



Mr Hans Hoogervorst Chairman of the International Accounting Standards Board 30 Cannon Street

London EX4M 6XH United Kingdom

Our Ref. Phone CTL/HDF +49-89-

+49-89-7445-4555

+49-89-7445-4874

Fax

E-mail

Crispin.Teufel@linde-le.com

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+49-89-35757-1587 +49-89 35757-1555 Hans-Dieter.Fladung@linde.com

Re: Revenue from Contracts with Customers November 2011

Comment Letter of The Linde Group

Dear Hans,

The Linde Group is a world-leading gases and engineering company with approximately 50,500 employees working in more than 100 countries worldwide. In the 2011 financial year it achieved sales of EUR 13.8 billion. We offer a wide range of compressed and liquefied gases as well as chemicals and we are therefore an important and reliable partner for a huge variety of industries. Our engineering division is successful throughout the world, with its focus on promising market segments such as olefin plants, natural gas plants and air separation plants, as well as hydrogen and synthesis gas plants.

The Linde Group is listed in the leading German share index (DAX) and prepares its consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. In 2011, revenues from our engineering division amounted to EUR 2.5 billion. Revenue recognition for long term construction contracts is hence very important for the financial statements and the financial performance of The Linde Group. We therefore appreciate the opportunity to comment on the Revised Exposure Draft Revenue from Contracts with Customers from an engineering industry perspective.

The Linde Group welcomes very much to have the possibility to comment on the IASB's Exposure Draft ED/2011/6 "Revenue from Contracts with Customers". We appreciate the efforts undertaken by the IASB and FASB to clarify the principles for revenue recognition and to develop a harmonized standard under both GAAP's. Furthermore we appreciate most changes being made after the comments made regarding the first exposure draft by all constituents. Our main concerns with the issues Re-ED are relating to the presentation of credit losses adjacent to revenue and also regarding the treatment of onerous contracts.



In the Re-ED you propose to present credit losses adjacent to revenue in the profit and loss statement. Even though we appreciate the change in approach to not treat credit losses as part of the transaction price, we still feel that a presentation separate from revenue is not appropriate. In many industries, customer credit risk is not part of the product pricing and therefore the impression of a net revenue figure including customer credit risk is not beneficial for these industries. Furthermore we are convinced that users of financial statements get a better insight if revenue is disaggregated in the notes and respective initial and subsequent customer credit risk effects are presented accordingly.

According to the proposal in the Revised ED it is our understanding that typical long-term construction contracts constitute bundles of promised goods or services which are treated as single performance obligation as those are always highly interrelated and significantly customized. Meeting the criteria in paragraph 29 the bundle would also comprise warranties. We welcome that those changes have been incorporated in the Re-ED. Anyhow, we are astonished that the respective paragraphs were not made subject to public comments. Therefore we want to point out here that the application guidance provided in B10, contains examples for circumstances in which warranties should be handled as separate performance obligation. It is our understanding that the standard precedes the application guidance. Nevertheless, there is a discrepancy between the standard and the application guidance which might cause confusion why we would appreciate further clarification in this regard.

Furthermore, you maintained your proposal on the treatment of onerous contracts and further included some limitations to this rule. From our perspective, onerous contracts would then be treated partly in the Re-ED, partly in IAS 2 and partly in IAS 37, which we deem not to be appropriate. We believe that onerous contracts should be measured on the level of a contract and should be treated in one single IFRS standard.

If you have any questions or remarks, please do not hesitate to contact us. We would be happy to discuss any of our comments with you at your convenience.

Yours sincerely,

Dr Hans-Dieter Fladung Head of IFRS Competence Center Crispin Teufel
Finance Director
Global Acc./Controlling/Tax



Appendix I: Answers to the questions raised in the ED

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?

This importance of this proposal should not be underestimated: in economies where the service sector plays the dominant role, this type of revenue recognition is by far the most important one. Having pointed out this, it is worthwhile to question whether a rule that ties revenue recognition to "control" which is basically something physical, is the right basic principle for revenue recognition. Those paragraphs show – to our firm believe – the superiority of the existing standard over the proposed new one. Except for .35(a), the proposed standard has to leave its basic principle "control" when it gets to terms of revenue recognition in the service area. The criteria used to work around "control" in the service area are virtually the same that currently apply for revenue recognition:

- The lack of alternative use aims at transition of "risks and rewards"; those pass over to the client with rendering of services if the service is specially dedicated to the customer; in this case service providers' right to receive remuneration is created
- The same applies for simultaneous consumption => nothing can be
- .35 (b) (ii) takes explicit reference to the benefits of the work that are transferred to the customer
- Right of payment as stipulated under .35 (b((iii) is the prototypical criterion out of risk an rewards: the service provider has fulfilled and there is no further risk of fulfillment.

Not to be misunderstood: we highly support the proposal to recognize revenue over time in case that an entity transfers substantially all risks and rewards of a service to the customer which usually tales place on a continuous basis when rendered over time. But we doubt that a basic principle that needs support from principles that it pretends to supersede is – conceptually – the direction to go.

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 highly appreciate that the Boards refrained from their proposal in the original ED to reflect a customer's credit risk in determining the transaction price of a contract. The new proposal in the revised ED does not affect the amount recognized as revenue and is thus basically a matter of presentation. We generally agree with the proposal that an entity would apply IFRS 9 to account for amounts of promised consideration that the entity assesses to be uncollectible due to customer's credit risk but disagree with the proposal to present uncollectible amounts of consideration as a separate line item adjacent to the revenue line item.



Instead we do not think that the users of financial statements will receive more decision useful information if the amount of customer's credit risk is considered in the costs as presented according to IAS 1 based on the functional cost approach and further explanations would be provided in the notes to the financial statements.

Furthermore, for reasons of clarity we suggest to not treat the topic 'collectability' in the section 'Determining the transaction price' but 'Presentation' as in accordance with the Revised ED it is a matter of presentation only.

Regarding the measurement of uncollectible amounts, we understand that current re-deliberations of the Board might consider the different nature of trade receivables (with or without a financing component) and therefore would not treat trade receivables under the "3-bucket approach". We believe that trade receivables are generally of different nature than other financial assets. This should be reflected in the accounting treatment. We would ask you to consider that in many industries customer credit risk is not priced in the selling price of a product as in the insurance and banking industry. Therefore we would ask you to consider a less complex approach for the measurement of customer credit risk in respect of trade receivables which takes into account the way trade receivables are priced and managed, the typically short-term character of trade receivables and the cost of system implementations necessary for corporate entities to obtain all required data for the "3-bucket approach".

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?

Generally, we agree with the proposal of constraining the cumulative amount of revenue recognized. We also appreciate that the Boards refrained from their original proposal to define the amount to which an entity is reasonably assured to be entitled as limit instead of the amount which can be reasonably estimated. Reason for that is that estimates involve significant management judgment which dilutes the comparability of financial statement information.

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 strongly disagree with the proposal that the onerous test should be conducted on the level of single performance obligations instead of contracts. The proposal may lead to the fact that losses are recognized for single performance obligations although the contract as a whole is still profitable which does not reflect the underlying economics of most transactions. This approach would neither reflect the way the customer views a contracted project (thus not provide decision-useful information) nor be consistent with the entity's internal management steering the business on the level of contracts rather than single performance obligations. As a consequence, a liability would be shown in the balance sheet which does not represent an actual liability for the entity, thus does not fit in the definition of a liability provided in the Framework which states that a liability is recognized in the balance sheet only when it is probable that an outflow of resources (...) will result from the settlement of a present obligation (...).

Generally, contracts for projects are negotiated as a whole meaning that it is possible that for strategic reasons some performance obligations have a negative profit margin while the contract as a whole is profitable. Conducting the onerous test at performance obligation level combined with the extensive disclosures required for onerous performance obligation is not desirable as it might provide information of a company's pricing strategies to competitors which are potentially not subject tot IFRS accounting rules leading to competitive asymmetries caused by accounting standards.

It is our understanding that construction contracts constitute a bundle of promised goods or services which are treated as single performance obligations as those are always highly interrelated and significantly customized. With regards to warranties and spare parts we would appreciate further guidance on whether those are to be accounted for as a separate performance obligation or as part of the bundle. We would be very much in favor of treating warranties and spare parts as part of the bundle because we are strongly concerned about conducting onerous tests on the level of single performance obligations (e.g. for warranties and spare parts).



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 (in the IASB exposure draft, see paragraph D19 Appendix D). The disclosures that would be required (if material) are:

The disaggregation of revenue (paragraphs 114 and 115)

- A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- An analysis of the entity's remaining performance obligations (paragraphs 119-121)
- 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)
- A tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfill 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 acknowledge that revenue is a highly important figure for the users of interim financial reports why certain information should be included therein. Question however is how much information should be provided in order to keep an appropriate balance between the benefits of such information for users and the time and costs for entities of preparing and auditing that information. We think that the latter outweigh the benefits of users why we disagree with the proposal to add the disclosures mentioned above to IAS 34. IAS 34 states explicitly that time and cost considerations should be taken into account when defining the content of an interim financial report.

In our opinion disclosure requirements in IAS 34 meet the information requirements of users while being reasonable in terms of time and costs for entities preparing interim financial reports why we consider the existing requirements sufficient. We fear that amending IAS 34 in regard to disclosures might only be the start of adding more and more requirements for interim financial reports neglecting the fact that their objective is to provide users with an update of the detailed disclosures provided in the financial statements only. More information is not always better as it does not necessarily add to decision-usefulness and might make it harder to decide which information is important and which not.

Generally, we object amending single parts of standards in course of other projects as it is easy to lose sight of the standard's actual overall objectives and scope. If the Boards are of the opinion that IAS 34 is in need of improvement we recommend to treat the amendments as separate project. Further, the Boards might consider whether it makes sense to define one disclosure framework instead of specifying disclosure requirements in each standard separately. From the perspective of entities this approach would facilitate the preparation of disclosures in financial statements and interim reports.



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 (in the IASB exposure draft, see paragraphs D17,22 and D26 in Appendix D). 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 appreciate very much the application of consistency of one set of principle based criteria for the recognition of revenue on the one hand and income from other disposal transactions on the other hand We are yet unsure of the complete repercussions of introducing the control principles in the transfer of non-financial assets, but feel that especially the link to IFRS 5 might cause some issues under the current proposals.



Appendix II: Additional Comments

Disclosures

It is our understanding that disclosures required by the Revised ED do not materially differ from those required by the original ED. Therefore, we would like to repeat our concerns raised in the comment letter on the ED issued in June 2010. It is our opinion that the proposed disclosure requirements are overly excessive. They neither present decision-useful information nor are they justified from a cost-benefit perspective. The reasons for our concerns are explained in more detail in the following:

The question is not if disclosure requirements will meet the objective to help users understand the amount, timing and uncertainty of revenue and cash flows. The question is whether the required information will influence decision making. We share the boards' view that it should be the objective to provide readers of the financial statements with relevant information that enables them to make their assessment of timing and amount of future revenue and cash flows. Anyhow, we doubt that the information required by the boards meets this objective since we believe that narratives within the notes are hardly taken into account by users.

Furthermore, we are convinced that the most important information – namely the information about recurring and non-recurring revenue – should be addressed on the level of the statement of comprehensive income rather than in the notes. This is primarily a matter of revenue segmentation and the correct reflection of the underlying business model. Narratives should in this context be used as a corrective of misunderstandings rather than as a pro-active instrument for principal, essential information.

In addition, the proposed guidance is not definitive enough and leaves too much room for interpretations for the entities leading to non-comparable information. The additional information will thereby burden entities with significant additional costs without improving the decision-usefulness of financial statement information.