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The IASB's Exposure Draft *Revenue from Contracts with Customers*

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered through its Corporate Reporting Standing Committee the IASB's Exposure Draft (ED) *Revenue from Contracts with Customers*. ESMA welcomes the IASB's decision to re-expose and the opportunity to contribute to the IASB's due process. ESMA is pleased to provide the IASB with the following comments aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

It is important for financial reporting standards to provide a faithful portrayal of an entity's financial position and performance and to serve investors in making informed decisions. Given the importance of revenue for investors ESMA decided to carry out additional outreach to European investors. ESMA is grateful to the investors contributing to those outreach activities and highlighted their views in the detailed responses set out in the appendices.

Though ESMA believes that the principles suggested in the 2011 ED *Revenue from Contracts with Customers* should enhance consistent application compared to the 2010 ED, our main concerns relate to remaining inconsistent application and potential enforcement problems. Our detailed responses highlight several cases where we believe that the wording could be improved or where the Board should consider cross-cutting issues.

For IFRSs to be a consistent set of accounting standards ESMA believes that it is important for the IASB to use consistent wording throughout the standard(s) for similar concepts. In the proposals the Board makes regularly use of terms like *significant* and *material* however without clearly defining or distinguishing one term from the other. This could result inconsistent application of IFRS.



In general, ESMA agrees with the proposed principles and as emphasized by the investors during our outreach we would like to highlight in particular our support for (a) the presentation of credit risk losses in a separate line adjacent to the revenue line item and (b) the Board's initiative to specify the disclosures about revenue and contracts with customers that should be included in the interim financial statements.

However, as stated in our comment letter on the 2010 ED, ESMA does not favour the IASB's proposal to perform the onerous test at a performance obligation level and to limit the test to performance obligations satisfied over a period greater than one year.

Additionally, the IASB tentatively decided that the effective date would not be earlier than 1 January 2015 and that earlier application would be permitted. ESMA strongly disagrees with the IASB's proposal to allow earlier application for entities currently reporting using IFRSs as ESMA believes it would be detrimental to the comparability between entities.

Our detailed comments on the ED are set out in the Appendices to this letter.

We would be happy to discuss all or any of these issues further with you.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S/M'.

Steven Maijoor
ESMA Chair

A handwritten signature in blue ink, appearing to be 'Julie Galbo'.

Julie Galbo
Chair ESMA's Corporate Reporting Standing Committee

APPENDIX I – ESMA’s detailed answers to the questions in the IASB’s *Exposure draft Revenue from Contracts with Customers*

Question 1

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?

1. ESMA supports the principles specifying when an entity transfers control of a good or service over time as set out in paragraphs 35 and 36 of the exposure draft. Though ESMA believes the principles suggested in the 2011 ED *Revenue from Contracts with Customers* achieve higher consistency of application than the 2010 ED, ESMA is concerned that potential enforcement problems may arise. As set out below we believe that is mainly due to a lack of clear definitions.

Definition of ‘control’

2. The transfer of *control* of a good or service over time plays an important role in the process of revenue recognition. The ED provides however only a brief description and no clear definition of what control is. ESMA thinks that such a definition is key to achieve consistent application in practice. Whilst acknowledging that providing a definition of control goes beyond this project, ESMA believes that a clear definition should be provided within the Conceptual Framework.
3. ESMA welcomes the reference to the notion of transfer of significant risks and rewards of ownership of an asset as an indicator of control as it brings the definition more in line with the definition of control in IFRS 10 – *Consolidated Financial Statements*.

Transfer of control in the case of a performance obligation satisfied over time

4. The way the concept of transferring control in the case of a performance obligation satisfied over time is described in the ED is in our opinion not robust and could lead to inconsistent application and enforcement issues, due to:
 - The lack of a clear definition of the alternative use notion in paragraph 36. The Board should further explain what is meant by the effects of practical and contractual limitations on the entity’s ability to readily direct the promised asset to another customer. ESMA would also welcome further guidance as to when an entity has the “ability to readily direct the asset to another customer”; BC94 mentions that an entity does not have an alternative use if a contract pre-

cludes the entity from transferring an asset to another customer as a result of contractual or practical limitations. The Board should detail what is meant by practical limitations and includes those elements in the application guidance.

- As mentioned in the alternative view from Mr. Th. J. Linsmeier the above-mentioned criterion permits recognition of revenue over time even when the selling entity has not transferred to the customer any promised goods or services under the contract. ESMA believes that additional field testing should be carried out to assess the impact on the revenue recognition.

Performance obligations satisfied over time

5. The Board proposes two criteria of which at least one should be met to allow recognition of revenue over time. In assessing those two criteria, it is our opinion that sub-criterion (b)(i) of paragraph 35 could apply where the identified performance obligations are of immaterial services, e.g. expert services. ESMA believes that this may imply that when the service is performed the revenue should be recognised. Paragraph BC96 is however not clear in whether this criterion applies to services only. If the criterion is mainly envisages services ESMA encourages the IASB to express this more explicitly.
6. ESMA understands that the main intention for introducing *the need to substantially re-perform*-criterion as mentioned in paragraph 35(b)(ii) is to capture transportation services. Though ESMA would support such inclusion, we are concerned about the potential impact of the application by analogy to other performance obligations. We would recommend field testing to ensure consistent application and enforcement.
7. In addition, ESMA notes that paragraphs 35 and 36 are silent with respect to the effect of a change in the assessment of alternative use. In those instances where a contract is subsequently modified to reflect a change in the entity's economic environment (e.g. deregulation of the activity), ESMA believes that further guidance as to how to reassess the non-alternative use criterion should be provided for those assets created by the entity's performance that were assessed at contract inception as bearing no alternative use to the entity.

Performance obligations satisfied at a point in time

8. ESMA is concerned that the indicators of control proposed in paragraph 37 could lead to the inconsistent recognition of revenue between entities as those indicators are not decisive and rely unduly on the judgment of management. For instance, ESMA considers that it is not clear from the ED whether an update or a new version of a piece of software should be considered as a separate performance obligation or not.

9. As a last point, we do not understand the reference to paragraph 31 in paragraph 35(a) because it does not contain a requirement on control.

Question 2

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?

10. It is clear that revenue is an important figure for investors when assessing the financial performance and position of an entity. ESMA supports the presentation of credit risk losses in a separate line adjacent to the revenue line item as it provides useful information about the gross revenue and its associated credit risk. It is our understanding from our outreach to the investors' community that this approach provides them with the most relevant information to assess the quality of the revenue and the earnings.
11. ESMA notes the proposed reference to IFRS 9 – *Financial Instruments* regarding impairment losses. ESMA finds it difficult to provide further comments as it is not clear as of now what direction the IASB will follow on the impairment of financial assets. ESMA thinks that if the IASB intends to use IFRS 9 as the basis for the subsequent measurement, the initial recognition should also be in line with the standard..
12. In addition we would like to provide the following comments:
 - Paragraph 69 states that an entity shall present any impairment of the receivable [...] in profit or loss as a separate line item adjacent to the revenue line item if the contract does not have a significant financing component in accordance with paragraph 58. In order to enhance the enforceability and consistent understanding of this principle, ESMA believes that it would be beneficial if the Board could specify what is meant by a *significant* financing component. ESMA does not believe that there is a need for setting specific thresholds; the notion of materiality applies to all IFRSs and elements that are not material are not required to be presented.
 - ESMA believes that the ED is not clear as to whether credit losses should be determined on an individual basis or a collective basis. It could be argued that there will be no credit losses on an

individual basis whilst there could be on a collective basis. Entities know from experience what percentage of the receivables will not be collected.

- Paragraph 106(b) of the ED defines a receivable as “an entity’s right to consideration that is unconditional”. However, IAS 32 – *Financial Instruments: Presentation* does not require the right to be unconditional (see for example IAS 32.AG4). ESMA considers that both definitions should be aligned.

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?

13. ESMA agrees 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. Otherwise, it would present erroneous information to investors.
14. ESMA notes that the indicators presented in paragraph 82 where the entity’s experience is not predictive are the same as those in the 2010 ED. Those indicators are highly discretionary. Even more surprisingly, paragraph 83 asserts that the existence of any of those listed indicators does not necessarily mean that the entity is not reasonably assured to be entitled to an amount of consideration, when considering all facts and circumstances and using judgment.
15. ESMA believes that paragraph 83 does not ensure consistent application of recognising revenue in case the entity is not reasonably assured to be entitled to that revenue. ESMA believes that the indicators in paragraph 82 as well as the indication that all facts and circumstances should be consid-

ered in paragraph 83 are not decisive and need a lot of management judgement to decide whether to recognise revenue or not.

16. Based on its discussions with investors ESMA encourages the IASB to develop disclosure requirements on how the issuer assessed and predicted the variable amount of consideration to which the issuer expects to be entitled. As already indicated above ESMA is highly concerned that this will be very difficult to enforce and that divergent practises will developed over the recognition of variable considerations.
17. In addition, ESMA believes that paragraph 85 creates a specific rule for intellectual property licences. ESMA does not understand the background of this rule as it can be perceived as contradicting paragraphs 81 to 83. Moreover, as mentioned by EFRAG and as written in the ED, the rule does not apply to contracts that contain only a variable consideration. ESMA considers that the accounting treatment of variable consideration should be identical for contracts irrespective of whether revenues are fixed or variable.
18. As a final point we would like to mention that the IASB's project on lease contracts also deals with the accounting of variable rents. We would encourage the IASB to make a link between the two projects.

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?

19. In line with our comments on the 2010 ED, ESMA would like to reiterate its support for testing the onerous performance obligation at contract level. Indeed, under the model presented in the exposure drafts, a globally profitable contract that includes a loss-making item and other profitable items could result in an onerous performance obligation. The onerous test to individual performance obligations could result in less relevant information, in particular if the whole contract is expected to be profitable. ESMA does not see why it would add complexity if the onerous test would have to be carried out a contract level.
20. In BC207 the Board explains that specifying the contract as the unit of account could be arbitrary because the unit of account would depend on whether the entity provides its goods and services in

one contract or in more than one contract. Moreover it is not clear from the basis for conclusions why the IASB thinks it adds complexity to perform the onerous test at contract level. In addition, the recognition of losses on individual performance obligations in an overall profitable contract does not necessarily meet the definition of a liability.

21. The Board explains in BC207 that the unit of account issue was addressed by modifying the scope of the onerous test. ESMA considers that all contracts should be in the scope of the test (performance obligations satisfied at a point in time *and* over time) and that scoping out contracts for one year or less is not relevant. Indeed, this threshold is arbitrary and some contracts of less than one year can be onerous with a material loss (e.g. contracts based on crude-oil).

22. ESMA believes that a practical expedient should not be a rationale for scope exclusion; relevance is a fundamental characteristic of financial information. Based on our outreach to the investors' community, ESMA understands that investors also believe that all contracts (performance obligations) should be in the scope of the onerous test as they too think that contracts of less than one year can be onerous with a material loss.

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. 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 recognised 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.

23. ESMA agrees with the Board that there is not only a clear need for disclosures in the annual but also in the interim financial statements. ESMA therefore welcomes the initiative of the Board to specify the disclosures about revenue and contracts with customers that should be included in the interim financial statements. It is important for investors to understand the management's judgment and the potential changes in accounting policies.
24. When discussing the IASB's proposals with the investors' community it was made clear that disclosures are key to understand the revenue recognition pattern. Investors were generally dissatisfied with the quality and amount of disclosures that are currently provided. In addition, current disclosures are often not-entity specific and investors preferred more detailed disclosure requirements. ESMA particularly pays attention to the reconciliation of contract balances as it is key to understand the movements in cash and receivables.
25. Having said that, we would agree with the IASB performing further outreach and field-testing in order to ensure that all disclosures are respectively relevant and can be provided for by issuers in a reasonable way.

The Role of Disclosures and Interim Financial Statements

26. ESMA would like to use this opportunity to remind the IASB of our position as set out in our comment letter on the *2011 Agenda Consultation*. The Board might want to consider, in the light of recent experience, to add a project on the disclosure requirements in interim financial statements to its active agenda.
27. In addition, we take note of some recent criticism that disclosure requirements in IFRSs are considered by some stakeholders to be too voluminous and not always focused on the right disclosures. Though EMSA believes it might be a starting point triggering a wider discussion on the role of disclosures, we do not believe that the objective is to provide more or less disclosures but disclosures of the highest quality presented in a helpful way.

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.**

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?

28. ESMA agrees 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.

APPENDIX II – Additional comments

In addition to commenting on the specific questions raised in the ED, ESMA would like to provide some additional comments:

I. Contract Costs

29. ESMA supports the IASB's efforts to provide guidance in paragraph 91 and following as to what criteria the costs should fulfil to be recognised as an asset. Paragraph 92 of the ED refers to direct labour costs including some examples. ESMA would suggest adding a specific reference that direct labour costs are those in the scope of IAS 19 – *Employee Benefits*.
30. Paragraph 92 mentions costs related directly to a contract or a specific anticipated contract. ESMA does not agree that costs related to anticipated contracts should be capitalised. The reasons for that are (a) they do not fulfil the definition of an asset as defined under the *Conceptual Framework* (the control notion) and (b) as the ED does not further elaborate on what is a *specific anticipated contract*, ESMA fears that application will not be consistent as it leaves room for interpretations.
31. As a last point, ESMA believes that the Board should clarify that paragraph 96 does not aim to capitalise bid offer costs. Indeed, ESMA considers that the paragraph leaves room for interpretation and that some could understand that bid offer costs could be capitalised.

II. Time value of money

32. The Board proposes that when determining the transaction price an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is material to the contract. ESMA being supportive of principles based IFRSs it does not support the IASB to exclude contracts of less than one year and believes that the role of materiality is an important consideration in this context.
33. From our outreach to investors we however understand that they considered it as a good proxy, more so that, in their view, the amount should not be significant.
34. In addition, we note that the ED does not clarify how the valuation for a long-term contract should be carried out, e.g. would the rate be fixed at inception or not?

III. Right of return

35. The ED distinguishes sales with a right of return, sales subject to a customer acceptance and repurchase agreements and proposes different guidance for each situation. ESMA considers that the guidance provided is not always clear. For instance, where acceptance clauses and return rights are included in contracts (for example, goods ordered through the internet), the distinction is not operational. In addition, it is difficult to make a distinction between a payment for consideration and a deposit that will be returned if the asset is not accepted or is returned. ESMA considers that the Board should perform further work on those distinctions.

IV. Early adoption

36. ESMA does not support early adoption for existing IFRS preparers as it would seriously hamper comparability between entities. ESMA however understands that the earlier application of the standard might need to be considered for entities in jurisdictions adopting or converging towards IFRS.
37. From our outreach to investors we understand that investors also do not prefer early adoption of the standard due to the reduced comparability between entities.

V. Warranties

38. Paragraph B13(b) indicates that the length of the warranty should be taken into account to assess whether or not an additional performance obligation should be identified separately. ESMA considers that the suggested criteria are not sufficiently clear and is concerned that divergences may arise in practice. For example, some car manufacturers provide warranty of two years and some others warranty of seven years. How should the issuers assess whether these warranties provide a service in addition that the product complies with agreed-upon specifications? Should the average life time of the product be taken into consideration? Should the warranties considered as a separate performance obligation as long as its length is beyond the legal length.