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## Response to re-exposed ED Revenue from Contracts with Customers (ED/2011/6)

We appreciate the opportunity to respond to your request for comments on the re-exposed ED Revenue from Contracts with Customers. We limit our comments to what we think is pertinent to the construction industry.

Overall, our basic criticisms of the Revenue Recognition project, last put forward in our comment letter to the ED July 2010 remains. From a construction company's point of view the IAS 11 represents a well recognised and well experienced platform, which would have been suitable for taking on also additional demands on revenue recognition.

Credit should be given to the effort that has been put in place by the IASB to try to harbour the essence of present IAS 11 within the new standard. From that point of view progress has been made relative to the ED July 2010 version.

Nevertheless the fact remains, a user of the new standard now has to go into a set of rules contained in a huge package of some 130 paragraphs, 350 commenting paragraphs and 26 illustrative examples. Today the user of IAS 11 turns to an efficient booklet of 46 paragraphs and one illustrative example.

Add to that the difference in drafting, the "down to earth" language facilitating the understanding of IAS 11 in comparison with the new complex structure of terms and concepts that confronts the user of the ED.

We regret this development of complexity, and do question whether the efforts made, in the end, result in a higher quality of financial reporting. To our view much work remains to adjust and test for the operability of the standard.

### **IASB Question 1**

Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

We fully agree with the sense of the proposal of paragraphs 35 and 36. From a technical point of view however, paragraph 35 in its capacity as one of the key

paragraphs of the standard, presents a very complex structure and terminology for analysis. It would need further elaboration in order to meet practical operational purposes. The Boards will have to give even more attention to the issue of practicability than displayed so far, in spite of its different outreach activities during the present phase of the project.

Much is at stake when the Boards in their cost benefit analysis imply that present accounting models will have to be substituted for in a variety of cases. We expect the Boards to set the priority to fully elaborate and beforehand, in further cooperation with preparers, provide robust concepts and directives. We cannot afford to have a costly trial and error period of changing systems after the the standard is finalized. The standard to be must be thoroughly examined as to its practical consequences to preparers both in individual cases and to industries. We cannot have a situation where new requirements are set up, and then, due to shortcomings in the analysis, the requirements have to be reformulated. We strongly urge the Boards to pay respect to the situation of the preparers and take action for a specific trial and error period before the standard is being finalized and set for an effective date.

We also wish to highlight the conclusions drawn by Efrag (Comment Draft Letter issued 20 Jan 2012, paragraph 12 and 13.) where the ED enables that percentage-of-completion would be applied to sales of standard houses in circumstances defined. We share their understanding.

For your reference we quote the paragraphs in question:

12 For example, if an entity is constructing ten standard houses on its own land, a customer can agree to purchase a house to be constructed on a specific tract of land. By entering into such a contract, the entity would be prohibited from selling that house to someone else, unless the customer does not meet its obligations under the contract to pay the agreed consideration. As the contract is for a standard house, it would not allow the customer to specify major structural elements of the building. Accordingly, this contract would not be in the scope of IAS 11. When the requirements of IAS 18 for percentage-of-completion accounting are not met, current requirements therefore prohibit the use of percentage-of-completion accounting when constructing the house.

13 However, we understand that the ED would consider the construction of such a house as a performance obligation to be satisfied over time, provided that the entity has a right to consideration for the performance to date and the entity is expected to fulfil the contract as promised. This is because the proposals do not consider customisation of the house to be a deciding factor in determining if a performance obligation is satisfied over time, but rather consider whether it has an alternative use for the entity. According to paragraph 36 of the ED an asset would not have an alternative use to an entity if the entity at contract inception is unable, either contractually or practically, to readily direct the asset to another customer. Given the contractual restriction, the entity in the example above cannot sell the house to another customer. The house does therefore not have an alternative use for the entity and the performance obligation is considered to be satisfied over time.

## **IASB Question 2**

Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a

separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

We have a long experience from IAS 11. We have no understanding of any need for the additional complexity resulting from the paragraph 68 and 69 of the ED.

The principles-based guidance in IAS 1 is sufficient as it has worked appropriately in the past.

### **IASB Question 3**

Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

We agree with the principle.

### **IASB Question 4**

For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

We do not agree with the proposed limitation of scope. Nor do we agree with the requirement that the onerous test be performed at the level of the performance obligation instead of the one of the contract. In some cases, however, separate performance obligations that are purely sequential to each other (i. e. one cannot start until the other is finished) are practically, operationally, accounted for as two separate contracts. That could be the case in contracts where construction is succeeded by a performance of service and maintenance for a number of periods. In such sequential cases, onerous test would best be applied to the individual performance obligation.

We regard it necessary to take into the accounts the expected loss of any contracts. The restrictions introduced in the ED are contrary to this basic logic.

The ED statement in its present form also begs for a question. What are its effect on contracts now excluded from the requirement of accounting of an onerous obligation? Is the meaning that onerous contracts in this group do not need to or must not be accounted for?

## Question 5

The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports. The disclosures that would be required (if material) are:

- (a) The disaggregation of revenue (paragraphs 114 and 115);
- (b) A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117);
- (c) An analysis of the entity's remaining performance obligations (paragraphs 119–121);
- (d) Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123);
- (e) A tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

We think that interim financial reporting on revenue should not be subject to a subset of rules in other standards than the IAS 34 itself. Interim financial reporting disclosures on revenue should be guided by the general principle of IAS 34. It requires the entity to explain events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. We therefore fully support the view expressed by Efrag (Comment Draft Letter issued 20 Jan 2012, paragraphs 44 to 46).

For your reference we quote the paragraphs in question:

44 EFRAG acknowledges that revenue is an important figure and information about it should therefore be included in interim financial reports. However, we do not consider the list of specific requirements proposed in the ED to be in accordance with the principles underlying IAS 34 *Interim Financial Reporting*.

45 Currently IAS 34 paragraph 16A includes a list of only nine items for which disclosures should always be provided, if material. In addition, IAS 34 paragraph 15 requires an entity to explain events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. This information should provide an update of the relevant information presented in the most recent annual financial report.

46 EFRAG believes that the existing approach to disclosures in IAS 34 strikes the right balance between requiring information that is relevant to users and the costs to preparers. We are concerned that increasing the number of specific requirements would set a precedent that could lead to excessively detailed and unbalanced disclosure requirements for interim reporting which, among other things, could also affect the timeliness of this reporting. If the IASB is concerned

about the adequacy of interim reporting under IAS 34 then it should investigate that as part of a separate project on interim reporting.

The contents of the disclosure packet called for by the ED for the annual reporting is to our view very questionable, see our comments below.

### **Question 6**

For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

We agree with the principle.

## **Additional comments**

### **Disclosures**

We do not object to the stated overarching disclosures' objective of the ED "to enable users of financial statement to understand the nature, amount, timing and uncertainty of revenue and cash flows from contracts with customers".

However, we do not agree with the conclusions from this regarding the specific disclosure requirements of the ED. We find the demands too excessive to be useful. We primarily refer to the issues of the ED that are mainly addressing entities with long term contracts, such as the reconciliation requirements of contract balances and of onerous performance obligations.

As preparers of financial statements and a with long based experience of the financial markets we are very familiar with the demands of those markets on us. We are continuously acting on feed back from our market relations to secure the relevance of information provided. And, it has to be said, we are at the same time qualified users of financial statements as necessary part of our business development and financial planning.

From this experience we do not know of information requests similar to the reconciliation requirements of the ED. They appear very strange to us and we seriously question their relevance. They have no equivalent in our own internal reporting objectives or structure.

We want to put the Boards' attention to that the restructuring of reporting requirements inevitably carries very large costs. Especially so when related to large volumes of active projects counted in several thousands. Since we see no evident demand of information, no compensating value of disclosure output would come out.

We also recon that fixed reconciliation requirements contributes to bias the focus of attention from content to form, more adapted to the surveillance

authorities than to the users and preparers.

We suggest that ED paragraph 117 and paragraph 123 should be withdrawn in their capacity of a formal requirement.

### **Overlapping disclosure requirements**

ED paragraph 38 points out, quite correctly to our view, that as circumstances change over time, an entity shall update its measure of progress to depict the entity's performance to date. In practice the update is achieved by regular intervals during the full year. The effects of these changes shall be accounted for as a change in accounting estimate in accordance with IAS 8. From this follows the disclosure requirement of IAS 8 paragraph 39.

We think that the additional disclosure requirement ED paragraph 117 (a) (ii) of specific allocation changes in previous periods tends to overlap with that already stated by IAS 8. The ED paragraph 117 requirement is therefore questionable also from this point of view.

### **Waste materials & labour**

According to the ED paragraph 45 and 93, waste is a cost that qualifies to be immediately expensed. Conceptually, waste would represent activities that do not add to the value, or progress, of performance. We view the statements of the ED on this issue as trying to formulate an anti-abuse clause. Its purpose would be to counter what would be a gross premature representation of revenue by an entity, in indiscriminately applying increase of costs as a measure of progress.

Practially, operationally, the ED statement of waste is very problematic for several reasons. We think it is probable that the expression "abnormal waste", used by the previous ED July 2010, is closer to describe the character of an anti-abuse principle. However, the qualification "abnormal" highlights even more the basic generic ambiguity of the concept "waste". When is waste "waste" and not an inefficient use of resources with low or zero productivity during the course of the performance of a long term contract? To what degree does an observed excess of cost for example of direct labour in relation to the original cost estimate represent waste, and not represent the effect of insufficient labor productivity, or simply a necessary reality correction of an estimate error in the contract?

The ED provides no further information for guidance on the issue except for the qualification, see ED paragraph 45 and 93b, that waste as expense should relate to such waste that is not reflected in the price of the contract. However, we are not able to draw any operational conclusion from this statement.

Entities in the construction industry with revenue recognition based on percentage of completion based on costs know how to confront the fact that observed costs tend to deviate relative to the cost estimates. The entities do it on the basis that the cost deviation in its turn affects the update of the estimated total project cost. In that way it has a consequent impact on the net profit of the total revenue. Once that the proportions between total profit and

total cost are established, the degree of progress to date based on costs to date also provides the relevant figure for revenue to date. For all practical purposes "waste" as a cost in the project would have to be handled in the same way.

To observe the ED requirement of exempting waste from recognition of costs to fulfill a contract would, to our view, require an extensive development of additional data structure and data collection. A new design would be required in order to identify and process the due "waste expense" items. Those would, according to our way of interpreting the ED, have to be specifically excluded from the cost measurement base of the project.

We also would like to point out the practical requirements for the necessary project control and project monitoring and consequential feedback of experience for estimating forthcoming projects are that projects accounts are kept in a unified accounting structure for all relevant costs to the individual project. A cutting off of certain cost items or some elements of costs and directing them outside the unified project account is counter-productive. It adds to the complexity, with no compensating benefits.

From our own operational experience we see no need for a specific waste clause in the standard.

### **Uninstalled goods**

The ED paragraph 46, prescribes a specific accounting treatment of uninstalled materials. That treatment appears to us as part of the anti-abuse purpose we have commented on regarding waste above. Paragraph 46 indicates that in certain cases revenue from input of a good into a project should not be accounted for by its cost with add-on profit equal to the present profit margin of the project. Instead its revenue must not exceed cost until further performance of putting the good into the right place has been fulfilled.

However, we note that the paragraph is qualified by the criterium 'significant' in more than one aspect. The customer obtains control 'significantly' before receiving services related to those goods and the cost of the transferred goods is 'significant' relative to the total expected costs. We infer that the paragraph is aimed at situations of an extraordinary character from a construction project point of view. We find this character emphasized by the specific illustrative example to that paragraph. Our view is that with regard to the normal contents of performance in our project portfolio this paragraph very seldom will have to come into force.

Nevertheless, the implications of paragraph 46 for uninstalled goods are the same as the ones described above regarding paragraphs 45 and 93 on waste. We refer to the detrimental impact described above of cutting off certain costs from the unified cost accounting, whose structure designed for high efficiency of cost control and monitoring of the individual project.

We learn that a number of models for revenue recognition were identified by the staff during the preparations for the ED on this issue. At least three different models were presented for the Boards for its final choice. We believe that different performance requirements and different industry practice give rise to an even greater variety of relevant models than those three presented.

We strongly question the approach of the ED to prescribe one over-all model to reflect the momentous impact on revenue in those singular individual cases where a significant large "block" of input is added into the project. We propose instead that the standard should not be prescriptive on this issue, but instead indicate that explanatory information has to be provided.

### **Wrongful principle of cost corrections**

The instances described above, related to paragraphs 45 and 93 and paragraph 46 respectively fall into a broader category of corrections of the project cost accounting expected to take place before measurement of progress and revenue can be achieved. We describe this as a wrongful principle of cost correction in the case of the construction project.

Paragraph 46 states: "(W)hen using an input method, an entity shall exclude the effects of any inputs that do not depict the transfer of control of goods and services to the customer."

Moreover, paragraph 25 specifies certain restrictions to include certain activities in a performance obligation: "Performance obligations do not include activities that an entity must undertake to fulfil a contract unless the entity transfers a good or service to the customer as those activities occur." The paragraph cites the case of a service provider who may need to perform various administrative tasks to set up a contract. The paragraph indicates that since these tasks do not transfer a service to the customer at the time they are performed, they do not represent a performance obligation.

For the construction project environment the full practical implications of a such principle of cost correction are difficult to fully evaluate. During the whole proceeding of the project there are continuously a number of planning and coordinating activities related not to present day activities but to forthcoming future performance within the project. There are also activities supporting day to day functions of the site that represent transfer of service to internal site customers and resources and not to to the customer of the contract.

The practical implications also have to be evaluated against the general criteria of materiality of IAS 1. The outcome from a materiality test of paragraphs 25 and 46 in the typical project environment would generally be nil. In such a case the cost accounting unity on project basis would be preserved. However, to prevent potential areas of conflict regarding interpretation we require that the wording of the paragraphs cited above be rephrased for situations of extraordinary character. Example could be had from the model from paragraph 46 applying 'significantly' a threshold only for gross deviations to result in corrections of the projects cost accounting before progress measurement is achieved.

### **Effective date**

See our comments inserted under Question 1.



We are pleased to be at your service in case further clarification to our comments will be needed. We ask you to communicate to Mr. Peter Kindstrand, JM AB.

Yours sincerely,

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