Düsseldorf, 17 June 2009

Comment Letter from the German Construction Industry Association regarding the IASB/FASB Discussion Paper “Preliminary Views on Revenue Recognition in Contracts with Customers”

Dear Sir David,

The German Construction Industry Association (Hauptverband der Deutschen Bauindustrie) welcomes the opportunity to state its position on the proposals for the new revenue recognition regulations as outlined in the discussion paper “Preliminary Views on Revenue Recognition in Contracts with Customers”.

We have examined the board’s proposals from the perspective of the German construction industry against the background of previous experiences with existing standards. We would like to make some general remarks on the discussion paper in the form of the following commentary.

I. General remarks on the discussion paper

The existing regulations on revenue recognition as prescribed by IAS 18 and IAS 11, together with the interpretations IFRIC 12 and IFRIC 15 that are relevant for the construction industry, have proven their value for the German construction industry and have been applied for many years in the companies’ internal and external accounting. From a practical perspective, we therefore do not see the necessity to discard the existing standards on revenue recognition altogether and replace them with one single new standard, especially because this would require many companies to adjust their reporting and accounting structures. In individual cases this could lead to significant expenses that, in our opinion, are not offset by any additional benefit to the users of financial statements.
From a conceptual point of view it may be desirable to have a single revenue recognition concept for all types of contracts within all industries, as it would establish conceptual accordance with the framework.

A (typical) construction contract for construction companies differs from other contracts primarily in terms of the degree of influence the customer/client has on the provision of services prior to and during the construction works.

We interpret the planned method for revenue recognition for (typical) construction contracts set out in the discussion paper as follows: there is a continuous (in line with the stage of completion) effective transfer of control of the contractually promised asset from the construction company to the customer/client. This applies in particular, in our opinion, if the customer/client is able to specify the major structure elements of the design of the construction contract before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability).

An interpretation that differs from the one above, i.e. there is no continuous transfer of control of the contractually promised asset, would lead to a significant change in the present practice of revenue recognition at construction companies, with the result that, from an economic perspective, recognition of revenue from construction contracts for construction companies would be carried out too late and would therefore be inaccurate. Accordingly, the annual financial statements' purpose of giving its users decision-useful information would be restricted.

In this context we would like to refer to (Draft) Comment Letter, p. 3 of EFRAG: "As already mentioned, the proposal in the DP could result in a significant change to existing practice, with the recognition of revenue occurring much later than at present on some (but not all) construction-type contracts and service contracts. We think this would downgrade the decision-usefulness of the information provided to users of financial statements from existing requirements."

The material issues of our comments can be summarized as follows:

- We assume that the fundamental considerations on (partial) realization of profit that led to the percentage-of-completion method of IAS 11 specified again in IFRIC 15 should not be entirely reversed with the new approach. Rather, the assets-and-liabilities approach, too, in our opinion, allows for an economically correct realization of profit in case of a continuous transfer of assets.

- A proposed standard should therefore clarify the criteria/evidence that a (typical) construction contract for construction companies must present in order to assume a continuous transfer of control of assets. We will provide some example for this.

- Even those contracts where the transfer of the contractually promised asset from the construction company to the customer/client depends on parameters guaranteed by the contract or by facts which can only be proven at the end of the construction works are to be presented with a continuous revenue recognition, if the client/customer has decisive influence on the construction works.

- Accordingly, we are of the opinion that a written acceptance of construction works by the customer/client is primarily a formality and does not run counter to the continuous effective transfer of control of an asset from the construction company to the customer/client. Clarifying guidance on this matter should be included in the standard.
• Precedence of a uniform control approach over local legal framework must be ensured in order to guarantee uniform accounting throughout the Group in accordance with IAS 27.

• With regard to the regulations proposed in the discussion paper we would like to remark that contract variations are of significant importance in long-term contracts in particular, and should therefore be considered to a greater extent than has so far been planned in the discussion paper in (subsequent) measurement of rights and duties from the contract.

In light of the above issues, the present discussion paper seems, in our opinion, to be a basis for the conceptual implementation of the goal of establishing a uniform principle for revenue recognition based on the asset-and-liabilities approach. We have, however, a different opinion on some of the approaches or would wish for more detailed application guidelines. For more details please see the following responses to the individual issues raised in the discussion paper.

II. Answers to the questions of the Discussion Paper

**Question 1**

Do you agree with the boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Despite the opinion outlined in section I that from a practical perspective the German Construction Industry does not deem a change in existing regulations on revenue recognition to be urgent, from a conceptual perspective a single revenue recognition principle based on the asset-and-liabilities approach may be desirable, as it would establish conceptual accordance with the framework.

Closely linked to the assets-and-liabilities approach is the control approach dealing with the effective transfer of control of the contractually promised asset or the contractually promised services from the company to the customer/client. The construction business generally assumes a continuous effective transfer of control of the contractually promised asset from the construction company to the customer/client as stipulated by the IASB/IFRIC in IFRIC 15 for typical construction contracts within the meaning of IAS 11.

This corresponds to the board's statement in DP 6.18 also assuming that the approach for revenue recognition will not significantly change.

**Question 2**

Are there any types of contracts for which the boards’ proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

In the cases listed under DP 4.23 (continuous transfer of control; written acceptance by the customer is primarily a formality) as typical examples of usage for construction contracts in the construction industry, we assume that the application of the approach proposed in the discussion paper should lead to accurate and decision-useful information.
With reference to the construction industry, the approach proposed in the discussion paper leads, in our opinion, to economically inaccurate revenue recognition for those types of contracts where the transfer of control of the contractually promised asset from the construction company to the customer/client depends on parameters guaranteed by the contract or by facts which can only be proven at the end of the construction works (e.g. guaranteed power plant output or guaranteed product output).

In contrast to typical construction contracts in the construction industry, for these contracts (referred to as turnkey contracts in the following) the approach proposed in the discussion paper could lead to a situation that does not allow the assumption of a continuous transfer of control to the client, and where the entire contract revenue could only be recognized upon settlement of the final assessment of the critical parameters.

This approach would, in our opinion, not lead to decision-useful information and a fair presentation of the orders/contracts in the financial statements, as the customer/client has decisive influence on the construction works during the entire construction period; so in these cases, too, only continuous revenue recognition can reflect actual control and provide economically accurate information. These orders should be treated as typical construction contracts and recognized with continuous revenue recognition.

In those cases where there is either no customer-specific order or the client has no or merely insignificant influence on the construction works, recognizing revenue only on handover/acceptance leads, in our opinion, also from the perspective of the construction industry, to an economically accurate result in accordance with the concept currently stipulated by IFRIC 15.

**Question 3**

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We generally agree with the board's definition of a contract stipulated in DP 2.11, as we consider it applicable in and appropriate for the construction industry.

**Question 4**

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

We generally agree with the board's definition of a performance obligation suggested in DP 3.2. The DP, however, is not clear about the criterion underlying the definition of the scope of individual performance obligations (entire contract or separate contracts), so that the final standard should provide guidance on that matter.
Question 5
Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

We agree with the board that a company can separate a performance obligation resulting from a contract based on when the company transfers the promised assets. However, we do not see the necessity to separate a performance obligation resulting from a contract on the basis of when the company transfers the promised assets for the typical construction contracts in the construction industry, as we always assume a continuous (in line with the stage of completion) effective transfer of control of the entire contractually promised asset from the construction company to the customer/client.

In case the board intends to make separation obligatory in the proposed standard on revenue recognition, it has to be ensured that the resulting (analogous to DP 6.34) separate performance obligations reflect the units used for internal project control.

Question 6
Do you think that an entity’s obligation to accept a returned good and refund the customer’s consideration is a performance obligation? Why or why not?

We refrain from answering this question here, as it is of little relevance for the construction industry.

Question 7
Do you think that sales incentives (e.g. discounts on future sales, customer loyalty points and ‘free’ goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

We refrain from answering this question here, as it is of little relevance for the construction industry.

Question 8
Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

In our opinion a construction company transfer the control of an asset continuously (in line with the stage of completion) to the customer in a construction contract. Example 5 in Appendix A of the discussion paper shows, in our opinion, an appropriate form of presentation of transfer of control.

A continuous (in line with the stage of completion) effective transfer of control of the (partially) produced asset from the construction company to the customer/client prevails, when a customer/client has the possibility to make (significant) changes prior to or during the construction works. Evidence for that includes: Design supply, possibility for project control or construction monitoring by the customer/client, construction on the land of the customer/client etc.
To ensure this, the standard should – in accordance with the concept stipulated in IFRIC 15 – provide guidance (evidence/criteria) for contracts with a continuous effective transfer of control of a (partially) produced asset from the construction company to the customer/client.

In accordance with the board’s view in DP 4.23 we are of the opinion that a written acceptance by the customer/client (as stipulated by German law) is primarily a formality and does not run counter to the continuous effective transfer of control of an asset from the construction company to the customer/client. Clarifying guidance on this matter should be included in the standard.

Precedence of a consistent control approach over local legal framework must be ensured in order to guarantee consistent accounting throughout the Group in accordance with IAS 27. To this end and to facilitate international comparability of financial statements, the standard should not contain any regulations that could lead to differing revenue recognition as a consequence of different country-specific local legal framework.

This would result into different financial reporting of economically comparable matters, contradicting the principle of fair presentation of financial statements stipulated in IAS 1.15ff. There are contradictory statements so far in DP 4.18/4.19 and 4.23 concerning this matter, which should be clarified and unified within the standard.

**Question 9**

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

As already outlined in "General Remarks on the discussion paper", and comments to question 1, 2, and 8, it is our opinion that the proposed recognition of revenue only when a performance obligation is satisfied would provide decision-useful information only if construction contracts are presented as a continuous (in line with the stage of completion) effective transfer of the promised asset from the construction company to the client/customer and thus as a continuous satisfaction of the performance obligation resulting from a construction contract. This applies in particular, in our opinion, if the customer/client is able to specify the major structural elements of the design of the construction contract before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability).

If construction contracts would not be presented as a continuous transfer of control (continuous satisfaction of the performance obligation resulting from a construction contract) within the proposed revenue recognition model, the proposal would not provide accurate and decision-useful information, as recognition of revenue from construction contracts would be carried out too late and would therefore be inaccurate from an economic perspective.

**Question 10**

In the boards’ proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.
Question 10 (a)
Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

With reference to the arguments stated in DP 5.28 and 5.18 we agree that performance obligations should initially be measured at the transaction price.

Question 10 (b)
Do you agree that a performance obligation should be deemed onerous and re-measured to the entity’s expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

We do not agree that a performance obligation should compulsively be deemed onerous and re-measured to the entity’s expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation, as this approach would lead to an economically inaccurate result, if measuring the performance obligation led to recognising losses, but the entire contract itself was not classified as an onerous performance obligation.

Question 10 (c)
Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

We do not agree with the approach for subsequent measurement proposed in the discussion paper. To consistently implement the assets-and-liabilities approach proposed by the board, a revaluation had to be carried out in each annual and interim financial reporting date. Adjustment only in case of impending loss (onerous contracts) as proposed by the board in DP 5.39, in our opinion, infringes the principle of reporting date measurement.

With regard to the regulations proposed in the discussion paper we would like to remark that contract variations are of significant importance in long-term contracts in particular, and should therefore be considered to a greater extent than has so far been planned in the discussion paper in (subsequent) measurement of rights and obligations arising from the contract.

In the cases listed in the comments on question 2 (turnkey contracts) the proposed measurement approach also provides economically inaccurate information with regard to performance obligations. In case of these contracts, too, revenue should be recognized based on a continuous transfer of control to the customer.

Question 10 (d)
Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Provided mandatory application of reporting date measurement as discussed in 10 (c) we do not see the necessity for another measurement approach.
Question 11
The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

Question 11 (a)
Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity’s performance obligations? Why or why not?

We do not agree that contract fees charged to a customer/client should be taken into account in the transaction price of the initial measurement. Rather, these costs should be recognised as an expense in accordance with the board’s proposal, unless they give rise to a contract asset in accordance with IFRS.

Question 11 (b)
In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity’s financial position and financial performance? Please provide examples and explain why.

We are of the opinion that there are only few cases where the recognition of contract fees as an expense does not lead to economically accurate and therefore decision-useful information.

Question 12
Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity’s stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

We agree that the transaction price should be allocated to the performance obligation on the basis of the (calculated) stand-alone selling prices of the goods (assets) or services underlying the performance obligation.

Question 13
Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

We agree that if a company does not sell a good or service separately, the stand-alone selling price of that good or stand-alone service may be estimated for purposes of allocating the transaction price for initial measurement.
To avoid arbitrary allocation of income, the subjectivity of estimates should be limited by ensuring an appropriate and consistent approach for estimates of stand-alone selling prices, which are determined by the relevant specific parameters of the sector.

We would be pleased to answer any questions that you have or discuss any aspect of this letter.

Yours sincerely

Hauptverband der Deutschen Bauindustrie e. V.
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Prof. Dr. Ralf-Peter Oepen