

Project Manager International Accounting Standards Board 30 Cannon Street

London EC4M 6XH United Kingdom

Weinheim, 25/10/10

Dear Sir or Madam,

#### ED/2010/6 - REVENUE FROM CONTRACTS WITH CUSTOMERS

We appreciate the opportunity to comment on the boards' exposure draft (ED) on "Revenue from Contracts with Customers".

The Association for Participation in the Development of Accounting Regulations for Family-owned Entities (VMEBF) was founded in 2006 and consists of German companies with a strong family shareholder background. Beyond its members, the association represents the vast majority of family-owned large and medium-sized entities in Germany, often legally organised in the form of partnerships. The aim of the VMEBF association is to make the role of German family businesses as stakeholders in the development of international accounting more visible and to act as a constructive partner for the standard setters. We work closely together with the German standard setter GASC and the German Institute of Chartered Auditors (IDW) as well as other political institutions.

The IASB and FASB have the honourable objective to converge existing guidelines on revenue recognition and to develop a single standard regulating recognition and measurement of revenue from contracts with customers regardless of an entities industry or size. We strongly believe that meaningful regulations on revenue recognition are an inevitable requirement for large non-publicly listed entities deciding to apply IFRSs voluntarily. Thus, only an approach to revenue recognition that is capable of depicting the economic substance of a business transaction will be able to result in decision-useful information and thereby justify severe changes to the revenue recognition concept and subsequently to an entities internal processes and routines.

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Although we acknowledge the boards' efforts to develop a single comprehensive revenue recognition model, we do not agree with the major part of the proposals as described in the ED. From our point of view, the proposed model will result in economically misleading information, especially if applied to long-term customised construction contracts or some multiple-element transactions. Therefore, further excessive in-depth research would be required to develop a comprehensive approach to recognising revenue. We doubt that the revenue recognition model as described in the ED would be able to reasonably reflect the differences in the economic substance of a customised construction contract and an ordinary standard sale transaction. We would therefore recommend the boards to retain the current revenue recognition model for goods and construction contracts in the first place. Anyhow, the existing standards at least have to be amended with regard to additional guidance on services and multiple-element arrangements in order to at least reduce the inconsistencies within the existing IFRSs.

In summary, we do not at all identify the additional benefits of the proposed model outweighing the excessive costs resulting from its application. To add a further example, disclosure requirements as proposed would incur immense costs, an aspect that obviously was not sufficiently considered by the boards. We therefore oppose most of the views as outlined in the ED.

Please refer to the appendix to this letter for our detailed answers to the questions asked in the ED.

Kind regards,

Vereinigung zur Mitwirkung an der Entwicklung des Bilanzrechts für Familiengesellschaften e.V. (VMEBF)

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## Appendix:

# VMEBF comments on the boards' additional questions

## **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?

Principally, we understand the idea behind the principle as proposed. However, as economic reality is not always that distinct, we would propose the boards clarifying the principle to avoid the model being interpreted in different ways by different parties. We believe that in some circumstances price interdependency as a basic criterion might not lead to economically meaningful information. This might be the case if a contract comprises several aspects and only one of those aspects is changed. In substance, this does not necessarily lead to a new contract. Assume a long-term contract being re-negotiated due to an increase in commodity prices. From our point of view, such a contract modification should have to be accounted for as part of the original contract. However, we think that there is room for interpretation in how to deal with that example regarding the criteria in par. 13. Moreover, the boards should clarify how to deal with changes in frame contracts. Additionally, further clarification would prevent an entity from implementing extensive and costly routines for decision-making and documentation regarding the interdependency of prices, especially with regard to the entity's ERP system.

## **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?

Although we understand the boards' reasons for implementing this principle, we do not agree with some of the criteria defined in the ED and thus would propose some adjustments. First of all, we do not agree with the definition of a distinct good/service as defined in ED.23. From our perspective, referring to other entities selling identical or similar goods would not reflect the economic substance of the transaction in many cases. As pricing decisions in different entities — even assuming identical or similar



goods/services – can be based on completely different assumptions, it is rather unlikely to come to an economically meaningful separation.

Additionally, we do not think that the ED is clear enough on the level of separation of individual performance obligations. To adequately separate several performance obligations within a contract, an entity would have to analyse every single contract with respect to the criteria as defined in the ED. However, as those criteria are not clear enough, applying the criteria might lead to a rather arbitrary level of separation depending on the interpretation applied. For example, if another company enters into a market with a new business model selling similar goods/services separately (par. 23 (a)), it might be necessary for the reporting entity to account for its similar good/service as a separate performance obligation even if that should lead to economically misleading information with regard to the individual business model of the reporting entity. However, assume the other entity leaving the market one year later. This would again require the reporting entity to undo the changes made one year earlier due to the criteria set out in the ED.

Finally, the model would require an entity to review the vast majority of its contracts, especially customised construction contracts. This would lead to an unforeseeable increase in the costs of financial statement preparation as well as auditing, not least because of documentation and disclosure issues. We therefore do not see the outstanding benefits of the proposed model justifying the excessive costs imposed.

## **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?

Although we see the boards' efforts to implement control as a common principle throughout several IFRSs, we do not think that control is a workable principle in this context. We believe that under a substance-over-form premise the risks and rewards approach would better reflect the economic substance of most business transactions. In association with the contract-based model, the interpretation and application of the control principle would be subject to the national jurisdiction and the legal environment of an entity and therefore diminish comparability. Thus, we believe it is most important to develop a consistent revenue recognition model that is applicable across different legal forms and jurisdictions and complies with the control concept applied in other IFRSs as well. We therefore abstain from discussing the sufficiency of the guidance provided and propose to retain the risks and rewards approach in this context.

#### **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 reasonable 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?

We generally agree with the proposal 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 reasonable estimated. This will not only strengthen the decision-usefulness of the information provided but also prevent preparers from the application of costly but still rather arbitrary models separating performance obligations. However, from a cost-benefit point of view, we do not see the outstanding benefits of estimating the transaction price using the probability-weighted approach compared to the currently used best estimate approach. We therefore would propose to retain the current 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 do not think that the transaction price should reflect a customer's credit risk. Including the credit risk of a customer in determining the amount of revenue recognised would lead to unforeseeable volatility in the revenue line of the statement of comprehensive income. In this context, every change in a customer's credit rating would have an impact on revenue and deteriorate the predictability of future cashflows. Moreover, we wonder if the boards considered the interaction of this proposal with the information about customer credit risks already to be provided in accordance with IFRS 7.

#### **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?

Although we principally agree with the proposal, we would like to highlight the importance of materiality in this context. As in most kinds of transactions the cash collection would be rather short-term (< 1 year), we suggest to exclude revenues from the adjustments if payment can be expected within 1 year.

## **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 standalone 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?

Although we understand the idea behind the allocation of the transaction price to all separate performance obligations, we have severe concerns regarding the practical application of the approach. For example, in the construction contract business customised construction contracts are usually uniquely drafted and not comparable to other contracts. Therefore, the determination of the stand-alone selling prices of the separate goods and services would be highly arbitrary. This is also true for goods and services that are based on newly developed technologies. As there is regularly no history of selling prices available for such goods and services, the allocation would be rather arbitrary.

Moreover, if a discount would have to be "artificially" allocated to the separate performance obligations - i.e. to all performance obligations, even such with low margins - while the contract as a whole is profitable, this might result in misleading information for the users as allocating a part of the discount to the low margin obligations could result in the obligation being onerous. In general, this would not reflect the economic reality of the transaction as a vendor regularly would not provide discounts for contract components with low margins. Additionally, recognising a liability for such an issue would not be in line with the liability definition as described in the conceptual framework as an outflow of resources would neither be expected nor probable. We therefore would propose to allocate any discount to the components it is granted for and to perform the onerous contract test for the overall contract (as it is common practice today). Furthermore, we have similar concerns regarding the proposed allocation of any changes in the transaction price to all performance obligations on the same basis as at contract inception. We do not think that this would result in information reflecting the economic substance of an altering resp. flexible transaction. From our point of view, allocating any changes in the estimated transaction price should be done on a basis only affecting the performance obligations responsible for the changes.

## **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 do not agree with the proposal. We believe that criteria for capitalisation of costs should not be defined in a standard on revenue recognition. Instead, such criteria should be established within the conceptual framework or other relevant standards like IAS 2 or IAS 16.



#### **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?

We generally agree with the full direct cost method as a basis for capitalising contract costs and full direct costs as a basis for determining whether a contract is onerous. However, we do not agree with the onerous test being performed on an individual performance obligation level. As already pointed out in the context of question 7, we doubt the decision-usefulness of a provision being recognised for an individual onerous performance obligation if the overall contract is profitable. Additionally, we think that the onerous test should not be performed using probability-weighted costs.

## **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?

Although we acknowledge the boards' efforts to help users of financial statements understand the amount, timing and uncertainty of revenue and cashflows arising from contracts with customers, we do not think that the proposed disclosures are an adequate vehicle to accomplish that objective. We are concerned that the mass of new disclosure requirements would on the one hand challenge preparers of financial statements and their ERP systems and on the other hand would be likely to lead to an information overload on the user side (not least due to the very explicit qualitative disclosure requirements). As the extent as well as the level of detail of the information to be provided easily would exceed current disclosure requirements in IAS 18 resp. IAS 11, we think that the possible benefits could never outweigh the excessive costs resulting from the implementation of those disclosure requirements. Moreover, we often discuss the decision-usefulness of certain disclosure requirements with users of financial statements (investors, analysts). Most of them repeatedly bemoan that a large part of current notes disclosures are neither helpful nor decision-useful.

#### **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?

As we have severe concerns regarding the allocation of the transaction price to all separate performance obligations (cf. our answer to question 7), we do not agree



with the proposal. Furthermore, we do not think that the information required would have an extraordinary predictive value and help users to forecast future revenues or cashflows.

## **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 understand the importance of disaggregated information for users of financial statements. We also believe that management internally uses information reflecting amount, timing and uncertainty of revenues and cashflows best. We therefore think that the requirements as defined in IFRS 8 regarding disaggregated information (management approach) sufficiently fulfil the information requirements of users of financial statements.

## **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.

We do not agree with the proposal. The majority of entities applying IFRSs would already be challenged by adjusting their ERP systems, implementing contract management processes or extensive documentation issues in applying the model prospectively. We believe that on the one hand most entities would not be able to retrospectively apply the proposed model in a cost-efficient manner. On the other hand, we think that even sophisticated users of financial statements would have severe problems using that information properly. Therefore, an entity should be free to choose whether to apply the model retrospectively or prospectively. However, we principally would prefer the proposals of the ED not coming into effect at all.

## **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?

We think that a standard should define its general principles in a way that no or at least minimal application guidance should be required. This is also true for information set out in the appendices to the standards. However, we understand that due to the complexity of some transactions, further guidance is required. Yet, we do not think that the application guidance as presented in the ED could meet the requirements of most preparers. To be helpful for preparers of financial statements, the guidance would rather have to address complex issues.



#### **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 think that the proposed distinction is practicable. We believe that if a customer acquires control over a good/service, revenue for that good/service should be recognised entirely. Furthermore, IAS 37 should be applied to account for product warranties. Considering the disclosure requirements of IAS 37, we do not think that users of financial statements require any further information to understand the economic substance of the underlying transaction.

#### 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.

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 think that the boards should re-deliberate their proposals on licensing. This is due to the fact that there are plans to revisit IAS 38. We therefore propose to refrain from changing the revenue recognition model with regard to intangible assets until IAS 38 will be revised.

#### **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?



Although we do not agree with several details of the proposed model, we agree with the application of a revenue recognition model in accounting for the gain or loss on the sale of some non-financial assets.