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Siemens AG's response to the IASB Exposure Draft „Revenue from Contracts with Customers“

Dear Sir/Madam,

Siemens appreciates the opportunity to respond to the proposals set out in the Exposure Draft „Revenue from Contracts with Customers“. As the recognition of revenue (together with the realisation of allocated costs) provides the most relevant information about an entity's performance, it is the key area in external reporting but also management information and controlling.

Given the impact that the outcome of this project may have on revenue recognition - in general but especially for customer-specific construction contracts - it is of utmost importance that the accounting principles in a final standard provide relevant information to all users of financial statements. We welcome that the Exposure Draft includes several modifications compared to the Discussion Paper in order to adequately reflect the characteristics of customer-specific construction contracts (eg the inclusion of the indicator “customer-specific design or function”). However, this does not change that in our view the model in the Exposure Draft will have a significant impact on the accounting for construction contracts and – to a lesser extent - for other contracts. While the benefits of the proposed model have not been proven yet, we deem the costs

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associated with the proposed model will be significant if not tremendous. Our discussions with other constituents support this view.

We therefore encourage the boards to continue in their efforts to enhance the current model so that it provides appropriate answers to construction contracts along the lines of current accounting practices under IFRS.

In the first part of our comment letter we provide some general remarks, and highlight key issues, related to the proposed revenue recognition model. These remarks need to be read in connection – with our detailed responses to the specific questions in the Exposure Draft, outlined in the second part of our letter.

Should you have any questions or wish to discuss any of the issues in more detail please do not hesitate to contact Nikolaus Starbatty (nikolaus.starbatty@siemens.com, phone: +49 89 636 36371).

Sincerely yours,

Siemens Aktiengesellschaft

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1. General remarks and key issues

First of all Siemens appreciates that some changes in the exposure draft compared with the discussion paper, eg the rules for separations of contracts in performance obligations, are a step in the right direction. In our opinion, however, the proposed model still does not increase decision-usefulness of the information provided.

In our view, the existing guidance in IAS 11 and IAS 18 is well established and well understood by users. As a preparer we consider the regulations in the existing standards on revenue recognition, in total, as adequate and well-proven. However, we acknowledge the Board's desire to develop a single revenue recognition model that applies to all types of contracts. From a constituent's perspective, the Board must ensure that the information provided to users by a single revenue recognition model faithfully represents an entity's transactions and does not come with undue costs for preparers. It is our impression that the proposed model is likely to not adequately reflect an entity's performance in a number of cases. This specifically applies, but is not limited to, the accounting for construction contracts. A final standard, in our opinion, needs to consider these issues and eventually comprise principles that allow for an adequate distinction according to the given characteristics of customer-specific contracts and other types of businesses in order to provide decision-useful information about an entity's performance.

As stated above, our concerns with the model as proposed in the Exposure Draft relate particularly to the application of the proposed model to customer-specific construction contracts:

- The number of separate performance obligations may vary significantly from contract to contract. This results in several performance obligations to which, after their initial measurement, different margins are attributed. To the contrary, the internal management, controlling and reporting will continue to be based on the total project, resulting in a composite margin so that internal and external reporting disconnect.
- In contrast to today's practice, many construction contracts may require a disaggregation, following the criteria in the Exposure Draft. The bundling of performance obligations which are planned to be satisfied simultaneously will help to restrict the split of contracts to some degree, however, experience shows that time schedules may change significantly over the life of a project and we read the identification of performance obligations at contract inception must consider that fact. In total, the identification of pre-defined performance obligations may be costly and will imply a high degree of subjectivity.
- Customer-specific construction contracts typically contain customer acceptance clauses and the entity may not be in a position to objectively determine that the good or service provided to the customer is in accordance with the agreed specifications in the contract. In such a case, the proposed revenue recognition mechanism would ultimately result in "completed contract accounting". As individual contract volumes may be significant, the entity's performance in the reporting periods covering the life of a project may become significantly distorted. In practice, external users and management will demand adjusted revenue figures in order to provide relevant information related to significant construction contracts where control transfers upon customer acceptance.
- Especially within customer-specific construction contracts performance obligations identified at the beginning of the project may become obsolete and may be replaced

by other obligations (e.g. change of design). The same applies to subsequent contract changes or changes in the total contract volume due to price escalation clauses. It is our view that costs and complexity of remeasurement which might be necessary under the proposed model are unforeseeable.

Independently from the contract type, we believe that it is counter-intuitive to recognize loss provisions for separate performance obligations in an entity's financial statements when a contract with a customer is still profit-generating in total. This might result in recognizing loss provisions for parts of a contract (i.e. on the level of the single performance obligation) even if the whole contract is not onerous. We think this does not provide relevant information to users of financial statements. In addition, such loss provisions are not consistent with the Framework as a liability would be recognized even if an outflow of resources embodying economic benefits is not expected. This does not lead to a true and fair presentation of an entity's financial statements as such losses are fictitious. We believe that this proposal will further disconnect the internal management perspective from external presentation. In our opinion, the current guidance in IAS 37 adequately defines whether, and when, an entity should recognize a liability related to an onerous contract.

In addition, we find the proposals on the separation of two types of warranties not to be practical. This is true for the accounting set-up (at inception) as well as for the allocation of costs incurred for cases where both types of warranty could be identified within a contract. We consider a separation by warranty periods (standard / extended) as much less subjective and less burdensome. For standard warranties we consider the current provision accounting to be adequate and to be more in line with the transfer of control concept: The customer has already taken control of the asset for which the supplier only warrants that it is free of defects for a certain limited time. This treatment could avoid as well a situation where in addition to the distinction of the contractual warranties a separation of the embedded statutory guarantees is required in order to properly account for the still existing IAS 37 requirements on non-contractual liabilities.

In total, we believe that the proposed model - if transferred unchanged to a final standard on revenue recognition - will impose excessive one-time, and ongoing, costs of implementation on preparers of financial statements. Revenue recognition is the "heart" of every business IT-system that is linked to logistics, controlling, tax, other accounting as well as administrative processes of an entity. The customizing of existing IT-systems in order to automatically process business transactions is complex and very costly, evidenced by the experience of European Union preparers that recently introduced IFRS. The proposed excessive disclosure requirements will increase these costs additionally.

In contrast to the costs related to implementing the proposed model, we do not see the proposed model's improvement on decision usefulness as compared to current accounting practice. The boards have not yet sufficiently demonstrated any improvements that justify such immense costs.

Having evaluated in depth the proposed model, we recommend the boards rethink how to align the proposals in the exposure draft in order to adequately reflect an entity's performance when fulfilling a contract with a customer. In our opinion, an activity-based principle provides a more appropriate and more reliable measure of an entity's performance than the model presented in the Exposure Draft.

2. Comments on the specific questions raised by the boards

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?

Basically, we agree with the boards' proposed principle for combining or segmenting of contracts. However, regarding the criterion 15 (b) we would like to emphasize that for construction contract business the supplier, on the one hand, may grant some discount on the included goods and services as compared to stand alone selling prices. On the other hand, the customer may be prepared to pay an additional premium to the supplier for taking over the interface risks and guarantee contractually the functioning of a complete facility. Both effects may compensate each other - or, in some cases, even a premium may result. It is counter intuitive to segment a contract in such a situation where the customer pays an incremental price for the interface-free "one-stop shopping" of his services and supplies. The boards should clarify that in these cases any segmenting of a contract is not adequate because it does not reflect the economic substance of the transaction.

Further we do not agree with the proposed principle for contract modifications. It is Siemens' position that the adequate unit of accounting for customer-specific construction contracts should be - by default - the contract as concluded with the customer. Variations and change orders to the original contract are usually subject to the same contract conditions, may have an impact on the whole project timetable and are directed by the same project management. Therefore, subsequent variations and change orders relating to the same purpose of the original contract (i.e. construction of a manufacturing line) should form part of the original unit of accounting as it is current practice. The criterion of "price interdependency" as proposed by the ED could possibly lead to a separate accounting of such variations and change orders. Given the close interrelations with the original contract this does not reflect the economic coherence and would not increase decision-usefulness. In addition, it could become burdensome to decide and document for each and every variation / change order (and there could be many of them for big contracts) whether the prices are independent or 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?

Overall, we do not agree with the proposed principle. In our opinion the distinction between the principles for segmentation of contracts and identification of separate performance obligations is not clear because both contain the criterion "the entity, or another entity, sells an identical or

similar good or service separately". In general, we do not consider it practical to consider other entities business practices in such assessments.

Further, there is no guidance how a distinct bundle of goods or services should be accounted for adequately, if the goods or services in the bundle have different patterns of performance.

If performance obligations which are planned to be satisfied simultaneously are – due to changes in project time plans – satisfied at different points in time, when and how should this fact be considered for accounting purposes?

Assuming that a continuous approach implies more than one performance obligation, i.e. one unit of accounting, within which the items/assets to be continuously transferred to the customer are accounted for on the basis of one overall margin applied to all transferred items, it would, in effect, introduce the same complexity as described in our general remarks. Since the proposed model does not seem to represent the economic view and management approach we want to give an impression about this issue and would like to outline some characteristics as well as circumstances regarding customer-specific construction contracts:

- Many contracts that are currently accounted for under IAS 11 are managed and controlled as a whole. Percentage-of-completion (PoC) accounting allows aligning the internal management perspective with the external reporting by looking at the project as a whole as well as its progress, i.e. performance. Within one construction contract, the separation of single performance obligations with individual margins will lead to a disconnect between controlling (project perspective) and accounting (perspective of separated performance obligations).
- Furthermore, customer-specific construction contracts are characterized by not being comparable one to another. In many cases, products, components or services are used which are not offered on an active market. Evidence of stand-alone selling prices of such products, components or services may be scarce as they vary from transaction to transaction. Moreover, in order to adequately unbundle a contract into performance obligations, the proposed model seems to require a decentral in-depth analysis for every single contract – activities to be undertaken in order to allocate the original transaction price to separate performance obligations whose allocation basis is highly subjective.
- For customer-specific construction contracts it is not uncommon that performance obligations can only be identified during project implementation. Many contracts include clauses like "fit for its intended purpose" or "state of the art" clauses. Performance obligations identified at the beginning of the project may become obsolete and may be replaced by other obligations (e.g. due to a revised design). Impact on the project's costs may be limited but the assets transferred may be significantly different from those identified at contract inception. In addition, there are contingent obligations within a contract (e.g. the necessity to build an anti-noise barrier depending on a subsequent noise-level measurement performed) which can only be assessed once the project progresses.

We welcome that an atomisation of customer-specific construction contracts seems not to be intended under the ED regulations and noticed that additional guidance, e.g. by example 11 of the Application Guidance, has been included to illustrate such a direction. We fear, however, that the conclusions in such an example could change drastically, if for example, the activity "contract management" is offered on the market by other companies and therefore, meets the criterion "distinct".

We therefore propose that a close interrelation between the activities, supplies and services carried out under a single contract - as evidenced through a common contract management, a common project time table and mutual impacts of changes during execution – is the adequate criterion in order to identify separate performance obligations.

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?

With regards to construction contract business, we welcome that the indicator “customer-specific design or function” has been introduced. However, a legal interpretation may still prevail as not one of the preceding indicators determines by itself whether the customer has obtained control of the goods or service. To result in consistent accounting, it should be clarified that the other indicators do not need to be examined further when the indicator “customer-specific design or function” is fulfilled. This would facilitate significantly the accounting set-up for construction contracts and increase comparability.

We have also significant concerns regarding the guidance on customer acceptance included in the application guidance. Customer-specific construction contracts typically contain customer acceptance clauses which are generally not considered a formality only. For many individualized customer projects the entity may have difficulties to objectively determine on an audit-proof level that the good or service provided to the customer is in accordance with the agreed specifications in the contract. In such case, the proposed revenue recognition mechanism would ultimately result in “completed contract accounting”. As the individual contract volumes may be considerable, the entity’s performance in the reporting periods may become significantly distorted. In practice, external users and management will demand adjusted revenue figures not including the one-time effects of such significant contracts with customer acceptance clauses.

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 proposed principle seems to be subjective and requires significant management judgment, which reduces the decision-usefulness of the information to users of financial statements. In our opinion, contingent amounts should only be realized when they are earned, i.e. when the underlying performance is rendered.

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?

Summarised we do not agree that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated and we do not 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.

Analyzing this new approach of covering customer's credit risk we see three main issues:

1. An assessment of customer's credit risk will result in a reduction of the transaction price and, hence, of revenues in nearly all times. From our understanding this does not reflect the actual performance of the entity. The proposed approach is based on the concept that there is a direct relation between contract value and customer's credit risk and supposes that a higher credit risk results in a higher contract value. This is a very simplified correlation and does not reflect the true market processes.
2. As a second point we want to underline that the assessment of customer's credit risk is subjective and hard to verify. At least, upon receipt of the full payment, the full contract value - notwithstanding other regulations - should be realized as revenue. These proposed regulations open a way to control and level revenues by the entities. We cannot see any benefit for users of financial statements as the revenues of several entities will not be comparable in any way.
3. In total, revenue should reflect the amount that the customer is willing to pay in exchange for goods and services. For larger contracts, the public expects that the contract values (as published in press releases) are transformed into revenues upon execution. This should be the general presumption of the regulations - notwithstanding the general requirements regarding the time value of money (in case of very significant financing components).

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?

On the basis of the proposed model and our current knowledge about the model, we think 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).

However, it should be underlined that the "materiality-clause" is essential in order to avoid significant time and effort to identify and allocate the financing component. Additionally, as outlined in our answer to question 5, the public expects that the contract values are transformed into revenues upon execution and deviations should be restricted to really significant and (usually) rare cases.

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 a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations.

As outlined in paragraph 50 of the Exposure Draft, the stand-alone selling price of a good or service is the price at which the entity would sell a good or service separately to the customer. Therefore the entity needs to allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception. Based on this it should be defined how to allocate the transaction price in cases when one or more stand-alone selling prices can not be estimated. In paragraph 52, the exposure draft proposes methods of suitable estimations, namely the "expected cost plus a margin" approach and the "adjusted market assessment" approach. However, in cases of e.g. new technologies a reasonable estimation even based on those methods may not be possible.

The proposals in the Exposure Draft do not include any guidance for this case.

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?

Basically, we agree with the boards' proposed requirements on accounting for the costs of fulfilling a contract.

In relation to the definition of contract costs we encourage the board to specify the handling of overhead costs. The proposed definition in ED.58 includes "costs that relate directly to the contract" which differs from the effective IAS 11.16 (b) "that are attributable to contract activity in general and can be allocated to the contract". To us it is not clear whether the exposure draft intends to restrict the extent of allocated costs eligible for capitalization.

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?

On the basis of the proposed model and our current knowledge about the model, we agree with the proposed costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use in order to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

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 think it worthwhile pointing out that some of the required disclosures in the exposure draft are already provided to users via the operating segments information under IFRS 8. However, we

think the disclosure package will impose significant additional costs on preparers of financial statements without improving the decision usefulness of financial statements. In our opinion, the accounting model itself should provide decision-useful information to users of financial statements so that such excessive disclosure requirements are dispensable.

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?

The proposed disclosure of the timing and amount of performance obligations, relating to contracts with an original duration exceeding one year appears to be extensive. In addition, there is a very high degree of uncertainty when estimating the timing of satisfaction of performance obligations so that such disclosure may not provide decision-useful information. To improve the usefulness of the disclosures we recommend including regulations on the market-known figures of order intake and orders on hand. These figures are a good basis for estimating future cash flows and are generally accepted by the market.

In addition, we would like to point out that onerous performance obligations that are generated on a performance obligation level while the overall contract is profitable would not only have to be recognized immediately – which we oppose, as explained in our general remarks -, but would also trigger substantial disclosures whose validity and decision usefulness is highly questionable.

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 agree with the boards thinking that the basis for meaningfully disaggregating revenue will not be uniform. Therefore, we welcome very much that the strict categorization of revenue types as per the current IAS 18 requirements will become abolished due to its limited usefulness. In our opinion the disaggregation of revenue on the operating segments provides the best decision useful information to the users of the financial statements.

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.

Given our large number of outstanding contracts including a high portion of long term construction contracts, a retrospective application of the proposals would result in very high costs for Siemens. The highly individualized conditions of many of our contracts would require a contract by contract assessment in order to apply the new model. To this adds that Siemens and other entities filing a Form 20-F-2 must present comparative figures for two years. Hence, Siemens would need to keep up and support both models of accounting for a minimum two years. Assuming Siemens applies the new standard as of fiscal 2013/2014, Siemens would be forced to implement the new

accounting model as early as 1 October 2011. On the other hand, a prospective application comes with other disadvantages. A prospective application would lead to applying two accounting models for of up to, and sometimes exceeding, 10 years.

In our view, the proposals should be applied retrospectively with materiality constraints. Importantly, the impact of implementing the proposals significantly reduces if a final guidance does not result in significant changes compared to the existing standards on revenue recognition.

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?

In principle, we appreciate the proposed application guidance because it helps making assists in applying the standard. However, in our opinion some parts of the proposed standard are not self-evident and we recommend working out robust definitions instead of clarifying the standard in the application guidance (e.g. example 11). If the standard itself is well defined the application guidance could focus more on examples where the accounting is not so obvious.

Additionally we do not understand the proposed accounting in example No. 29. This is because paragraph 66 of the Exposure Draft states that “an entity shall present an unconditional right to consideration as a receivable (not as a contract asset) and shall account for that receivable in accordance with IFRS 9. A right to consideration is unconditional when nothing other than the passage of time is required before payment of that consideration is due.” In our opinion, this criterion is fulfilled at contract inception (on 1 January). Why should an entity recognize the receivable only when it is due (on 31 January)?

In general we recommend clarifying the principles rather than adding application guidance.

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?

In our opinion the distinction between a warranty that provides a customer with coverage for latent defects in the product and a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer will be difficult and often, arbitrary. A distinction between standard warranties (warranties which are usually granted in a business) and extended (abnormal) warranties would be more operational and presumably result in more decision-useful information for users.

We do not agree with the proposed accounting for warranties that provide a customer with coverage for latent defects in products. This is because with the delivery of a product control,

typically, transfers to the customer. Therefore, no revenue should be withheld at this point in time. To the contrary, a separation of a performance obligation related to latent defects for deferring parts of revenue would contradict the principle of distinct performance obligations. Therefore, it is more appropriate to account for the standard warranty as a liability in accordance with IAS 37.

For extended warranties we agree that a separate performance obligation should be regularly identified.

Additionally we do not understand how the entities should account for warranties without legal/contractual obligation which are currently treated as constructive obligations in accordance with IAS 37.

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 consider the current regulations on licences as adequate but would not object to the proposed changes in accounting for licenses.

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 the proposed principles should be applied on accounting for the gain or loss on the sale of some non-financial assets.