposed standard is not intended to change how revenue from construction activities under service concessions arrangements is currently accounted for under IFRIC 12. However, the proposed standard is silent on this point. In view of the above, we encourage the boards to clarify this to avoid any confusion or misinterpretation. In particular, we request that additional guidance is added to IFRIC 12 to state that construction activities relating to building the infrastructure that is the subject of an IFRIC 12 service concession would generally fall within the scope of paragraph 35(a) of the revenue standard, as by definition the infrastructure is regarded as being under the control of the grantor throughout the service concession period.

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<u>Part B: Other comments</u>

B.1 Requirement in paragraph 4 to "apply all of the following steps"

We note that paragraph 4 of the "Introduction" section of the draft standard states that 'to achieve that core principle, an entity shall apply all of the following steps". Although we agree that in principle this is the case, in practice in many situations of "contracts with customers" the entity will not go through a 5 step process to arrive at an appropriate measure of revenue to recognise and therefore we find that this statement in paragraph 4, without any further guidance, adds to the complexity of the standard and its implementation.

In order to mitigate any unintended consequences of this paragraph, we recommend that the "Introduction" section be expanded to highlight the fact that in many cases the application of the 5 steps will be an automatic process, for example:

- in a normal retail transaction, the contract between the customer and the performance obligations are self-evident and the only issues that will need to be addressed are the rights of the customer to return the goods and any

warranty obligations that may attach to the sales; and

- as noted in paragraph 42, if an entity has the right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example a services contract in which an entity bills a fixed amount for each hour of service provided) then revenue is recognised in the amount to which the entity has the right to invoice.

B.2 Application of the portfolio concept to compute expected values

We believe that the practical expedient in paragraph 6 (and its application as shown in Illustrative Example 22) to the Exposure Draft, which provides an opportunity of applying the proposed standard to a portfolio of contracts, rather than individual contracts, is unintentionally too narrow in scope and that therefore the wording needs to be modified. Further details are as follows:

Paragraph 6 only permits the use of a portfolio approach "if the entity reasonably expects that the result of doing so would not differ materially from the result of applying this [draft] IFRS to the individual contracts or performance obligations". We consider this is too narrow as illustrated in the following example:

A retailer allows customers 30 days in which to return goods. Past experience indicates that for every hundred sales at least 10 items will be returned under this policy. However, if the retailer applies paragraph 55 to each *individual* sale, the retailer would apply paragraph 55(b) as there is a binary outcome for each sale and in each *individual* sale the "most likely" outcome is that the customer will not return the goods.

In this example, taking a portfolio approach would indicate that 10% returns should be expected, however it is clear that this would be materially different from "the result of applying this [draft] IFRS to the individual contracts or performance obligations" and therefore, if paragraph 6, is read literally the retailer would be precluded from taking such an approach.

To avoid confusion over how paragraph 6 interacts with paragraph 55, we suggest that the boards to broaden the scope of the practical expedient in paragraph 6 by stating that a portfolio approach would also be taken in accordance with paragraph 55 if the entity has a large number of contracts with similar characteristics and the use of expected values is judged to better predict the amount of consideration to which the entity will be entitled for the portfolio as a whole than the use of the most likely amount for each individual contract.

B.3 Identifying the boundaries of contract "promises"

Identifying the boundaries of a contract could be problematic in practice because of the ambiguity in paragraphs 14 and 24 (and related paragraphs BC33 and BC63) around whether a contract only includes rights and obligations which are enforceable under the relevant legal jurisdictions, or whether it also

includes other deliverables which the customer expects to receive as a result of an entity's customary business practices even though those expectations are not legally enforceable. If the boundaries of the contract cannot be identified at step 1, then this creates difficulties for applying steps 2 to 5 of the model.

We consider it would be useful to include an illustrative example and/or further guidance which distinguishes between unwritten contract "promises" and other situations where a customer expects that a business will behave in a certain manner (for example, due to the business' past behaviour), but that expectation does not arise from a contract "promise" that is "enforceable" and hence does not create a "performance obligation".

For example, if the principle of this standard is that contracts should be enforceable, then there should surely be a distinction drawn between (a) a situation where a software developer promises in the sales contract that, if and when that developer releases a new version of the software within the next 3 years it will provide a free upgrade to existing users, and (b) a situation where in practice the software company has often provided such free upgrades as part of their marketing strategy for a limited period, but has made no promise to the customer that it would continue to do so in the future and may cease at any time. It would be useful if an illustrative example could be included in the implementation guidance to cover this distinction for the avoidance of doubt.

B.4 Combining contracts if the customers are not related

Paragraph 16 limits the provisions for combining contracts to contracts entered into with the "same customer (or related parties)". By comparison, the existing IAS 11 requires contracts to be combined "whether with a single customer or with several customers" provided the conditions set out in IAS 11.9 are met (i.e. the contracts are negotiated as a single package, the contracts are closely related etc, criteria which are similar to those set out in paragraph 16 of the ED). The focus in the ED on the relationship between the customers therefore represents a significant change compared to the focus in IAS 11 on the inter-relatedness of the contract subject matter.

In our view, the proposed standard should continue to advocate the principle in IAS 11.7 that combining contracts (regardless of whether they are with the same or different customers) would be appropriate if doing so reflects the substance of the contract(s). To achieve this, the words "with the same customer (or related parties)" in paragraph 17 should be replaced by the IAS 11 words "whether with a single customer or with several customers".

B.5 Distinguishing between contract modifications and other variations in transaction price

We consider that paragraph 20 causes confusion to arise between a "contract modification" and any other change in transaction price which ought properly to be regarded as a change in variable consideration. This is particularly the case where a contract negotiation may occur simultaneously concerning variation of prices relating to items already delivered (for example as a result of unexpected

cost increases which the contractor is seeking to pass on to the customer) and changes in the scope of the remaining work to be done. We consider that the proposals would be clarified if paragraph 20 were deleted and the definition of a "contract modification" in paragraph 18 were narrowed to relate only to a substantive change in scope (by which we means changes in the scope which should impact on contract value, such as adding an extra balcony, and not changes which are substitution of items of equal value such as changing the paint colour). For example, paragraph 18 could be reworded as follows:

> "A contract modification exists when, and to the extent that, the parties to a contract approve a substantive change in the scope of a contract in respect of goods or services yet to be transferred. Other changes in transaction price unrelated to any substantive change in the scope of a contract shall be dealt with in accordance with paragraphs 77-80. If a contract modification has not been approved …".

B.6 Guidance on recognising revenue intermittently over time

From outreach activities in Hong Kong, we understand that recognition of revenue "over time" is not synonymous with recognising revenue "continuously". That is, we understand that the revenue for a single performance obligation satisfied "over time" may be recognised on an intermittent basis, as and when milestones are reached, if this is an appropriate depiction of the transfer of goods and services. In this regard, we find that this conclusion is not readily apparent from paragraphs 38 to 47 and that readers are in practice assuming that some form of percentage of completion accounting is expected for performance obligations recognised "over time", as this is illustrated in example 8 (in paragraph IE7). We request that the question of recognition of revenue in accordance with milestones is clarified in the standard, at least by the inclusion of an additional illustrative example.

B.7 Appropriateness of advocating break-even accounting

Paragraph 48 appears to have been adopted almost word-for-word from paragraph 33 of IAS 11 and paragraph 27 of IAS 18. We find that this paragraph appears out of place in the new revenue standard, as it bears no clear relationship to steps 3 and 4 of the model (i.e. estimating transaction price and allocating to performance obligations) or the "reasonably assured constraint" in paragraph 81. Instead it appears to be advocating holding back profit margin in case future costs are greater than expected. We consider that the question of whether future costs will exceed future revenues is adequately covered by the requirement to consider onerous contracts and that all other uncertainties concerning revenue are adequately dealt with under the "reasonably assured" constraint. We therefore do not support the inclusion of paragraph 48 in the new IFRS on revenue.

B.8 Practical expedient – time value of money when revenue is recognised progressively

Paragraph 60 implies that the practical expedient as set out in that paragraph only applies when control of the goods or services are transferred to the customer at a point in time within one year from the date of payment. We believe that paragraph 60 should be re-worded to allow the practical expedient to also cover situations where, when control is transferred continuously, each of the periods between transfers of control of a promised good or service and payment by the customer is within one year.

B.9 Contracts with intermediaries

It appears that there is a lack of clarity in the Exposure Draft regarding how to deal with situations involving a customer's customer.

For example, it is not uncommon to find in the automotive industry a manufacturer delivering a car to a dealer together with certain incentives which are intended to assist the dealer in selling that car through to an end-customer, e.g. a manufacturer may agree to reimburse the dealer for the costs of car maintenance provided by the dealer to an end-customer. We are unclear as to how the principles in the Exposure Draft should be applied to such a fact pattern i.e. whether the manufacturer should regard this as a reduction in the revenue from the sale of the car, should regard this as a marketing expense, or should consider that the car dealer is acting as the manufacturer's agent so far as the maintenance services are required and that the manufacturer should therefore apply paragraph B13 i.e. should assess this as warranty with a service element.

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Likewise, in the case of customer loyalty schemes operated by credit card companies, the arrangement involves 3 parties: the credit card company, the merchant and the merchant's customer: when the merchant's customer buys goods or services using a credit card, it is the merchant who pays the transaction fees to the credit card company, but it is the merchant's customer who earns the entitlement to free goods or services by accumulating points on their credit card. The standard does not clearly articulate how the credit card company in such situations should apply the principles in the revenue standard.

We also note that the example on slotting fees has been deleted compared to the first ED – this is an issue likely to cause diversity in practice if the only guidance is a cross reference from paragraph 65 back to paragraphs 28-29 to determine what are "distinct" fees. For example, if the retail shop gives the supplier <u>the choice</u> of whether to pay a lump sum to the retailer for placing the product in a prominent position (or e.g. having their product included in a specific promotion run by the retailer), can/should this be regarded as distinct from sale of product? (and as being sufficiently different from the payment of slotting fees that the supplier must pay if it wishes to sell to the retailer?).

To prevent diversity in practice, it would be helpful if the boards clarify these issues in the proposed standard, for example by including additional illustrative

examples in this regard.

B.10 *Accounting for discounts and contingent consideration*

Although paragraphs IN20-IN21 imply that accounting treatments for discounts and contingent consideration are similar under the Exposure Draft, this is not clear based on the existing wording in paragraphs 74 – 76 as paragraph 75 refers to "one (or some)" and paragraph 79 refers to "one or more", but paragraph 76 refers to allocating "entirely to a distinct good or service". Therefore, we would encourage the boards to clarify the wording of paragraph 76 to indicate that in a single contract there could be more than one situation where the principles in paragraph 76 apply.

B.11 *Improving IAS 2 Inventories to cover "costs to fulfil a contract" comprehensively*

Consistent with our response to question 9 in the first exposure draft, we continue to believe that the accounting and disclosure requirements relating to costs to fulfil a contract should be addressed as consequential amendments to the relevant standards (e.g. IAS 2), rather than being included in the proposed revenue standard at paragraph 91. We are therefore particularly concerned to note that in addition to retaining this aspect of the proposals, the consequential amendments set out in paragraph D15 propose to narrow the scope of IAS 2 still further by excluding the guidance on work-in-progress inventory of service providers.

Our view is that both of these proposals are counter-intuitive and result in an unnecessary complication of the IFRS literature structure, as paragraph 91 is drafted as a fall-back if any "costs to fulfil" are not included in any other IFRS. In our view, IAS 2 is the most logical place to cover the accounting for "costs to fulfil" a contract and this is already demonstrated by the references to IAS 2 from IAS 16 as a source of guidance on measuring cost and the similarities between paragraphs 16 to 20 of IAS 11 and paragraphs 10 to 22 of IAS 2. Given the already existing overlap in principles, we consider that the changes necessary to IAS 2 to compensate for the withdrawal of IAS 11 are relatively straightforward and that the IASB should not ignore this opportunity to streamline IFRS literature to have one IFRS for revenue from contracts with customers (including the costs of obtaining that contract) and one IFRS which covers the accounting for the costs to fulfil that contract.

Therefore, in our view,

- the principles set out in paragraph 91 should be included in IAS 2 instead to clarify the treatment of upfront costs, such as the design effort that may be involved in tendering for a specific project, which is currently allowed to be capitalised under paragraph 21 of IAS 11;
- any of the other guidance in paragraphs 92 and 93, which is not already stated in IAS 2, should be included in IAS 2;

- the disclosure requirement in paragraph 128 should apply only to costs of obtaining a contract; and

- the proposal to amend IAS 2 to delete the guidance relating to the work-in-progress of service providers should be dropped.

B.12 Transitional provisions – further limitation of retrospective adoption

We believe that retrospective application of the proposed standard as required under paragraphs C2 – C3 in the Exposure Draft is excessively burdensome as it will cut short the length of time that an entity will have to prepare its systems for change, it may require running dual systems for transaction processing and/or it may require excessive amounts of manual re-work.

As a compromise between providing relief and ensuring comparability across accounting periods, we strongly recommend that full retrospective adoption should be limited to those contracts which remain unfulfilled as at the date of initial adoption. In other words, entities should not be required to restate prior periods in respect of any contracts that have been completed before the date of initial application. This would provide more extensive relief than the proposed relief in paragraph C3(a) as C3(a), as currently worded, only provides relief to contracts “that begin and end within the same annual reporting period”.

B.13 Application of the guidance in paragraph B16-B19 to customer loyalty programmes

Paragraphs B16-B19 contain guidance on distinguishing between principals and agents. This guidance appears to be closely based on the guidance in paragraph 21 of the appendix to IAS 18. In this regard, we are concerned that useful guidance found in IFRIC 13 on awards supplied by third parties will be lost when IFRIC 13 is superseded by the new IFRS. We therefore request that additional guidance and an illustrative example is included in the new IFRS using the material from IFRIC 13 on this issue.

B.14 Application of the guidance in paragraph B34 to movie distribution contracts

We note that paragraph B34 states that “control of rights to use intellectual property cannot be transferred before the beginning of the period during which the customer can use and benefit from the licensed intellectual property”. In this regard, we find that there is diversity of views over how to identify the point in time at which “the customer can use and benefit from the licensed intellectual property” in the movie distribution industry. For example, can a distributor recognise revenue once the customers (the cinemas) have the right to start advertising the upcoming movies and taking advance bookings, or does the distributor have to wait until the customer is permitted to start screening the movie to the public? To avoid diversity in practice, we request that the boards clarify the concept articulated in paragraph B34 with specific reference to typical distribution agreements in the movie industry.

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B.15 Clarification of Illustrative Example 6 to illustrate that legal terms should be substantive

With respect to Illustrative Example 6 (paragraph IE5) dealing with a shipment of a product with risk of loss, we note that the boards have concluded that there are two separate performance obligations: (a) to provide the customer with a product at the point of loading; and (b) to cover the risk of loss during transit. We are surprised at this conclusion as the fact pattern described indicates that the legal transfer at the point of loading is non-substantive, inserted into the contract simply to enable earlier recognition of revenue. This impression is further supported by it being the supplier, and not the customer, who chooses the carrier.

We are therefore concerned that this example will encourage non-substantive terms to be included in contracts to accelerate revenue recognition. We are also concerned that it appears contrary to the guidance in paragraph B53 on bill-and-hold transactions. We therefore recommend that the fact pattern of Example 6 should be strengthened to indicate that the reason for the legal transfer at point of loading was substantive. For example, the facts could be changed such that:

- the supplier’s customary business practice is to replace the item free of charge only if the product was unable to withstand normal shipping in the protective packaging provided by the supplier; and

- for an additional fee the supplier would agree to replace the product if it was damaged as a result of any other incident during shipping, including if the ship sunk.

In our view, these two facts together would indicate that the transfer at point of loading was substantive i.e. that the unpredictable risks of shipping had been transferred to the customer unless the customer chose to buy additional insurance. In such a fact pattern, the retained risk from the promise of replacement if the packaging is defective is no more than a warranty that the product will meet agreed-upon specifications, to be recognised in accordance with paragraph B12.

B.16 Completion of Illustrative Example 22

Illustrative example 22 finishes at the point where an amount of revenue is allocated to the discount voucher. Our constituents would find it useful if that example could be completed by showing the entries that would arise when the discount voucher is redeemed or expires unexercised.

~ End ~