1820-100 Comment Letter No. 619

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SAP's comment on the IASB Exposure Draft ED/2010/6 'Revenue from Contracts with Customers'

Dear David

SAP welcomes the opportunity to comment on the ED/2010/6 'Revenue from Contracts with Customers'.

We appreciate the joint efforts of the IASB and the FASB to create a revenue recognition standard that applies to all transactions in all industries. We also appreciate the effort to base such standard on one single revenue recognition approach. We do, however, believe that the 'transfer of control' approach chosen in the ED is not appropriate and difficult to apply to services and construction contracts (including software development services). For services and construction contracts we prefer the current IAS 11 model under which revenue is recognised continuously as work under the contract progresses.

We also disagree with the ED's approach to allocate transaction prices to the individual performance obligations based on estimated sales prices regardless of whether such sales prices can be estimated reliably. Committing future software functionality to a customer in connection with a software sale is one example of a scenario in which sales prices cannot be estimated reliably.



The ED proposes retrospective application of the new guidance. We disagree with this proposal. In our industry revenue recognition policies significantly impact how contracts with customers are structured. Consequently, material changes in the revenue recognition policies will result in new contracts being structured differently from past contracts. Thus applying new standards retrospectively to contracts entered into under the previous standards does not result in decision useful information. Additionally, retrospective application would require preparers to record revenue under two different regimes for two to three years which creates a burden that is not justified by the benefits of retrospective application.

Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact us.

Sincerely,

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Enclosure



Appendix

Recognition of revenue (paragraphs 8-33)

Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) 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 believe that price interdependence should not be the only factor to consider when combining or segmenting contracts for accounting purposes. Specifically, the functional interdependence between deliverables within distinct arrangements is a factor that is not sufficiently covered by the current proposal.

For example, consider two arrangements entered into and fulfilled in parallel with one deliverable each where the prices are fixed and equal the respective list prices but where

- the deliverable of the one arrangement is essential to the deliverable of the other arrangement, i.e. the one deliverable is of no use to the customer without the other and or
- the customer has the right to return the deliverable purchased under the one arrangement should he not be satisfied with the deliverable purchased under the other arrangement.

If price interdependency was the only criterion the two contracts would not be combined although all three indicators listed in para 13 of the ED are met.

A practical example of functional interdependence of deliverables is when the sale of software (or software systems) includes software products and the delivery of services for significant production, modification, or customization of the software (or software systems). The same above-mentioned issues apply to these scenarios as to essential services.

We also wonder whether the indicator listed in para 13(c) (concurrent or consecutive performance of the contracts) is a valid standalone indicator. We struggle to think of scenarios in which two contracts are not negotiated together (i.e. the indicator in para 13(b) is not met) but nevertheless linked due to concurrent performance.

Further, the proposed 5-step approach of the Exposure Draft assumes that once the contract is identified in step 1, in step 2 distinct performance obligations are identified. It is unclear whether the identification of distinct performance obligations is limited to the contract identified in step 1 or whether multiple contracts must be considered for this purpose, i.e. are the steps segmenting/combining contracts and identifying performance obligations sequential steps or combined steps? There might be situations where a single performance obligation (as identified in step 2) is delivered through multiple price-independent contracts (as concluded in step 1).



The following example demonstrates further scenarios where the outcome of the price interdependence criteria is questionable:

A software vendor sells a non-exclusive license for CU 1.000.000 and software implementation services for CU 800.000. The software is delivered at the outset of the arrangement and the implementation services are expected to be delivered over a one-year period. The customer agrees to pay a performance bonus of additional CU 400.000 for successful implementation of the software. The vendor has sufficient experience and can reasonably estimate that the performance bonus will be earned. The standalone selling prices of the software and implementation services are CU 1.000.000 and CU 800.000, respectively.

Conclusion a)

The vendor regularly sells the software separately and other vendors regularly sell identical implementation services separately. The customer does not receive a significant discount for purchasing both items within the same contract. Accordingly, the arrangement is segmented in two contracts: (i.) software, (ii.) implementation services. The performance bonus is allocated to the contract for implementation services. Upon delivery of the software CU 1.000.000 is recognized as revenue.

Conclusion b)

Assume the same facts as above except that the implementation services are priced at the same amount but with a different pricing metric, i.e. as 80% of the software fee = CU 800.000. In this fact pattern the arrangement is not segmented due to the price interdependence of the goods and services in the contract. Accordingly, a portion of the performance bonus is allocated to the software and recognized upon delivery, CU 1.222.222. A portion of the performance bonus (CU 222.222) is front-loaded into revenue although the delivery of the implementation service hasn't even started.

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?

As mentioned above, for software arrangements the topics of functional interdependence (e.g. essentiality and services for significant production, modification, or customization of the software) should be covered either in the step 1 or in step 2 with more clarity on the hierarchy of applying these steps.

By applying the criteria in paragraph 23 (b)(i) to an essential service within a separate contract the entity would conclude that the essential service is distinct and thus a separate performance obligation: "A good or service ... is distinct if ... the entity could sell the good or service separately because... it has a distinct function – a good or service has a distinct function if it has utility ... together with other goods or services that the customer has acquired from the entity..."

In our view the topic of distinct performance obligations must be evaluated in combination with segmenting and combining contracts, i.e. at the level of contracts and not solely within a single identified contract.



For the purpose of identifying distinct performance obligations we recommend applying the concept of stand-alone value to the customer. While it is stated in the Basis for Conclusions (BC 52) that the distinct function requirement is consistent with the guidance on multiple-element arrangements in ASC Subtopic 605-25, i.e. the stand-alone value to the customer, which the Boards rejected because that could suggest that an entity must identify performance obligations on the basis of its assessment of the customer's intended use of the promised goods or services. The Boards noted that it would be difficult, if not impossible, for an entity to know the customer's intentions in any given contract. In our view such a position is inconsistent with the position taken in the area of determining when control transfers to the customer: BC 63 states that the definition of control could be applied from the perspective of either the entity selling the good or service or the customer purchasing that good or service. Although, in many cases, both perspectives are likely to lead to the same result, the Boards have articulated the proposed indicators of control from the perspective of the customer. In our view this is an inconsistent approach.

As also stated within other comments, we recommend taking the perspective of the customer for assessing stand-alone value and thus defining the units of accounting. Nevertheless, for the recognition of revenues we recommend taking the perspective of the entity to depict the entity's performance of contract fulfillment.

We believe that the criteria laid out in para 23 of the ED are unclear:

- Regarding para 23(a) it is unclear what efforts an entity needs to undertake to identify whether another entity somewhere in the world offers a similar good or service. We believe that entities should only be required to consider the information that they are aware of without further effort and that offers of other entities should only be considered as far as they exist in the very market that the reporting entity's transaction is taking place.
- Regarding para 23(a) it is unclear how the criterion of distinct profit margin should be applied to intangible assets. Take, for example, new releases of a software product for which licenses are (a) sold together with support contracts to new customers and (b) given to existing contracts under existing support contracts. Do such software products have a distinct profit margin although the direct cost of one license is close to zero (the cost of development are not specific to the individual license and thus the resources needed to provide the license cannot be separately identified) and although the licenses are marketed in different manners?

We do not agree with the conclusion in para 24 of the ED that it is not necessary to apply the recognition and measurement requirements of the ED separately to the different performance obligation in a contract if the performance obligations are fulfilled in the same period(s). We believe that separate application of the requirements is needed for two reasons:

- The requirements in para 74 of the ED to disclose disaggregations of revenues cannot be met unless the performance obligations are accounted for separately
- The requirements to record liabilities for onerous performance obligations on the level of the individual performance obligation cannot be met unless the performance obligations are accounted for separately



Question 3: Do you think that the proposed guidance in paragraphs 25–31 and related implementation 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?

We believe that the revenue recognition model proposed in the Exposure Draft does not result in decision-useful information for construction contracts and service contracts:

Construction Contracts

We understand the approach presented in the Exposure Draft to foresee the following for revenue recognition for multi-period construction contracts: If control of the constructed asset is transferred to the customer at the end of the construction, no revenue is recognized before the end of the contract. In contrast, if the contract with the customer provides that during the construction period control over the unfinished good is transferred to the customer, some of the total revenue is recognized upon such transfer of control over the unfinished good.

We do not believe that such accounting results in decision-useful information as the following example from our industry shows (the example describes a common transaction in our industry):

Assume an arrangement under which a software vendor develops a software product to the customer's specifications (customer-specific software product). The intellectual property of the developed product remains with the software vendor and the software vendor grants to the customer, upon contract completion, a non-exclusive license to the developed software. The agreed-upon contract fee clearly exceeds the expected cost, i.e. the project is profitable. The customer pays upon contract completion.

From the criteria in para 30 of the Exposure Draft it appears that the majority of the criteria indicate that control has not been transferred before contract completion:

- Indicators that the customer has <u>not</u> obtained control before contract completion:
 - Para 30(a) of the ED: The customer has no unconditional obligation to pay before contract completion
 - Para 30(b) of the ED: The customer has no legal title to the developed intellectual property and will never have such title.
 - Para 30(c) of the ED: The customer has no physical possession because the delivery of the software (via DVD or download) does not occur until contract completion
- Indicators that the customer has obtained control before contract completion:
 - Para 30(d) of the ED: The developed software is customer-specific

If, however, the vendor decided to deliver to the customer, at the end of every day, the current unfinished software and granted a license to use this unfinished product it appears that the criteria in para 30(b) and para 30(c) are met and thus the majority of the criteria indicate that control has been transferred before contract completion. While we are fully aware that the assessment of control transfer under para 30 of the ED is not a simple 'count the indicators' exercise we are concerned that non-substantive changes in the agreements with the customer, like granting licenses to unfinished software, may affect revenue recognition.



In the discussions of the Exposure Draft we have experienced so far (including discussions with IASB Board members and staff), a particular emphasis was put on the indicator in para 30(d) (customer-specific design or function of the good or service). Such particular emphasis is, however, not reflected in the Exposure Draft. Rather the opposite: By its wording, indicator 30(d) appears to indicate the expectation that control will transfer rather than that control https://example.com/hasalready/been/ transferred ("it is likely that the entity would require the customer to obtain control").

Service Contracts

We understand the Exposure Draft to assume that there is a transfer of control for services as much as for products. We further understand the Exposure Draft to assume that such transfer may well occur over time rather than upon completion of the entire agreed-upon service.

We believe that the timing of such transfer is difficult to identify and may, again, depend on form rather than substance. In the customer-specific software development example above the question may be raised whether the arrangement is for a service (development of customer-specific software => delivery over time) or a product (license to the developed software => delivery upon contract completion). This may finally depend on the form of the contract rather than its substance. Assume the following example:

A software vendor provides software to a customer in a hosted environment. I.e., the software is not delivered to the customer for installation on the customer's hardware but rather remains on the software vendor's hardware and the customer accesses the software over the internet (so called Software-as-a-Service). The arrangement between the software vendor and the customer provides that the fees for the use of the software are due quarterly in arrears but that the fee will only be paid if the software was available for use at each and every day of the respective quarter. Applying the Exposure Draft's guidance is difficult because it is unclear what the customer is actually controlling and when such control transfers to the customer. Does the customer control the use of the software although numerous other customers may use the software concurrently? And does the control over the use of the software transfer continuously or not before the end of the quarter because this is when the vendor has delivered one quarter of access without downtime?

Based on this example we do not believe that transfer of control is an appropriate concept for the timing of revenue recognition for services.

We would like to emphasize that the continuous approach to revenue recognition which we prefer over the Exposure Draft's approach would not result in the difficulties outlined above.

We would like to point out that in the example of customer-specific software developments two views can be taken and each leads to a different conclusion on the pattern of transfer of control.

We understand that the current revenue recognition model which relies on delivery in IAS 18 and on performance in IAS 11 encounters difficulties whenever it is unclear whether a transaction falls under IAS 11 or IAS 18. We do, however, see similar difficulties in the application of the Exposure Draft's model which relies on the concepts of 'control over services' and 'continuous transfer of control' that are very difficult to apply in practice. The new model is therefore not superior to the existing



standards. As we believe that percentage of completion accounting for multi-period contracts provides decision-useful information we recommend to continue the current distinction between goods and services that are accounted for under a performance-based approach and goods and services that are accounted for under a delivery-based approach.

In the application guidance section of the future standard, we recommend adding further guidance that clarifies the issues that the software industry faces.

Measurement of revenue (paragraphs 34-53)

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize 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 recognize 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 recognizing revenue when the transaction price is variable and why?

We agree with the principle.

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 recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

We understand the ED to require that revenue is recognised at the probability-weighted amount of consideration that the entity expects to receive. Any difference between the amount originally estimated and the amount actually received from the customer is recorded outside revenue as a gain or loss on the receivable. This contrasts the current practice where such differences are recorded

- as additional revenue if the amount actually received is higher than the amount originally estimated,
- as an expense (bad debt expense) if the amount actually received is due to customer financial difficulties lower than the amount originally estimated.

We evaluated all three possible approaches:

- 1. Approach 1: the current practice as outlined above (subsequent changes in estimate to be recorded as additional revenue or expense depending on the direction of the change)
- 2. Approach 2: the approach of the ED (all subsequent changes in estimate to be recorded outside revenue)
- 3. Approach 3: an approach under which all subsequent changes in estimate are recorded in revenue



We believe that all three approaches have disadvantages

- Approach 1 is inconsistent as it treats changes in estimate differently depending on the direction of the change.
- Approach 2 will result in scenarios in which the customer pays the full transaction priced but nevertheless the amount revenue recognised is smaller.
- Approach 3 results in out of period adjustments of revenue which impair the usefulness of the revenue number as an indicator for a customer's business volume in a given period. Take, for example a revenue generating transaction in year 20X1 with two years payment terms in which the original estimate of the consideration expected to be received is 100. Two weeks before the payment is due in 20X3 the customer surprisingly files for bankruptcy and is unable to pay any consideration. Under Approach 3 the vendor would record negative revenue of 100 in 20X3. Thus total revenue of period 20X3 is negatively impacted by something unrelated to the business of that period (total revenue of period 20X3 may even be negative)

Based on this analysis we agree with Approach 2 (i.e. the ED's approach) as it appears to be the lesser evil. However, we do not agree with the use of probability weighted estimates but prefer a best-estimate approach at the contract level. The technique of a best estimate at the contract level should be consistent with the principles of a best estimate for a single obligation as described in IAS 37.

We would like to point out that the proposed accounting for changes in estimate due to creditworthiness of a customer is inconsistent with the accounting for changes in estimate regarding variable consideration. Accordingly, in transactions with variable consideration the accounting for changes in estimate depends on whether the entity concludes that the change in estimate is an adjustment to a previous estimate of variable considerations (leading to a revenue reduction) or a result of an adjustment of the creditworthiness assessment (leading to an expense). We recommend that the final IFRS provides application guidance to clarify this difference.

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?

We generally agree that the time value of money should be considered when material. We believe, however, that the term "material financing component" in para 44 of the ED is unclear with regard to whether the financing component must be material to the individual contract or material to the financial statements taken as a whole.

We also believe that it will be difficult for entities that do not provide financing outside sales transactions to determine an interest rate that would be used in a standalone financing and that considers the time value of money and the credit risk. We therefore suggest that the final IFRS includes guidance on simplified approaches that can be used whenever an individual interest rate is difficult to be determined.



We also believe, that the ED is unclear on how the effects of a financing component must be determined at the contract level, i.e. how to determine the time value of money-adjusted transaction price for an arrangement consisting of price-independent performance obligations with a financing component at the contract level.

Example

Entity A sells to customer B a facility. The arrangement also provides that A will deliver extensions of the facility in future years. The transaction price for the contract is 1.000 CU which covers both, the basic facility and the future extensions. Entity A receives a cash payment of 1.000 CU from customer B upon delivery of the basic facility. It is agreed that facility extension 1 is delivered 2 years after contract inception and facility extension 2 is delivered 4 years after contract inception. As entity A regularly sells the basic facility and the facility extensions separately, the company accounts for the items as distinct performance obligations of one contract.

Determination of stand-alone selling prices:

The basic facility has an estimated selling price of 1.000 CU when sold separately for cash today.

Facility extension 1 (fees due in 2 years) has an estimated selling price of 250 CU when sold separately for cash today. Facility extension 2 (fees due in 4 years) has an estimated selling price of 500 CU when sold separately for cash today. The discount rate that would be used in a separate financing transaction between entity A and customer B is 10%. This rate will be used to determine the effects of the time value of money.

The relative stand-alone selling price method results in the following allocation of the transaction price:

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Allocation for PO basic facility: 1.000 \text{ CU} * (1.000 \text{ CU} / 1.750 \text{ CU}) = 571,43 \text{ CU}
Allocation for PO facility extension 1: 1.000 CU * (250 CU / 1.750 CU) = 142,86 CU
Allocation for PO facility extension 2: 1.000 CU * (500 CU / 1.750 CU) = 285,71 CU
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Present value of PO's upon delivery:

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PO basic facility (delivery today): 571,43 \text{ CU} * (1,1^0) = 571,43 \text{ CU}
PO facility extension 1 (delivery in 2 years): 142,86 \text{ CU} * (1,1^2) = 172,86 \text{ CU}
PO facility extension 1 (delivery in 4 years): 285,71 \text{ CU} * (1,1^4) = 418,31 \text{ CU}
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Consequently there is additional revenues due to financing effects of 162,60 CU. The question now is how the additional revenue of 162,60 CU

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Alternative 1 – adjustment at contract level
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Adjusted transaction price: 1.000 CU + 162,60 CU = 1.162,60 CU

Adjusted allocation of transaction price:

Allocation for PO

basic facility: 1.162,60 CU * (1.000 CU / 1.750 CU) = 664,34 CU

Allocation for PO

facility extension 1: 1.162,60 CU * (250 CU / 1.750 CU) = 166,09 CU

Allocation for PO

facility extension 2: 1.162,60 CU * (500 CU / 1.750 CU) = 332,17 CU

Alternative 2 – adjustment at PO level

The amount allocated to each PO equals its present value as determined above.



Conclusion:

It is not possible to determine the time value of money at contract level when separate PO's with different values and times of transfer are involved. Adjusting the transaction price and then reallocating it to the performance obligations will lead to inconsistent/biased results (e.g. performance obligations, which maybe onerous are not identified as onerous and vice versa).

Thus, we recommend to clarify in the final IFRS that the effects of time value of money should be considered at the level of the individual performance obligation. We also recommend to add an example similar to the above to the Application Guidance

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?

We agree that the transaction price should generally be allocated to all separate performance obligations in a contract in proportion to the standalone selling prices as far as such selling prices are reliably estimable. We believe that there are numerous realistic scenarios in which such reliable estimates are not possible and we do not believe that unreliable estimates should be used.

In the software industry one scenario in which reliable estimates cannot be made is when future software products or future functionalities are committed to a customer. Such commitments do occur even if the "value" of the committed functionality or product can be estimated as the incremental cost of delivering the products or functionalities to the customer are inconsequential. Such commitments may be made even before the development of the product or functionality has started and thus before the scope and future pricing of the product is defined and the respective costs of development can be estimated. Thus, there may be no basis whatsoever to reliably estimate the stand-alone selling price.

Based on our belief that an allocation of the transaction price should only be based on reliably estimable stand-alone selling prices additional guidance is needed for scenarios in which such reliable estimates cannot be made as such scenarios do exist in practice.

We recommend the following guidance for such scenarios:

- If the standalone sales prices of all but one performance obligation in a contract can be reliably estimated the standalone sales price of this one performance obligation shall be deemed to be the difference between the contract's total transaction price and the total of the estimated sales prices of the other performance obligations (residual method)
- If the standalone sales prices of more than one performance obligation in a contract cannot be reliably estimated all performance obligations without reliably estimable sales prices shall be accounted for as one single performance obligation and the amount to be allocated to this performance obligation shall equal the difference between the contract's total transaction



price and the total of the estimated sales prices of those performance obligations with reliably estimable sales prices.

We have noted para BC125 of the ED which states "that a residual (or reverse residual) technique may be an appropriate method for estimating a stand-alone selling price if there is a directly observable price for one performance obligation but not the other". We believe that this guidance should be in the text of the standard rather than in the basis for conclusion. We also do not understand why the residual method should be appropriate if the sales price of the other performance obligation is "directly observable" but not appropriate if the sales price of the other performance obligation can be estimated reliably although it is not "directly observable". This sounds as if the IASB sees different levels of reliability of standalone sales prices which affect the accounting. Such view needs to be better explained and justified as it appears very rules based and adding to the complexity of revenue accounting.

We struggle with the allocation based on estimated standalone selling prices when a portion of the transaction price is variable and this variable portion is clearly linked to one particular performance obligation. The following example illustrates our struggle:

A software vendor sells software to a customer and a service to implement the software. The arrangement is such that the software and implementation service are two performance obligations under the same contract. The agreed fees are CU 100 for the software and CU 25 for the implementation. Both of these fees equal the respective standalone selling prices. Additionally, the customer commits to pay as a bonus and additional CU 10 if the vendor manages to implement the software in 5 months rather than the 6 months implementation time committed in the arrangement. Based on prior experience the vendor is confident to meet the 5 month deadline.

In a relative sales price model the vendor would allocate 80% of the bonus to the software and would recognise it upon software delivery although it is clearly a compensation for the implementation service.

Based on this example we believe that variable compensation that is clearly linked to one particular performance obligation should be allocated to this particular performance obligation. Such accounting would, additionally, eliminate an inconsistency that would otherwise result from para 16 of the ED. This para 16 provides for the allocation of compensation to different contracts and that subsequent changes in the amount of variable compensation should only be allocated to the contract to which the variable compensation relates. In contrast, para 53 appears to require the allocation of compensation to the different performance obligations in one contract and subsequent changes in the amount of variable compensation should be allocated to all performance obligations based on the relative standalone sales prices.



For the example above the guidance in para 16 and 53 of the ED would mean that

- if the software and implementation are determined to be two separate contracts:
 - 80% of the initial estimate of the bonus would be allocated to the software while 100% of any subsequent change in the variable compensation would be allocated to the implementation. I.e., if the vendor in our example fails to meet the 5 month deadline he would recognise CU 108 for the software (based on the initial allocation) and CU 17 for the implementation (CU 25 + CU 2 CU 10).
- if the software and implementation are determined to be two separate performance obligations in one contract:
 80% of the initial estimate of the bonus and any change in this estimate would be allocated to the software.

We don't believe that the accounting under para 16 is appropriate and we don't believe that there should be a difference in the allocation of subsequent changes in estimate to (i) different contracts and (ii) different performance obligations in one contract.

Contract costs (paragraphs 57-63)

Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, *Intangible Assets*), an entity should recognize an asset only if those costs meet specified criteria. Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

We believe that matching cost with revenue provides useful profit information and therefore agree with the proposal to recognise an asset for cost of fulfilling a contract.

We understand the ED to propose that an asset is recognised for cost of contract fulfillment that meet certain criteria but that no asset is recognised cost of obtaining the contract. We believe that

- it is oftentimes very difficult in practice to differentiate between cost of
 obtaining a contract and cost of fulfilling a contract (example: to convince a
 customer to order the development of a customer-specific software a
 software vendor prepares a blueprint that shows the functionalities and look
 and feel of the software). This blueprint is used for the development after the
 customer has ordered the development service. Are the cost incurred for the
 blueprint cost of obtaining the contract or cost of fulfilling the contract?)
- such guidance contradicts the proposed guidance for insurance contracts which does not require cost of obtaining a contract to be expensed as incurred.

Based on these considerations we recommend to record an asset for both, direct cost of obtaining a contract and direct cost of fulfilling a contract.

Para 58 of the ED provides that direct labour cost of employees who provide a service are cost that relate directly to the contract under which the service is sold to the customer. We recommend to clarify whether, similarly, the direct labour cost of



employees who produce a good are cost that relate directly to the contract under which the good is sold to the customer. Such guidance should consider that a single performance obligation may be a hybrid the sale of a good and a service. Differences in guidance for the direct cost of goods and the direct cost of services may thus be difficult to be applied.

Para 60 of the ED provides that cost are to be recognized in expense if an entity cannot distinguish the costs that relate to future performance from the cost of past performance. We believe that this is overly conservative. We recommend allowing allocations of the cost to the past and future performance if reasonable allocation mechanisms can be identified.

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of

- (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and
- (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

see our response to question 8.

We would also like to comment on the ED's approach to recording a liability for an onerous performance obligation:

We understand the ED to require the onerous test to be performed

- a) on the level of the individual performance obligation (rather than the level of the contract) and
- b) by comparing a performance obligation's total revenue with its total costs (rather than comparing unrecognised revenue with unrecognised cost).

We agree with this approach because

- performing the onerous test separately for each individual performance obligation is consistent with the ED's approach of recognizing revenue separately for each performance obligation,
- comparing a performance obligation's total revenue with its total costs make the loss recognition independent of the timing of changes in estimate.¹

We discussed whether it would be more appropriate than the ED's approach to only record a loss if

- the contract as a whole is onerous based on a total revenue/total cost basis
- the contract as a whole is onerous based on a remaining revenue/remaining cost basis

Imagine a service contract with estimated total revenue of CU400 and estimated total cost of CU 360 both to be recognized ratably over 4 periods. Subsequent to contract closure the cost estimate increases by CU 30 to CU 390. If the onerous test compared remaining revenue with remaining cost a loss would be recorded if the change in estimate occurred at the start of period 3 (remaining revenue = CU 200, remaining cost = CU 180 + 30 = 210) while no loss would be recorded if the change in estimate occurred at the start of period 2 (remaining revenue = CU 300, remaining cost = CU 270 + 30 = 300)



We noted that performing the onerous test on the level of the individual performance obligation may result in scenarios in which a loss is recorded for one performance obligation while, possibly even in the same period, a positive margin is recognized for a second performance obligation sold under the same contract. We gave, however, a higher weight to the following arguments in favour of an onerous test on the level of the individual performance obligation:

- the conceptual consistency of using the individual performance obligation as the level for both, separate revenue recognition and separate onerous test
- if the onerous test is performed on the contract level, the individual performance obligations cannot be managed separately by the delivering units of the reporting entity but need continuously be evaluated together for purposes of onerous tests.
- If an entity that presents in its P&L more than one revenue line item (e.g. product revenue and service revenue) and consequently more than one cost of revenue line item performed the onerous test on the level of the contract the expense from recording an onerous contract liability would need to be allocated to the different cost of revenue line items and consequently would impact the gross margin of all revenue areas although only one performance obligation incurred a loss.

Para 83(d) requires disclosure of the discount rate used in the measurement of liabilities for onerous performance obligations. In contrast, the section of the ED on such liabilities (para 54 et seq. of the ED) does not provide guidance on the determination of the appropriate discount rate. We recommend adding such guidance.

We also recommend to clarify in para 55 of the ED that when recording a liability for an onerous performance obligation the debit posting is to expense not contra revenue. Para 56 of the ED provides such guidance, however limited to changes in measurement.

Disclosure (paragraphs 69-83)

Question 10: The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

We are surprised to see that the ED is yet another proposed standard that requires more disclosures than its predecessor. We do not understand how the accounting proposed in the ED can be superior to the prior accounting if significantly more disclosures are needed to provide useful information.

We believe that a significant number of the disclosures requirements proposed will result in useless boilerplate, particularly for companies with heterogeneous businesses. What should, for example, a reporting entity disclose in response to the requirements in para 77 of the ED if such entity sells multiple different products and services through multiple different channels at multiple different payment terms and with multiple different warranty terms? Most likely such disclosure will be similar to the following: "in 20X1 we have promised to transfer all goods and services from our product and service offering" or "Payment terms agreed with our customers depend



on the products and services sold and reach from cash upon delivery to multiple years". Similar boilerplate are likely to result when an entity with numerous onerous performance obligations in different areas of its business tries to satisfy the disclosure requirements in para 79 of the ED.

Para 75 (e) of the ED requires separate disclosure of contracts acquired in business combinations. It is unclear where contracts acquired outside business combinations should be disclosed and why a separate disclosure of contracts acquired in business combinations is useful considering that in the case of a long term contract the acquisition may have occurred years ago.

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?

We struggle to understand why such disclosure should be useful for a contract with an original duration of one year that will be fully satisfied within the first month after period end while it is not useful for a contract with an original duration of 2 months that will also be fully satisfied within the first month after period end.

We believe that it is sufficient to disclose material unsatisfied performance obligations as far as they are unusual in size, nature or terms.

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 that a disaggregation of revenues into categories can provide useful information. We also agree that the categories should not be predetermined by the standard but rather reflect how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. The final IFRS should, however, clarify that an entity should chose the most appropriate categorisation to clarify that it is not required to provide multiple disaggregations based on different categorisations.



Effective date and transition (paragraphs 84 and 85)

Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance 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.

We disagree with the retrospective application and see such an approach as neither useful nor practicable for the following reasons:

- In certain industries such as technology and software, revenue recognition standards have a significant impact on how contracts are structured. When revenue recognition standards change fundamentally, it is not a valid assumption that contracts closed under the prior revenue recognition standards would have been structured in the same way under the "new" standards. Take, for example, a construction contract entered into prior to the new revenue recognition standard that does not meet the criteria for continuous transfer of control. Would the reporting entity have known the continuous transfer criteria at the time of entering the contract, the entity would have tried to negotiate and structure the contract in a manner that continuous transfer of control occurs? Going forward, the entity will structure similar contracts in that manner. Therefore the retrospective application of the new standard to the prior year's contract does not provide an indication on the entity's future revenues.
- A retrospective application can lead to prohibitive costs for the preparer with only limited (potentially even biased) information for users. Preparers would be required to perform, for a minimum of one year (two years in case of SEC registrants) parallel revenue accounting, (i) based on current standards and (ii) based on the new standards. Considering that revenue frequently are measures for employee compensation and other variable payments to third parties this would be a very complex and burdensome exercise. Additional cost would be incurred, for example, for audit fees because auditors would need to audit two sets of revenue accounting for the years of transition.
- In the light of the significant number of new IFRSs that are announced for 2010 and 2011, the accounting departments of preparers will have to manage accounting changes in within multiple areas, not only in the area of revenue. While the effective dates of significant new standards are subject to a separate project and not finalized, should the effective dates fall within a relative short timeframe, the implementation of multiple new standards will lead to significant additional efforts.
- For long-term contracts reaching several years back a re-assessment of all years affected would be required. The efforts of retrospective application would therefore not be limited to one or two years.

It will hardly be possible to make retrospective estimates regarding collectability, standalone sales prices etc without hindsight.



Overall, we recommend a prospective application of the new standard with further clarification on details of the transition technique and related implementation guidance (specifically for long-term contracts entered into in the past that reach into future periods).

Implementation guidance (paragraphs IG1-IG96)

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Please find our recommendations for additional or more specific applications guidance within our responses to specific areas. As the software industry is well known for complex revenue recognition challenges we recommend adding additional guidance that helps determine the appropriate accounting for areas of concern in the software industry.

We would also welcome implementation guidance on the requirement that a contract must be in place to recognise revenue. A significant amount of guidance exists on this question under current US GAAP and it is unclear in how far this guidance in applicable under the ED.

Scenarios in which the contract requirement is difficult to apply include

- explicit or implicit interim arrangements that are oftentimes entered into to allow work for a customer before the final arrangement is entered into,
- contract is substantially entered into at the end of a period (e.g. vendor sends contract to customer, customer signs and sends back to the vendor but vendor does not countersign until a few minutes after midnight of the last day of the quarter OR contract is entered into before period end but inconsequential changes are made after period end)
- reporting entity has transactions in different time zones (local midnight versus headquarter midnight as cut-off time)

With regard to individual paragraphs of the implementation guidance we have the following comments:

- We believe that the guidance in para B16 of the ED should be moved to the standard text because it expresses a principle.
- We believe that in para B26 of the ED it should say "at a price that is within the range of prices <u>typically charged to similarly situated customers</u> for those goods and services".
- We believe that in Example 7 a clarification is needed that the customer's option to renew is an enforceable right because without such enforceable right there would be no basis for allocating the joining fee to periods after the initial year.
- We believe that in para B35 is should say "when the customer is <u>entitled</u> to
 use and benefit from the rights" rather than the current wording "when the
 customer is able to use and benefit from the rights" because there may be
 multiple reasons why the customer has all rights to use the license but may
 not able to do so (e.g. hardware defect unrelated to the software).



- We recommend modifying Example 14 to clarify whether and how the impact of the time value of money has to be considered.
- We do not understand why B60 requests that for a customer to have obtained control of a product in a bill-and-hold-arrangement the customer must have <u>requested</u> the contract to be a bill-and-hold arrangement. Why should the determination depend on whether (i) the request came from the customer or (ii) the vendor offered it to the customer and the customer agreed?
- Example 15 should be expanded to explain the difference in accounting if there are no non-refundable progress payments.
- In Example 19 we do not understand the relevance of the fact that the contract does not have a large number of possible consideration amounts.
 Why should the accounting be different if there were a large number of possible consideration amounts?
- We believe that in Example 27 a clarification is needed that the customer's option to renew is an enforceable right.
- Example 31 refers to a software vendor who sells upgrade rights separately for at least one product. The example should be expanded to consider scenarios in which (a) the vendor does not sell any upgrade rights separately and (b) where the upgrade right is not granted for an entire product but only a single future functionality is committed to be delivered in a future upgrade that the customer receives under an existing support contract. Both are relevant scenarios that occur frequently in practice.

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 the proposed guidance it unclear whether an insurance warranty service is satisfied (i) continuously, (ii) upon repairs of faults, or (iii) at the end of the coverage period. We do not see any conceptual difference in the question of transfer of control between (i) insurance warranties, (ii) separately priced extended warranties, or (iii) in general, services that include a stand-ready to perform obligation.

We therefore recommend that the final IFRS provides guidance as follows:

- that for stand-ready-obligations mentioned in para 21(d) of the ED control is transferred continuously rather than at the times when the vendor provides products and services in fulfilment of its stand ready obligations
- that insurance warranty services fall under the guidance for stand ready obligations



Question 16: The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license 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 license; and
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license. Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

We concur with the ED's proposals regarding the treatment of licenses which are based on exclusivity of the license (i.e. a non-exclusive license is a single performance obligation which is satisfied as soon as the customer is able to use the license; and an exclusive license is a performance obligation that is satisfied continuously during the period in which it permits the customer to use the intellectual property).

However, for the assessment of whether a license is exclusive or non-exclusive, we recommend considering the concept of "giving up something" from the perspective of the entity, i.e. a license is non-exclusive when the entity does not give up any rights when a license is granted to a customer. E.g. a software license is non-exclusive if the number of additional licenses that the entity is allowed to grant is identical before and after the license grant. Here, the entity, by granting the license, does not give up something. Conversely, a franchisor granting the exclusive right to a franchise in a specific geography grants an exclusive license because the franchisor gives up the rights to a grant further franchise rights in that geography.

Consequential amendments

Question 17: The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial 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 with the proposal. However, we recommend that the final IFRS clarifies that the presentation of such gains or losses on the sale of some nonfinancial assets differs from the presentation of revenues. Particularly, the final IFRS should clarify that

- gains or losses on the sale of some nonfinancial assets are reported net
 while revenues are reported gross (i.e. in revenue accounting you record the
 full recognizable transaction price in revenue and separately record an
 expense (cost of goods sold) for the reduction in stock. In contrast, for the
 sale of nonfinancial assets you record the difference between the proceeds
 received and the book value of the asset in income or expense.
- Gains or losses on the sale of some nonfinancial assets are classified as income or expense, not as revenue.