financial executives international

canada

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

Re: Exposure Draft ED/2010/6 – Revenue from Contracts with Customers

The Committee on Corporate Reporting (CCR) of the Financial Executives International Canada (FEI Canada) is writing to provide its response to the International Accounting Standards Board (IASB) Exposure Draft (ED) ED/2010/6 *Revenue from Contracts with Customers.*

FEI Canada is the all-industry professional membership association for senior financial executives. With eleven chapters across Canada and more than 2,000 members, FEI Canada provides professional development, thought leadership and advocacy services to its members. The association membership, which consists of Chief Financial Officers, Audit Committee Directors and senior executives in the Finance, Controller, Treasury and Taxation functions, represents a significant number of Canada's leading and most influential corporations.

The Committee on Corporate Reporting is one of two national advocacy committees of FEI Canada, CCR is devoted to improving the awareness and educational implications of the issues it addresses, and is focused on continually improving the standards and regulations impacting corporate reporting.

We agree with some of the proposed requirements, however have two primary concerns. The first concern is that the concept of transferring control to the customer is not sufficiently developed or explained to ensure appropriate and consistent application. The second concern is that some of the disclosure requirements are onerous without necessarily providing additional useful information to the users of the financial statements. We also believe some of the disclosure requirements will require smaller entities to disclose sensitive competitive information.

Our responses are set forth as laid out in the ED:

<u>Recognition of Revenue</u>

Question 1

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

- ***(a) To combine two or more contracts and account for them as a single contract;***
- ***(b) To segment a single contract and account for it as two or more contracts; and***
- ***(c) To account for a contract modification as a separate contract or as part of the original contract.***

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

We agree with the principle as described in paragraphs 12-19, however we found parts of the guidance to be unclear.

When considered in the context of other parts of the ED, we had difficulty understanding when a contract should be segmented, or treated as a single contract with a number of individual performance obligations. Without further explanation of the distinction between segmenting contracts and identifying performance obligations, we believe the guidance will cause confusion and lead to inconsistent application. Clearer examples and further details in BC38 would also assist with an understanding of the guidance.

In addition, we did not find the examples related to contract modifications helpful because they do not provide clear guidance as to when a contract modification should be accounted for as a separate contract or as part of the original contract.

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 agree with the principle that an entity should identify separate performance obligations on the basis of whether the promised good or service is distinct. However, as mentioned above, we had difficulty distinguishing between when a contract should be segmented, and whether separate performance obligations within a contract should be identified. We believe further explanation and clearer examples of the distinction are needed.

Question 3

Do you think that the proposed guidance in paragraphs 25 – 31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

We do not believe the proposed guidance for determining when control of a promised good or service has been transferred to a customer is sufficient. While determining when control is transferred to a customer in the sale of goods is usually, by its nature, relatively straightforward, we believe the proposed guidance would be difficult to apply in practice for the sale of services, particularly contracts for construction and software development services.

After considerable discussion, our view is that the difficulty is related not only to the sufficiency of the proposed guidance, but also that we disagreed with the terminology of requiring transfer of *control* to a customer for the satisfaction of a performance obligation in the sale of a service.

For example, it is counter-intuitive to assess that a customer has *control* when a customer has no physical possession or legal title. Our concern is that, depending on the interpretation of the guidance, it would be very difficult to demonstrate that *control* has been transferred to the customer in contracts for services such as construction and software development until the final product is delivered. We do not believe the intention of the proposals is to restrict the use of percentage of completion revenue recognition for these types of services, but we are concerned that without clearer descriptions and examples, the interpretation of the requirements may result in inconsistent or inappropriate application.

We believe the concept of transferring control to the customer requires more explanation and examples of its application across a number of industries and circumstances.

Measurement of Revenue

Question 4

The boards propose that if the amount of consideration is variable, an entity should recognize 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 recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

We agree that if the amount of consideration is variable, an entity should recognize revenue only if the transaction price can be reasonably estimated.

We also agree an entity should recognize revenue on the basis of an estimated transaction price and agree with the proposed criteria in paragraph 38 including the fact that experience of other entities can be used.

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 recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

We do not agree that the customer's credit risk should affect how much revenue is recognized. We do agree however, that the customer's credit risk should not affect whether an entity recognizes revenue.

We believe that adjusting the transaction price for the customer's credit risk would provide less useful information to users of the financial statements, effectively netting the effect of credit risk with the revenue earned.

We believe the customer's credit risk should be considered in the measurement of consideration receivable but reflected separately from revenue in an expense line item on the financial statements, providing clear information regarding the effect of credit risk to the users of the financial statements.

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

We agree that the measurement of revenue should be adjusted to reflect the time value of money if the contract includes a material financing component.

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 agree that an entity should allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling prices, estimated if necessary.

We believe that, as long as the guidance on the factors that should be considered when estimating the selling price of a separate performance obligation is not overly restrictive, this method will ensure that discounts are appropriately allocated across performance obligations. For example, an entity selling internally developed software to many different customers would likely estimate selling price with reference solely to market conditions and competitive pricing, while an entity selling manufactured goods would also reference the cost of the goods and profit objectives.

The committee was confused by paragraph BC125 that seems to be contradictory with respect to the use of the residual method. The paragraph first indicates that the residual value should not be used to allocate the transaction price, and then states that the residual method would be appropriate to estimate a stand-alone selling price if there is no directly observable price for one of the performance obligations.

Contract Costs

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 recognize 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 do not agree with the proposed requirements on accounting for the costs of fulfilling a contract.

Specifically, we are concerned the requirement that an asset only be recognized if the costs relate to future performance (paragraph 57b) would result in the inability to defer the cost of direct sales commissions and recognize as an expense over the period the associated revenue is recognized. In our opinion this is inappropriate and is inconsistent with the principles related to accounting for transaction costs related to financial instruments. The guidance in paragraphs 58 and 59 appear to be trying to achieve similar treatment to the accounting of financial instruments transaction costs, but are significantly less clear and succinct.

We suggest that requirements similar to those for financial instrument transaction costs would be more appropriate.

Question 9

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

With respect to the recognition of an asset for resources that the entity would use to satisfy performance obligations in a contract, please refer to our response to Question 8. In addition, we are concerned paragraph 58 c) is open to significant interpretation and may result in inconsistent application. We suggest that requirements similar to those for financial instrument transaction costs (incremental and directly attributable) and the elements of cost of Property, Plant and equipment (directly attributable) would be more appropriate and provide for better consistency with other IFRSs.

We do not agree that a liability and a corresponding expense should be recognized for an onerous performance obligation. We do not believe it is appropriate to recognize a liability for an individually onerous performance obligation if all the expected future economic benefits of a contract exceed the expected costs of fulfilling all the remaining performance obligations.

For these purposes, we believe the contract should be considered as a whole; it is appropriate to recognize a liability for an onerous contract if the unavoidable costs of meeting all the remaining performance obligations exceed all of the remaining economic benefits that are expected to be received under the contract.

<u>Disclosure</u>

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?

In general, we believe the disclosure requirements will meet the objective of helping users understand the amount, timing and uncertainty of revenue and cash flows. However, we believe some of the disclosure requirements are unnecessary to fulfilling this objective. In addition, some of the disclosure requirements seem unnecessarily onerous and, depending on the size of the entity, some may require the disclosure of sensitive competitive information.

Paragraph 74 includes requirements regarding the disaggregation of revenue. We believe the type of requirements in 74 b) – d) are more appropriately included in IFRS 8 Operating Segments. In addition, for smaller entities, these requirements may require the disclosure of sensitive competitive information. We believe that this disclosure requirement could result in a different disaggregation of revenue than the requirements within IFRS 8, and that inconsistency would be confusing to the users of the financial statements. We assume the purpose of these requirements are to provide information regarding the risk associated with future cash flows, but believe this information is already incorporated in the application of the recognition and measurement principles and the current requirements of IFRS 8.

Paragraph 75 includes requirements regarding reconciliations of contract assets and liabilities. We believe the concepts associated with contract assets and liabilities are technically useful for developing the principals of recognition and measurement, however we believe the information provided by this disclosure would be excessive and do not believe that the majority of financial statement users will find it understandable. We believe the requirements associated with the recognition and measurement of revenue in the financial statements is sufficient.

Paragraph 80 includes requirements to disclose information regarding onerous performance obligations. We believe this information is excessive and does not provide the users of financial statements with useful information beyond that provided by the recognition and measurement requirements for onerous performance obligations. Please also refer to our response to question 9 regarding the recognition of onerous performance obligations.

In addition, we are concerned that the requirements in paragraph 74, 75 and 80 may require the disclosure of sensitive competitive information for smaller entities.

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 with this proposed disclosure requirement. We believe this information is excessive and does not provide the users of financial statements with useful information beyond that provided by the recognition and measurement requirements for revenue. We are also concerned that this requirement may require the disclosure of sensitive competitive information for smaller entities.

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?

We do not agree with this proposed disclosure requirement. Please refer to our response to Question 10.

Effective Date and Transition

Question 13

Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

We agree with the requirement to apply the new requirements retrospectively. However, the proposed changes are significant and would necessitate a significant amount of time between the publication of the final requirements and the mandatory effective date (a minimum of three years).

Application Guidance

Question 14

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

We believe that the application guidance for a few areas could be made clearer.

Paragraph B2 - We had difficulty understanding when a contract should be segmented, or whether performance obligations within a contract should be identified. Without further explanation of the distinction between segmenting contracts or identifying performance obligations, we believe the guidance will cause confusion and lead to inconsistent application. Clearer examples and further details in BC38 would also assist with an understanding of the guidance.

Paragraph B3 - We did not find the examples related to contract modifications helpful and that they do not provide clear guidance as to when a contract modification should be accounted for as a separate contract or as part of the original contract.

Paragraph B47-52 - We did not understand the significance of this example provided, the scenario described seemed to simply be a right of return, and would be accounted for accordingly.

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 between the types of product warranties.

We believe that distinguishing between the types of product warranties would be difficult in practice any would not provide any useful information to the users of the financial statements.

We also believe that accounting for all product warranties as a separate cost, as opposed to a reduction of revenue, provides a disaggregation that is clearer and more useful to the users of the financial statements.

Question 16

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

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

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

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

We do not agree that the pattern of revenue recognition should depend on whether the license is exclusive. We do not see how, by itself, the fact that a license is exclusive would indicate whether or not there are performance obligations to be fulfilled subsequent to the sale.

We believe that whether the license is exclusive or non-exclusive, the entity still has an obligation to permit the use of its intellectual property for the term of the license. Whether this obligation meets the definition of a *performance obligation* should depend on what it is the entity has

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promised to transfer to a customer rather than the fact that the license is restricted to one customer.

<u>Consequential Amendments</u>

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 agree that in accounting for the gain and loss on the sale of some non-financial assets, an entity should apply the recognition and measurement principles of the proposed revenue model. We do not believe the presentation and disclosure requirements should apply.

<u>Non-public Entities</u>

Question 18

[FASB only] Should any of the proposed requirements be different for non-public entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

We have no comments on this FASB proposal.

We appreciate your consideration of the comments made in this letter and welcome the opportunity to further discuss any and all matters related to this ED.

Yours very truly,

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Chair
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