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CFA Society of the UK response to consultation questions on Revenue Recognition IASB/FASB Exposure Draft

Dear Henry,

Thank you for the opportunity to respond to the IASB/FASB Exposure Draft on Revenue Recognition.

The CFA Society of the UK represents more than 9,000 investment professionals working across the financial sector. For advocacy purposes, these members are represented by committees that consider proposals relating to Financial Reporting and Analysis Committee.

OVERVIEW

The Society supports the principle of recognising revenue when the goods/services are transferred to the customer. This is a big improvement on percentage of completion. Where control is difficult to determine, there may be a case for considering the balance of risks/rewards as a back-up. Some of the (generally welcome) pragmatism in the ED might, however, dilute the principle. We also support the principle of identifying separate performance obligations where the distinction is clear.

On measurement, our main concerns are to do with the increased reliance on estimates, management judgment and probability weighting. This represents a move away from an emphasis on reliability of numbers. It may mean that similar transactions are reported differently and in some cases, eg where the outcome is binary or the conditions unique, the outcome may be meaningless.

This approach also calls for a plethora of disclosures of the assumptions made in doing the calculations and arriving at the judgments.

On contract costs, we are generally wary of capitalisation. The balance sheet approach to revenue recognition creates some complications that are well illustrated in this section.

On disclosures, we are concerned about their proliferation and believe that the increased use of estimates and judgments fuels this. Some of these requirements stray into management commentary/key risks territory. Disclosure of key assumptions is obviously helpful, but to what extent do we want the annual accounts to reflect management

forecasts of the future?

Recognition of revenue (paragraphs 8–33)

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?

Yes

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?

Yes

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?

The society supports the principle of transfer based on control. Reservations:

- a) The approach might be more balanced if it also took account of the transfer of risk.***
- b) Some members disliked the idea of interpreting someone's ability to prevent the use of an asset by someone else as a form of transfer.***
- c) Paragraph 32 a-c gives significant leeway that sometimes resembles a percentage of completion method. There is a two-way pull here between pragmatism in applying the standard (and making the change from the old method less radical), and a potential departure from the transfer of control principle. Probably pragmatism wins, but the dilution of the principle might result in differing interpretations so that similar companies recognise revenue in different ways. It may also mean that, as under the percentage of completion method, some revenue is recognised too early.***

Measurement of revenue (paragraphs 34–53)

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 proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

The society is concerned about the definition of the transaction price as a probability-weighted estimate of the consideration that will be paid. Main reservations:

- a) **The shift in basic principle from prudence to neutrality and the increased reliance on estimates were thought likely to lead to higher levels of early revenue recognition.**
- b) **The use of probability weighting where outcomes are binary, or unique, might give rise to meaningless reporting. This is in line with the society's opposition to the use of probability weighting in liability recognition.**
- c) **The increased use of estimates could lead to a further divergence from cash flow.**
- d) **The increased use of management judgment and the need to recalculate estimates at each reporting date is complicated and could lead to greater variability of reporting by similar companies. This may reduce the reliability of the revenue number.**

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?

See above reservation about estimates. Much depends on the interpretation of "can be reasonably estimated". How will cyclical factors be taken into account, for instance? Some members oppose taking account of customer's credit risk in the transaction price, preferring an approach that keeps the two events – selling and collecting – separate. They do not wish to lose any transparency on the impairments, preferring that these are shown separately in the P&L.

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?

It is useful to have the financing element separated out. Management judgment on the discount rate might lead to differing treatment of similar transactions, but the related disclosures would be interesting.

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?

In principle yes, where there is clear evidence of standalone prices but with reservations, as above, about the reliance on estimates.

Contract costs (paragraphs 57–63)

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?

The asset/liability approach to this standard makes this section more difficult to understand than it ought to be. We have not been asked about pars 61 and 63, but these are examples of the complications. The Society's main concern is that the door should not be opened to capitalising costs that should not be capitalised, especially when contracts are still under negotiation.

Most of the conditions in pars 57-59 look sensible and could be applied to other models.

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?

There is some doubt about the way an "onerous performance liability" is to be recognised. Yes we want to know that the contract is running into loss-making territory but is this the best way to do it? Will these difficult judgments become more common because of the potential for early recognition of revenue based on probability-weighted estimates?

Disclosure (paragraphs 69–83)

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?

Yes in the sense that disclosures will never make it more difficult to understand what is going on. But that does not mean that this approach is perfect and we are concerned about the proliferation of disclosure requirements. In this case requirement for such extensive disclosure has been fuelled by the increased reliance on estimates and management judgment.

Some members feel that is also the result of bundling factors such as credit risk into revenue that might have been clearer if kept separate.

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?

In a balance-sheet orientated method, this is inevitable as well as useful.

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?

See above. This sounds like management commentary/key risks territory. Disclosure of the key assumptions employed by management is obviously helpful. But to what extent do we want them to forecast the future?

Effective date and transition (paragraphs 84 and 85)

NB Date not inserted yet

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?

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

This is really a question for preparers. We do not want to make unreasonable demands of them. One member said: "It sounds like a very expensive thing to ask preparers to apply the requirements retrospectively. Though I understand the comparability argument, asking preparers to revisit the assumptions/estimates they had to make one or two years ago does not sound like the best use of their time, in particular when hindsight will take over."

Application guidance (paragraphs B1–B96)

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?

It looks like more guidance might be necessary – see answer to Q3.

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

(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...

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?

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?

Consequential amendments

Question 17: The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

If the model is good for other types of revenue recognition, it should work for these transactions. Transfer of control would seem a good principle here. The timing of payment(s) and any uncertainty over it would also be captured.

We hope that these comments have been useful and would be pleased to provide additional feedback in future.

Yours,

Jane Fuller, Chair Accounting Advocacy Committee

Will Goodhart, Chief Executive