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### **Exposure Draft ED/2010/6**

## **Revenue from Contracts with Customers**

The Swedish Enterprise Accounting Group (SEAG) is a forum for the Chief Accountants from the largest Swedish listed companies outside the financial sector. SEAG is administered by the Confederation of Swedish Enterprise, to which most participating companies of SEAG are joined.

Representing preparers' point of view, SEAG welcomes the opportunity to comment on the above-mentioned exposure draft.

### **Summary**

We appreciate the fact that the Board has tried to present a general model for revenue recognition for most but not all types of contracts, but we are not convinced that the conceptual approach presented in the ED, based on "control" and that identification of performance obligations for all contracts would be a logical approach, is suitable for all contracts covered by the ED. The scope exceptions in the ED clearly indicate that such a general model is not suitable for all types of contracts. Therefore we suggest that the model presented in the ED should be limited to multiple-elements contracts.

We strongly recommend that present IFRS revenue recognition standards become amended in relation to multiple-elements contracts. The proposed accounting for these contracts we generally agree with and we believe is welcomed by those companies, typically IT-related companies that have multiple-elements contracts.

But we also strongly recommend the IASB to not let the proposed accounting principles override existing principles that works well today and would do so also in the future. Most companies have rather simple deliveries and thus no need for change, while others have large contracts with only one element. The ED would not improve financial reporting for the later type of companies.

IAS 11 is a commonly accepted world-wide, well functioning standard for contractors' construction contracts. It has a long application record based on well-known practical concepts. It is well established among the various parties engaged in the construction process and among external financial parties such as banks, investors/analysts and owners.

We acknowledge the trouble and delay of the process the IASB has taken to gain insight to the construction industry's accounting issues. However, the solution presented in the ED is unfortunately inadequate for the purpose of resolving the issues that IAS 11 already presents solutions for.

So, in summary, we recommend an introduction of multiple-elements accounting for the type of companies that have multiple-elements contracts, for examples combinations of hardware products, software and services. From an efficiency perspective the amendments should be made so it becomes as obvious as possible which type of companies and contracts that shall apply the multiple-elements revenue recognition principles.

By not focusing only on the companies concerned we see two risks:

- The proposed principles may not become effective due to criticisms for complexity and cost inefficiency from companies and other constituents that see no improvement due to the ED.
- IFRS will be regarded as too complicated by many companies. It does not improve image of IFRS. Due to efficiency reasons companies only want to implement changes they see as being helpful. Evolution, not revolution, is preferred.

#### *Recognition of revenue*

##### **Question 1**

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

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

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

We agree with the principles of paragraphs 12 – 19 (stand alone). But from the perspective of the ED as a whole we foresee practical problems to differ between segmentation and the identification of separate performance obligations (PO). This is an essential issue that can materially impact the timing of revenue since revenue is only allocated within a contract. Further guidance, for example through cross references between paragraphs 12 – 19 and 20 – 24, is recommended by us.

Regarding contract modification we want to point out that we agree with the principle of paragraph 14, which states that the price of another contract should not be interdependent of the original contract solely because of discounts and rebates. However, we do not see how this view is reflected in the Application Guidance example B3 Scenario 2. Please clarify.

Construction contracts already apply these principles through the contract due to the combining and contract segmenting rules of IAS 11, which have the same effect as proposed in the ED.

## **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?*

For SEAG, this is the main question – and SEAG strongly recommends the following:

- Add the principles according to this ED (except for proposed allocation as explained by us under question 7) of treatment of different PO:s to the existing standards, preferably IAS 18. This would be welcomed by companies in certain business sectors, see below.
- Keep IAS 11, since the principles of the ED, not being performance based, are not adequate for reflecting the economic substance of contractors' construction contracts. The ED may have included some elements similar to performance measurement based on the percentage of completion method, such as the concept of "continuous transfer of control" (revenue recognition of continuous transfer supported by input measures), but fails to present how these elements are used to achieve a better and more coherent model than IAS 11.
- Important parts in such a cost-based revenue model for the case of continuous transfer (such as e. g. recognition and measurement of onerous contracts, contract price variation and modification, contract cost identification and variation) still await for clarification and integration. New concepts, like "contract management" also have to be integrated in such a performance model.
- By our proposed approach, improved guidance would be given where definitely needed (multiple-elements contracts), but without increased costs for (neither for preparers nor users), in our view, unnecessary or incorrect changes in the current standards. Such an approach, we believe, would be very welcomed.

Within our member companies, the 30 largest listed companies of Sweden, we have three categories of companies in relation to this question:

- No or low impact.

- For those companies that through one contract offers different types of products and services, for example IT and telecom vendors, paragraph 23 gives valuable guidance.
- Companies that work with comprehensive contracts for long-term construction undertakings, such as residential and commercial house building, tunnels, bridges, aircrafts and ships, and normally manage the contract as the basic profit unit. Accounting based on the assumption that such a contract is expected to disintegrate into separate PO:s is both misleading and cost excessive.

A general comment is that we note that “distinct” is a new term that we expect to be consistently used in other standards.

### **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?*

Legal control is a control indicator that has limited usefulness when deciding when a performance obligation is satisfied, for several reasons. It is clear from the ED that there is a need for exceptions, i.e. when legal title is not a useful indicator, see e.g. paragraph 28. Legal title is also not a useful control indicator concept for services. Further on, a focus on legal title will not achieve greater comparability, if legal title passes from vendors to customers at different times in different jurisdictions in identical transactions.

We would like the standard to be clear on that extensive investigations on the timing of legal transfer, according to local legislation in different jurisdictions, should not be needed in order to adopt correct revenue recognition in the future.

We also think that there might be confusion between legal title to a contract object and the fulfillment of legal contractual obligations in the ED. Fulfillment of contractual obligations in a legal meaning occurs continuously (or step-by step) during a contract than contains more than one contract obligation for a vendor. When legal title, in the meaning of some or all legal rights attached to the contract object (e.g. a good), passes to the customer is dependent on how the contract is structured and the law in a jurisdiction. In some situations legal rights to the contract object does not pass at single point of time but instead gradually over time. It should also be pointed out that the meaning of legal title is ambiguous. It might refer to the right for the customer to (legally) direct the use of the asset etc at some point in time but it might also refer to a (different) point in time when the customer is protected from the vendors' creditors.

The relation between control indicators and the satisfaction of each separate performance obligation is also not clear for other reasons. In e.g. paragraph 30 (a) in the ED it is stated that an indicator that the customer has obtained control of a good or service is that the customer has an unconditional obligation to pay, typically because the customer has obtained

control of the good or service. It quite clear that this is a circle argument (control leads to obligation to pay which indicates control).

Obligation to pay for a good or service arises from what is legally stipulated in a contract. But the timing of payments might in many contracts (other than simple delivery of goods) not be aligned with satisfaction of a performance obligation as defined in the ED but instead with the fulfillment of a single or a number of legal contractual obligations by the vendor. The definition of performance obligations in the ED is not based or aligned with the legal obligations in a contract. While they might in some cases be similar or identical, it is by no means so in every contract with a customer. Therefore, it is very confusing that the ED uses legal indicators (obligation to pay, legal title, physical possession) to solve the question of when performance obligations are satisfied. By creating a definition in the ED of performance obligations that is independent from legal (contractual) obligations, how then can legally based indicators solve the question of satisfaction of a performance obligation (the “building-blocks” are not identical)? The logical answer seems to be that also the concept of satisfaction of a performance obligation must be defined or explained in a non-legal way. Using legally based indicators or “proxies” for satisfaction of performance obligations only works from a practical point of view when contract obligations and performance obligations are identical or at least very similar to each other.

To construction contracts the concept of control, in the case of continuous transfer of control, may not have the same implications in cases when the contractor performs as a subcontractor compared to the case when he performs the same contract as a general contractor, since the application of control indicators of the ED may differ between the two cases.

#### *Measurement of revenue*

##### **Question 4**

*The boards propose that if the amount of considerations 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.*

Yes, we agree, for those companies where it is possible to define PO:s, on the general principle that an entity should recognise revenue on the basis of an estimated transaction price.

Please also refer to our answer to question 7 in relation to the allocation of revenue. We propose an alternative treatment of discounts compared to the model in the ED.

##### **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?*

No, we do not agree.

From our perspective it would be rare that we already at the inception of a contract expect credit losses. Since it is already stated in IAS 39 how to measure financial receivables we do not see any reason for including rules about collectability in the standard for revenue recognition. Furthermore, we believe that the proposal regarding collectability contradicts the current standard of IAS 39, where impairment losses only shall be recognised if there is any objective evidence that the asset is impaired.

We would also like to point out that should we get an expected loss model, as is being discussed in the IFRS 9 project, we expect some guidance on how to make a clear distinction between what regards should be made regarding collectability at the time of revenue recognition versus the measurement of the financial receivable.

According to paragraph 43 of the ED, effects of changes in the assessment of credit risk associated with the right to consideration shall be recognised as income or expense rather than as revenue. As the ED proposes that the initial revenue should reflect the customer's credit risk we foresee that there might be situations where we do get more payments from customers compared to what has been reported as revenue. According to the ED this will never be shown as revenue, instead as income. However, according to paragraph 13 of the ED for Financial instruments, impairment gains and losses resulting from changes in estimates in relation to financial assets that are measured at amortised cost should be presented in comprehensive income and not as income or expense. Could you please clarify?

#### **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?*

Yes, but only when the effect from time value of money is material.

In general, we acknowledge that there is a lack of general guidance for an overall principle on how to reflect the time value of money, both regarding what timeframe should be critical for start considering the time value of money and what discount rate to use.

#### **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?*

Yes, we agree that stand-alone selling prices or estimated prices, if they are possible to estimate with a reasonable effort, shall be the basis for revenue allocation, but not strictly in proportion. If an entity signs a contract and identifies different PO:s and the activities under the different PO:s represent different business sectors with typically different margins, for example software and service deliveries, the allocation must reflect normal levels of margins, including levels of discounts. See the example below.

Selling prices should not be list prices, but the real prices used in the company's transactions. However, when there are no references to stand-alone selling prices at all, the performance obligations are somewhat correlated and price estimates would only be based on judgments with a large degree of uncertainty, we would prefer to open up for a possibility to aggregate performance obligations in order to facilitate the reporting of revenue with regard to cost/benefit arguments.

By allocating revenue considering normal segment margins, the proposed treatment of onerous PO:s (paragraphs 54 – 56 in the ED) would become more logical and reasonable. By that, also the allocation of revenue would in general have the purpose to show and being based on that relevant gross margins are recognized as PO.

Example

A contract includes the following two PO:s.

	Cost	Allocation of discount	Margin	Price TCU
PO A	400	- 200	- 100	100
PO B	100	- 80	- 25	- 5
Gross price	500	- 280		
Discount 25%	- 125			
Net price	375			

PO:s A & B represent different business sectors and have distinct functions/margins and are identified as separate performance obligations and are also reported in separate segments.

Purchases over TCU 450 result in a discount of 25%. Application of paragraph 50 (allocating the discount in proportion to the stand-alone price under-laying each of those performance obligations) results in an onerous performance obligation (See above PO B).

The assumption for granting this discount is based on that the discount shall be allocated in relation to the estimated margin for each of the company's segments (PO A = 21% & PO B = 10%).

Allocation of discount	Margin in %
A -115      85	21%
B - 10      10	10%

This type of situation is common within many business sectors, for example IT- and telecom industries as well as consumer product industry.

*Contract costs*

**Question 8**

*Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC*

*Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specific criteria.*

*Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?*

Yes, we agree. As the requirements are similar to those for inventory valuation we also believe they have a theoretical base.

#### **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.*

Please see question 8.

#### *Disclosure*

#### **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 in general believe that the disclosure requirements are too extensive. For all disclosure requirements we therefore emphasize the importance of communicating on the detail level suitable for the operations of the company. Revenue recognition disclosures of a construction company should have different main focuses and perhaps more elaborated disclosures in some areas, than for example a manufacturing company with quite simple transactions. There should be no disclosure requirements on a negative basis ("we do not have this and that/ it is not material"). If the disclosure requirements just become a checklist to tick off, the notes to the statements will be cluttered with details and take focus from the most important company specific information.

#### **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? In not, what, if any, information do you think an entity should disclose about its remaining performance obligations?*

No, we believe that such disclosures risk being too extensive and vague if estimates are needed and if mandatory for all companies with no materiality levels. Detailed requirements of disclosures of amount and timing of remaining performance obligations should only be valid for companies operating solely with long-term contracts where amount and timing of future flows can be predicted reliably.

Note that for really long contracts, with more than 3 years duration, re-negotiations and modifications are common. This diminishes the value for a user of this type of information and we recommend that these disclosures are limited in a future standard.

### **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?*

Yes, but it should be according to management's view, according to the principles and in conjunction with IFRS – and consequently the “segment note” of an annual report.

*Effective date and transition*

### **Question 13**

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

*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.*

It will be very time-consuming and costly to apply the new requirements retrospectively and if decided it will require extensive guidance to do so, especially for long-term contracts. We suggest outreach activities to investigate the cost – benefit of performing such an exercise.

To require a full retrospective application would, besides significantly added costs for preparers, have to be based on estimations to a great extent (when did the company transfer control of different PO:s etc) and large and risky re-runs of ERP systems (impacting not only accounting modules). Comparative amounts will be uncertain and therefore have low value for a comparison over time.

The adoption of IFRIC 15 retrospectively also pointed out the difficulties the market has to understand drastic changes in revenue recognition restatements of previous years, especially considering how to explain previous year's dramatic changes in revenues. This could both be due to new accounting methods but also due to the effects a financial crisis has on the market conditions certain years. Moving revenue between a number of years will not always give a clearer picture of the company's performance with new accounting standard in the future.

We therefore propose an approach based on materiality and what is practically possible to achieve by companies. The new standard should as from the transition date only be applied for new contracts (“moving forward basis”) and existing contracts that are material at transition date (as well as being practically possible to apply a retrospective application on). Companies should be required to disclose how the transition to the new standard has been made with, if possible, qualitative disclosure about the impact of the transition method applied.

*Application guidance*

**Question 14**

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

We do not believe that it is possible to answer all implementation issues with a detailed application guidance and still keep a principle based standard. There will always be a request for more guidance, but we believe that the needs will not be fulfilled because the examples will always be too simplified, whereas reality always has more details to consider.

We would appreciate if the final application guidance included references to other standards such as leases (IAS 17) and perhaps also impairment (IFRS 9 and IAS 36) and guidance on how to combine the standards in a transaction involving for example sale with collectability and expected loss considerations.

Regarding sale and repurchase of an asset we have some questions regarding the put option described in B48 (c) and B53. Our understanding is that B53 concerns sale of an asset where the value doesn't decrease significantly during the repurchase option period, e.g. a building. However, we have not found any other guidance than B53 concerning a repurchase agreement over a long time period with a fixed end price where the value of the asset will probably decrease significantly. We interpret B53 as if a repurchase agreement with a fixed price exists; a repurchase liability for the full consideration received from customer should be recognized. This indicates that revenue will not be recognized until the end of the repurchase agreement, which according to our view does not give a true and fair view of the control transfer of the transaction. However, we emphasize that further guidance is needed regarding a repurchase agreement with retained residual value risk in the product sold. Our suggestion is that revenue should be recognized over the repurchase agreement and not at the end of the agreement.

We also note the absence of a long-term scenario applied on long-term contracts with continuous transfer and revenue recognition based on costs.

**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 believe that a warranty should only affect revenue recognition if effectively being a PO, for example an embedded separate service, stated as “warranty” in a customer contract. The treatment of “embedded” products and services is covered in paragraphs 20 – 24, but perhaps a more specific requirement on identification of “embedded PO:s” should be added though.

We believe that a warranty should only affect the revenue recognition if sold as a separate service and as such has been priced accordingly or if "warranty" effectively is a service performance obligation (but defined as a warranty in the contract). Other warranties for latent defects (not separately priced) are often seen as a necessary cost required meeting customer expectation of no-fault deliveries. Repairs within a normal warranty period are effectively a correction of a production error, not a service. The customer view should decide classification. It would be more suitable to accrue the probable cost for such warranties as prescribed under IAS 37.

*Example from a member company*

We believe that a warranty needs to be divided into standard warranty & extended warranty. A standard warranty covers latent defects as described in IAS 37. An extended warranty is normally sold as a separate service with a separate price but can also in the contract be described as "warranty", i.e. with no separate price. An extended warranty shall affect revenue recognition, treated as a separate performance obligation.

#### **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 pattern of revenue recognition proposed by the boards? Why or why not?*

We have no opinion on this.

*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?*

In general we appreciate consistency in principle between different standards.

*Non-public entities*

**Question 18**

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

Not applicable.

We are pleased to be at your service in case further clarification to our comments will be needed.

Yours sincerely,

CONFEDERATION OF SWEDISH ENTERPRISE

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