A F E P

Association Française des Entreprises Privées

IASB
30 Cannon Street
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Paris, 22 October, 2010

Re: ED *"Revenue from Contracts with Customers"*

We welcome the opportunity to comment on the IASB's exposure draft dealing with "*Revenue from Contracts with Customers*" (the ED).

- Although we recognise that the IASB has made some improvements and clarified some matters compared with the Discussion Paper on revenue recognition (the DP), we do not think that these proposals represent an improvement in accounting for revenue over the existing standards IAS 11 and IAS 18. On the other hand, the cost of the modifications in systems and all the other additional costs (such as, for example, those linked to the consequences of misinterpretation and the lack of relevance of the resulting information to the needs of the management of the entity) that entities will have to face to implement these proposals would be considerable. In our view, the improvement over the existing revenue recognition standards must be substantial in order to justify the cost that existing appliers of IFRS will incur in implementing these new proposals. We are therefore opposed to the adoption of this proposed standard in the body of IFRS.

- In this respect, we think that the existing IAS 11 and IAS 18 are mutually consistent and largely satisfactory. We do not see any advantage in changing to a different model of revenue recognition on the grounds of solving the existing problems faced by US GAAP and working towards convergence. In our view, any substantial change of the IFRS model for revenue recognition without a clear and substantial improvement over the existing model is both retrograde and unjustifiable. However, if the IASB and the FASB persist in wanting to develop a common model, we think that they should explore other approaches which recognise the importance of revenue as an indicator of activity and performance, as is implicit today in IAS 18 and IAS 11.

- We are disappointed that the IASB has not responded to the expectations of us and other respondents to the DP that it should first develop a clear concept of the significance of revenue in financial reporting before embarking upon its detailed standard for revenue. In our view, it is unlikely that the IASB will achieve a satisfactory accounting standard without first having clearly defined what revenue is intended to represent and what information it should convey to users.

- We are still not convinced that the transfer of control is the best basis for the recognition of the turnover of an entity as it does not reflect the way entities manage their activities. The Board has failed to demonstrate the supremacy of a control-based model over a risk-and-rewards approach, whether in this project or in any other ongoing projects as Leases, Derecognition and Consolidation.

- Finally, we do not think that the ED can be used as a robust basis for a future standard. The principles laid out in the ED cannot be applied without consulting in detail the host of application guidance and examples, and even reference to the Basis for Conclusions. In addition, some of this subsidiary guidance is contradictory to, or muddles, the general principles of the proposals. For example, it is far from clear why up-front, one-off fees have to be spread over the period expected to benefit from the revenue (example 8) whereas the fees for non-exclusive licences are recognised in their entirety immediately. We are concerned that these elements will result more in a rules-based standard than one based on principles, and that it will result in numerous difficulties in interpretation and hence divergent application.

In addition to these principal comments, we provide responses to the detailed questions of the invitation for comment in the appendix.

Should you wish any supplementary comment or explanation, please do not hesitate to contact us.

ACTEO	AFEP	MEDEF
Patrice MARTEAU	Alexandre TESSIER	Agnès LEPINAY
Chairman	Director General	Director of economic and financial affairs

Appendix to our letter on IASB ED "Revenue from Contracts with Customers Answers to the specific questions raised in the invitation for comments

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

(a) Tocombine 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?

Combine or segment contracts

While we might agree that this might be a reasonable principle for combining or segmenting contracts, we have serious doubts about the feasibility of the application of the "price interdependence" concept. We think that the principles of the existing IAS 11 are equally valid and present the advantages of being understood and currently applied by preparers. In addition, the existing criteria are, in our view, clearer and helpfully symmetrical in the way they distinguish between the contracts to be aggregated and those to be disaggregated. It is not clear to us therefore, why the new principle has been developed. In addition, we do not find the examples given in the Application Guidance in appendix B of the ED to be helpful or convincing, as discussed further below.

The application of notion of price interdependency is poorly articulated in appendix B in respect of the modification of contracts. We are left perplexed by example 2 in the appendix, which seems to highlight the discount accorded in the four subsequent years as the determining factor in the judgement of whether the modification is price-interdependent with the existing contract. This would be in contradiction with the statement of paragraph 14 in the proposed standard that a discount resulting from an existing customer relationship should not be on its own a determining factor in making such a judgement.

The application of the notion of price interdependence is also difficult to understand in the context of renewal options. The interdependence of the prices of the initial contract and the subsequent contract is not clearly explained either in example 27 (which may or may not contradict the principles of paragraph B26 and example 6) or in the Basis for Conclusions (BC216 and 217) – is the treatment of the option based on its being assimilated to an extension of the first contract or is it a performance obligation included in the initial contract?

Moreover, we think that the reference to other market participants as the primary factor in determining whether an element of a contract is price-interdependent is not relevant. Since the purpose of revenue reporting is to provide information about the specific performance of an individual entity in the context of its business model, we think that the appropriate deciding factor should be the goods or services sold by the reporting entity, not those sold by other entities whose business model may be completely different.

Identifying the contract

We agree with the IASB that a contract between an entity and its customer is necessary before the entity can recognise revenue and we broadly agree with the definition of a contract proposed in this exposure draft. However, we believe that the future standard should allow for the exercise of judgement, requiring that all facts and circumstances be properly considered. The analysis of how parties to the contract are committed should not be based on a legal analysis alone, but the approach should also be to acknowledge that parties are compelled to follow rational economic behaviour. Indeed retail operations often handle great numbers of customer transactions, most of which would not comprise– on an individual basis - amounts which it would be economically worthwhile pursuing by expensive legal means if customers fail to pay the amounts due. In these cases, the customer cannot be considered bound to pay the agreed price and so the assessment might be made that an enforceable contract might not exist.

We also wonder how the notion of a contract should be applied in the context of a master contract which gives the price per item but does not define a fixed quantity. In the case of a change of price during the period of the master contract, how should paragraphs 17 to 19 be applied? Is each delivery against the master contract a separate individual contract, i.e. prices are not interdependent, or should the price change be allocated also to previous deliveries, as the prices are interdependent?

Question 2 — The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

We think that the treatment of contracts with multiple components is an area in which the existing IAS 11 and 18 should be improved. We do not believe, however, that the proposals provide a fully satisfactory solution either.

First, we think that the segmenting of the contract into performance obligations must be based upon the business model of the reporting entity if it is to provide relevant information to the user. We therefore encourage the IASB to remove all the references which suggest that the activity of other entities should be the determining factor in judgements about contract segmentation or aggregation, and the identification of performance obligations. For the same reason, we believe that a distinct margin should be considered by the management to be valid criteria of disaggregation into distinct performance obligations only if the margin actually exists (and not if it is an artificial construct). In order to be eligible to qualify as the basis of a separate performance obligation, an asset should be routinely sold separately by the reporting entity. Unbundling is useful but should not be extended artificially beyond business practice and the commercial substance of the contract.

We also think that the way this principle is articulated in the ED will lead to difficulties in interpretation and may lead to a potential proliferation of individual performance obligations with the accompanying need for allocation, estimation and onerous-obligation tests (see below). For example, the principle in paragraph 20 refers to the entity's customary business practice, but paragraph 23 leads one to think that the breaking-down of a good or service into much smaller components is dependent on other entities' business models. In contrast, the example of the identification of performance obligations identified in Example 11 and paragraphs BC56 and BC57 provide what we think is a more reasonable approach to the identification of performance obligations.

Onerous performance obligation

We do not agree with the assessment of onerousness at the individual performance obligation level rather than at the overall contract level. The allocation of the transaction price to performance obligations is driven by the proposed accounting requirements and is to some extent arbitrary. In general, the entity enters into a contract on the expectation of making a margin on the contract as a whole package, but will allocate revenue to important parts of the contract for management purposes. Under current accounting for long-term construction contracts this view is acknowledged by the requirement to provide for an expected loss only when total contract costs are expected to exceed total contract revenues, even if there are cost overruns on individual elements of the contract compared to the revenue allocated to that part of the contract for management purposes. This situation currently forces the management to assess the overall contract outcome carefully but does not result in the recognition of a loss when that is not expected overall. The proposed approach in the ED could have the effect of recognising losses on part of the project even when it can be reliably estimated that the contract as a whole will result in a profit. We do not think that this is a fair representation of the economic effect of the contract and believe that it can result in the wrong message being conveyed to users.

Distinction between performance obligations and marketing incentives

We regret that the board has not resolved one of the main issues of the desegregation of contracts into different performance obligations, that is, how to distinguish goods or services that are marketing incentives from those that give rise to performance obligations.

From our point of view, the only way to resolve this issue is to focus on the business model of the reporting entity, and not to maximise on an arbitrary basis the number of obligations of performance. If a reporting entity has two kinds of business model which it applies and manages in different ways, this should be reflected in the way it identifies its performance obligations. This means that, even if the entity sells separately a certain good in its business model A, it could also have a second business model, in which this good is used only as a way to attract new customers. The first model should not automatically dictate the way the good is treated in the second model.

Question 3 — Do you think that the proposed guidance in paragraphs 25–30 and related application guidance is 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?

Control model

We are not convinced that the transfer of control is the most suitable indicator upon which to base the accounting for revenue, particularly in the case of construction contracts and services contracts.

The IASB has been attempting to use the notion of control in a number of projects recently, such as, for example, consolidation and leasing, as well as revenue recognition. In view of this, we think that it is important first to elaborate at the conceptual level what control means in the different contexts of the control of an entity on the one hand, and the control of an asset on the other, in order to achieve consistency at the level of individual standards. In addition, the purpose and significance of the individual lines of the income statement, and in particular revenue, need to be established at the conceptual level in order to assess consistently what should be presented in the income statement.

In the Basis for Conclusions to the current staff draft of Consolidated Financial Statements, we note the statement that there is a close interdependence between control and risk and rewards: control is not present if the entity has no exposure to the risks and rewards. We think this shows that, even in a model based on control, the role of risk and rewards is essential and should be explicitly considered as an important factor in assessing the passage of control in the context of revenue recognition.

We note too that in the current project on leasing, the notion of control has been considered to be unsuitable as the determining criterion in the judgement about whether the performance obligation or derecognition approach should be applied. The IASB has had recourse to a risks-and-benefits method as a proxy in this case. The same conclusion has been finally reached concerning the accounting for REPOs in the Derecognition project.

In addition, the ED appears to us to approach the notion of transfer of control from the viewpoint of the customer, that is, whether the customer has obtained control. This seems to us to be inconsistent with what we think should be the purpose of the revenue recognition standard, which is to depict the performance of the reporting entity.

We think it is more logical to look at the issue from the perspective of the entity, but the application of the transfer of control approach from the point of view of the entity- that is, whether the entity has given up control- may not be appropriate either and would not always result in the same conclusions as those reached by management of the business. We do not think that management uses the notion of transfer of control when assessing its performance for the period, and hence its revenue, but instead uses the notion of what it is entitled to, or has earned, as a result of its activity.

Our preference is therefore for a model which is consistent with the business model of the reporting entity and which evaluates the revenue-earning activity that the entity has achieved during the period in performing under a contract. The contract must provide the entity with the assurance that the risks and benefits are transferred to the customer, as under the current model.

In our view, the housing construction industry is one sector whose performance will be poorly represented by the proposed standard. Our analysis of the indicators of transfer of control as laid out in paragraph 30 of the ED is that none of them would be satisfied in many cases until around the time of the completion of the construction work. Paragraph 30(d) does not help in this case as the customer's ability to specify changes is limited to minor matters, such as the decoration or choice of fittings. In contrast, current standards IAS 11, IAS 18 and IFRIC 15 allow for the recognition of revenue on a percentage-of-completion basis, which seems appropriate to us.

Indicators

Should the IASB decide to continue with the model based on the transfer of control, we would urge that this be defined from the point of view of the entity and not that of the customer. Only the indicator described in paragraph 30(a) appears to be applicable in some instances to the reporting entity at present.

We also think that the illustrative examples given in the application guidance depict only very basic straightforward situations. We therefore think that it is important that the future standard should make it clear that judgment must be applied in order to conclude on the more complex, real transactions that will rarely exactly fit into these criteria. To this end, paragraph 31 needs to be redrafted to make it clear that judgement will have to be used in identifying the most relevant indicators and in utilising them to assess specific situations.

We have the following comments on the indicators and examples contained in the ED.

- When applying *criterion 30(a),* we believe that business practice and substance must prevail over the form of the agreement / contractual rights and obligations:

  Example 15 is too simplistic. It may apply for activities within some very specific frameworks (e.g. contracts for Defence Ministry work where the rights and obligations of both parties are specified in a particularly formalised way) but this not necessarily applicable in other European businesses or for export contracts.

  Example 15 considers criterion 30(a) is met because non-refundable progress payments are made and the customer has an obligation to pay for any partially completed equipment in case of termination. However, in some businesses where there are complex and individually significant contracts:

  - Progress payments are directly linked to formal technical acceptance by the customer. Once the acceptance is obtained, the probability of a refund to the customer is very low. Nevertheless, progress payments are not contractually "non-refundable".
  - The probability of the customer terminating the contract (without proper cause, from the entity's point of view) is very remote (for example, the customer will not cancel the construction of a naval frigate without a serious failure in performance from the contractor). Deadlock situations therefore usually end with negotiations and arbitration between the different parties, and the contractor is compensated for the work performed, based on the customer's technical acceptances of progress. Hence the unconditional obligation to pay could be considered to be met even if not formally expressed in the contract. We therefore believe we cannot place reliance on a remote event (i.e. the termination of the contract) when assessing the ordinary course of a business.

- The criterion set out in paragraph 30 (d) emphasises the customer's involvement during the manufacturing phase (that is, its ability to specify major changes). Thus, customers' formal technical acceptances during the contract are good evidence that the asset is specific, even if such technical acceptance may be theoretically subject to final acceptance.

  Example 15 considers criteria 30(d) is met because, amongst others, customer has the ability to "take possession of the equipment during the manufacturing and engage another entity to complete the manufacturing". This situation appears "theoretical" as, in many situations, a third party would not be capable of finishing a partially completed asset that is highly customer-specific (for example telecommunication satellites ….)

Question 4 — The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

The principle of recognising revenue only if the transaction price can be reasonably estimated seems appropriate in these circumstances. Nonetheless, we have concerns about the requirement in this respect and in other areas of this ED to use probability-weighted estimates to measure items. As in the case of the proposed changes to IAS 37, we do not think that such a requirement is appropriate. In our view, the requirement should be for the entity to make its best estimate of the amount to be received or refunded.

In some cases the probability-weighted average may be the most appropriate, but in other cases it will not be. The entity should be allowed to make its judgement as to what the best estimate is, taking into account all relevant factors, including cost/benefit considerations, rather than there being a systematic requirement for the probability-weighted approach.

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 disagree with this approach. In our view, revenue should be the measure of the activity and output of the entity. It should reflect the consideration the entity is entitled to under the terms of its contracts with customers. The risk of non-performance of the customer is of a completely different nature, and we do not agree that it should be mixed with the revenue figure. The comingling of the two results in a figure for revenue which does not reflect activity and is inconsistent with the entity's internal control and invoicing systems.

Extract from our comment letter on ED "amortized cost and Impairment"

We would suggest that the principle should be to recognise these receivables initially at the full transaction price unless there are specific indicators that the receivable will not be recovered. On the contrary, where there is a large portfolio of homogenous receivables a reliable statistical data base could be used to set up a provision on an expected loss basis, but this should not be a requirement for all non-financial entities. In either event, we think that the most useful representation is to show the credit losses separately from the revenue line, as this is consistent with the different natures of the two.

Our second concern is the treatment of adjustments to the initial estimate of the credit risk, including the difference between the estimate and the consideration received. We think that such adjustments should be made in the revenue line of the income statement, as this is the line in which the original transaction amount is recorded. In addition, this is consistent with the principle (which has been applied almost universally until now) of reflecting changes in the same line as the original estimate, and is also consistent with the adjustment for variable consideration.

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?

While we can agree with the underlying principle proposed, we nevertheless think that the use of the phrase "significantly before or after the transfer" is vague and does not have any meaning in the framework of IFRS. This will, in our view, result in different interpretations. We think it may be more helpful to use the customary business practice in the context of the entity's business model and the sector in which it operates as the reference

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?

We believe that the transaction price should be allocated to the performance obligations on the basis of the entity's own stand-alone selling prices. The stand-alone selling prices of the entity to be retained in the allocation are those relevant to the context of the transaction. For example, an entity may offer different stand-alone selling prices for the same goods or services when some goods and services can be provided in their own right or are provided –either partly or totally – as sales incentives at inception of the contract (see Q2 and the focus on the business model). When incentives of this sort are granted at inception of the contract, we do not think that that revenue ought to be recognised on such sales incentives if the profitability of the contract remains dependent on contingent sales, or usage. In these instances, we believe that no revenue should be recognised in excess of the cash received, as to do so could result in premature recognition of contingent sales.

In addition, we think that it must be made clear that the "observable price" referred to in paragraph 51 is the price realised by the entity when it sells the good or service separately, and not that of other market participants. Where the stand-alone price has to be estimated, the entity should make its best estimate using a method it can justify and which it applies consistently. We think it is important to avoid any suggestion of a hierarchy of methods or approaches.

Finally, as explained in our response to Question 1 above, we do not agree that subsequent changes in contract price should be allocated to all performance obligations on the same basis as the initial allocation, and in particular, completed performance obligations should not be changed unless the price change relates directly to them. We think that it is more logical to allocate the changes to the specific performance obligations that are directly affected by the change. Allocation of subsequent changes to all performance obligations should be the "fall-back" approach where no more rational basis exists.

Question 8 — Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

We agree that there is a need for additional guidance in order to account for all costs involved in a customer contract since IAS 2, IAS 16 or IAS 38 do not currently provide an appropriate answer in certain cases.

However, the guidance proposed seems to be quite restrictive as only direct costs seem to be eligible for capitalization and this notion is not clearly defined in this exposure draft. It may be appropriate to retain the current guidance in IAS 11 (paragraphs 16 to 21), which we think is well understood and consistently applied. We are not aware of a need for change in this area and we agree with the general approach of IAS 11, which is aligned with the way contract costs are internally managed (that is, eligible costs for deferral include costs that relate directly to the specific contract; costs that are attributable to contract activity in general and can be allocated to the contract; and such other costs as are specifically chargeable to the customer under the terms of the contract). We have also some concerns about the meaning of "abnormal costs" as mentioned in paragraph 59 (c) in the context of construction contracts. We are not sure whether there is really "a normal level of costs" for an individual contract as each contact tends to be unique. This notion of abnormal costs is one used in IAS 2 and IAS 16 but not in IAS 11, and, it would therefore be helpful to have some more guidance in this area.

Following on from this, we are quite surprised that the Board did not wish to discuss other specific existing guidance relating to costs of contracts such as, for example, "learning curve costs" (US ASC 605-35-25). This term refers to costs which are higher, on a per-unit basis, for the first unit(s) to be produced, because of the normal process of improving production efficiency over time. In our view, such costs should be eligible to be allocated to contracts, albeit with the test of onerousness as a safeguard. We think that it would be useful for the basis of conclusions at least to discuss this.

Furthermore, we do not agree to the systematic exclusion of the costs of obtaining contracts and, once again, we believe that the current guidance (IAS 11.21) is superior as it allows for the capitalising of some of these costs when they meet the general criteria (that is, they are related directly to a contract and expected to be recovered). It seems to us that in these conditions such costs do represent assets. Furthermore, this requirement is not consistent with other standards which require the capitalisation of directly attributable costs (IAS 16 and the proposed leasing standard).

We do not understand the rationale developed in the basis for conclusion (paragraph BC158) for the expensing of these costs, as our understanding of paragraphs 57 and 62 is that such capitalized costs are not part of the contract asset/ liability and therefore do not depend upon the satisfaction of a performance obligation.

Question 9 — Paragraph 58 proposes the costs that relate directly to a contract for the purpose 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 and why?

For discussion of specific costs, please refer to our response to question 8, and to our response to question 2 in respect of the onerous obligation test.

Question 10 — The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

We agree with this general objective even though we believe that some of the specific disclosure requirements should be removed or at least amended.

We also have some concerns about the level of aggregation of all the information required as this is not clearly explained. As an example, paragraph 75 requires the reconciliation of the "opening to the closing aggregate balance of contract assets and contract liabilities". Does this mean that contract assets and contract liabilities are added together and the aggregated balance reconciled, or does aggregated refer to the individual contract assets and contract liabilities which are reconciled keeping assets and liabilities separate?

In addition, we would like to comment on the proposed reconciliation even though there is no specific question on this. We believe that the detail required in this reconciliation illustrates perfectly the operational difficulties arising with an "asset/ liability" model. In our view, entities' systems will have to be seriously modified to provide the reconciliation required in paragraph 75. Even though the contract asset/ contract liability model as proposed is different from that of IAS 11, the ED may give rise to disclosures similar to those of the current requirement in IAS 11.42 (also known as "due to / due from disclosure"). Entities already find this a very challenging set of information to disclose in the notes and yet this information is rarely subject to comments from users, in our experience.

Our understanding is that these net assets / liabilities represent in effect “cut-off bookkeeping entries» which are required when the transfer of control does not match with the recognition of cash receipts or a financial asset. They do not depict a comprehensive position of the whole contract, since onerous provisions and work in progress are not included. This information is incomplete and therefore of uncertain relevance, but it is quite onerous to provide. Outstanding invoices and deferred income are determined at each closing date as a special exercise and presented in the financial statements on a gross basis. However, all the changes between the two closing dates are generally not tracked.

This proposed approach also raises the problem of the unit of account used in this standard. In many instances some items requiring estimation could only be assessed at the portfolio level, not the contract level (such as, for example, collectability and warranties). The disclosure of net assets/ liabilities at a contract level requires the allocation of this data in an arbitrary fashion to each individual contact.

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?

We do not agree. This requirement is aimed at obtaining some forecast information that could be very sensitive data from a commercial point of view. In addition, it could be difficult to predict with sufficient accuracy, thus potentially laying the entity open to serious consequences if the predictions turn out to be inaccurate. The forecast will also be difficult to audit, as it relies heavily on management plans and many underlying assumptions. If this information is believed to be useful, it should be provided in a management report, not in the notes, and only the total of outstanding orders should be provided without a breakdown by expected year of achievement.

Question 12 — Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

Such disclosures go further than the existing segmentation requirement in IFRS 8. While we recognise that users will wish to understand how future performance might differ from the historic performance, because revenue and cash-flows could react to different risks (credit risk for cash-flows, for example, and market risk for revenue), we think that this requirement is burdensome to produce and may not actually help users forecast future performance since it is purely historic data. In addition, the most useful analysis may consist of data which is of great commercial sensitivity to some entities. We think therefore that such analysis should not form part of the obligatory disclosures but be voluntary disclosure which entities may provide to users.

Question 13 — Do you agree that an entity should apply the proposed requirements retrospectively (that is, as if the entity applied the proposed requirements to all contracts in existence at the effective date and in the comparative period)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost to preparers? If so, please explain the alternative and why you think it is better.

Realistically, given the importance of the revenue line as a key performance indicator used in communication with users, we think that only a retrospective application can be envisaged. We do not think that users would accept comparative figures and figures for the current period drawn up using completely different models.

This raises the significant problem of the great effort and consequent high cost generated by this exercise. It appears to us that for most preparers it will be necessary to develop new systems to account for revenue in accordance with the proposed model and then to use the current and proposed models to track revenue in parallel during the transition period. In addition, it may be necessary to develop the statistical databases to enable the probability-weighted estimates required in several areas of the ED to be made reliably. Finally, this preparatory work will have to be carried out by all entities, even if they suspect that the ultimate impact of the change will not be material: until the work has been carried out, it will be uncertain what the impact of the new model will be. We think that the result of this will be substantial costs for most preparers.

At the current stage of development of this project, we are convinced that the proposed changes do not represent a sufficiently clear improvement in the accounting for revenue under IFRS to justify the expected high costs of implementation. We think it would be very damaging to the reputation of IFRS for the IASB to impose such a great change in the approach without being absolutely certain that this represents a step-change in the quality of the revenue recognition model under IFRS and without a clear idea of the magnitude of the costs it would induce. We do not think that it can be justified on the grounds of convergence. We would urge the IASB to address any perceived weaknesses in IAS 11 and IAS 18 by means of targeted marginal amendments to those standards.

For your information, our analysis of the process required to implement the ED's approach is that the following will be required for each current contract in the transition period: Verify whether the contract should have been combined with other contracts on the principle of price interdependence and deal with subsequent contract modifications in line with the ED;

- Consider the need to segment contracts into different performance obligations and apply the new requirements for warranties, renewal options etc.;
- Determine an estimate of variable price using a probability-weighted average based on historical data; reconstitute the historic credit risk of customers and any subsequent changes in them, distinguishing between those that should be reflected in revenue and those that should be presented elsewhere in the income statement;
- Identify the historic « stand-alone » price of the individual elements of the contract (some of which may have been in place for many years) in order to allocate the transaction price across the performance obligations;

- Make the conversion from accounting for movements on the basis of invoicing to one based on the expected consideration taking into account credit risks, and concurrently modify internal control procedures in line with this;
- Adjust revenue to reflect the effects on the timing of the recognition of revenue;
- Adjust deferred tax balances for any consequential change; and
- Finally, adjust revenue hedging techniques to reflect different timing and content of revenue.

Question 14 — The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposal operational? If not, what additional guidance do you suggest?

In our view, a good accounting standard contains clear principles which obviate the need for extensive application guidance. Using that criterion, we conclude that the principles of revenue recognition in this proposed standard require further refining.

We think that many of the examples in the proposed guidance are too simple to be useful in the complex situations entities have to deal with. Furthermore, some of the guidance appears to us to be contradictory either with the main body of the proposed standard or with other parts of the guidance.

As discussed in our response to question 1, example 2 appears to contradict the principle of paragraph 14. The distinction between example 6, where there is no material right, and example 27, where there is a material right, is far from clear.

Example 27 also raises questions in our minds about how the entity's customer should account for its maintenance service contract: should it be accounting for a non-refundable prepayment of future services if it believes it will renew the contract, or should it recognise the whole of the contractual cost immediately in each year as it arises? Should there be symmetry between the accounting on the opposite sides of the transaction?

On the question of presentation and disclosure, we note that paragraph 75(b) requires cash received to be shown as part of the reconciliation of the contract assets and liabilities. In looking at scenario 2 in example 29 on presentation, we find it unclear as to what gives rise to the cash received that should be shown in the reconciliation. Normally cash received is a reduction in a receivable, but paragraph 66 states that a receivable is not a contract asset.

The alternative interpretation would be that receipt of a cash payment, which is not unconditional (i.e. a non-contractual advance), would give rise to an increase in the contract liability. Clarification here would also help understanding of the proposed model as a whole.

Question 15 — The Boards propose that an entity should distinguish between the following types of product warranties:

(a) A warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation, but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) A warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

We do not agree with the distinction proposed as it does not result in a relevant outcome. Moreover, such a distinction will lead to operational challenges as it will be difficult in practice to ascertain whether a fault which is identified once the customer has taken delivery of an item was there when delivery was made or somehow came into existence afterwards.

In our view, the existing distinction and accounting requirements as stated in IAS 37 are still valid and provide useful information. We believe that the only distinction that can usefully be made is that between standard warranties, including legal warranties, and extended warranties, some, but not all, of which may be provided in return for additional compensation from the customer.

The first category should be analysed as a contingent additional cost of providing the good to the customer and thus accounted for as a non-financial liability. The customer will not pay more compensation for a good in working order, irrespective of whether defaults are latent or arise after the product is sold.

The second category of warranty –the extended warranties- has a separate economic existence as a product, and can easily have a transaction price allocated to it and be tracked separately.

We have a final concern relating to the proposed approach. The notion of a warranty as an unsatisfied part of a performance obligation is not consistent with the overall model proposed in the exposure draft: the transfer of control is analysed at another level than a "component of a product". When the customer takes control of a good, he takes it in its entirety, not component by component. Even if the good does not comply, the customer has control over the whole, including the defective part. Conversely, the entity has no control over the "components" it expects to have to bring back into stock when they are returned and the customer is refunded.

Question 16 — The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) If an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and

(b) If an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and satisfies that obligation when the customer is able to use and benefit from the licence.

(c) 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?

Firstly, we note from the ED that the word "licence" is used to describe many assets of very different natures. A software licence sold in high quantities in retail outlets is usually intended to be used by only one customer (and hence be for the exclusive use of one customer), but this is very different from a unique patent sold to only one customer for its exclusive use. Although exclusivity is an important element in a licensing arrangement and its economics, we are not sure that the distinction between exclusive and non-exclusive licences provides the best determining factor for whether a performance obligation exists. We believe that exclusivity is more a matter of valuation of rights granted rather than criteria for revenue recognition.

We are more in favour of a model based on the nature of the supplier's involvement over the life of the contract. In transactions where the entity will no longer be exposed to the risk or benefit from the licence it has sold to its customer, we agree that revenue should be recognised immediately. This will probably be the case for most software products. Conversely, if the entity is still exposed to some variability in its future income, due to some mechanism of profit-sharing for example, we believe that the entity has kept a continuing involvement in this asset, and revenue should be recognised on a continuous basis.

It could turn out that the recognition pattern resulting from an assessment of the involvement of the supplier over the life of the licence may not differ from that suggested in the ED, but we feel this approach is clearer and easier to understand

Under the approach we propose, the following are examples of the treatment:

- In the case of existing, developed products where the rights revert to the entity at the end of the period of exclusivity
    - Fixed fees which relate to a defined span of time during which the entity will refrain from providing the same product to another customer would be recognised continuously over that period. These are "exclusivity" fees.
    - Royalties, which are usually linked to future performance and are of the nature of a profit sharing mechanism, would be recognised over the periods that give rise to them.

- In the case of discoveries still in the research and development phase
  - Fixed fees which are in effect an entrance fee or compensation for costs already incurred would be recognised immediately.
  - Milestone payments would be recognised only when the milestone is achieved.
  - Exclusivity fees and royalties would be recognised on a continuous basis and when generated by sales, respectively.

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?

We think that the accounting for gains or losses on the sale of some non-financial assets should be consistent with the revenue recognition standard. If IAS 18 is replaced by the proposals in the ED, it seems appropriate to specify a consistent treatment for such transactions.

Other matters

To reiterate one of the major concerns we have discussed in our responses to Question 13 and elsewhere: we disagree completely with the Board's conclusion that the proposed requirements would improve financial reporting under IFRS at a reasonable cost. In our view, the proposals do not represent any improvement over current IFRS, and may indeed be retrograde, and the cost of implementation will not be reasonable but considerable for most entities who are already applying IFRS. We do not believe that it is in the best interests of entities or stakeholders in those entities to impose such a change on them.