

International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

Stockholm, 12 March 2012

## **Exposure Draft ED/2011/6**

# Revenue from Contracts with Customers

Representing preparers' point of view, the Swedish Enterprise Accounting Group (SEAG) welcomes the opportunity to comment on exposure draft.

In summary, we have the following views.

- We appreciate that the IASB has made a significant effort to improve the draft standard compared to previous exposure draft. However, we believe that some improvements can be made in order to achieve a high quality standard.
- We believe that the draft standard in some areas is not robust or clear enough. We
  therefore believe that there is a need for clarification and more guidance, e.g.
  regarding performance obligations satisfied over time and the identification of
  performance obligations.
- We support the proposals regarding consideration of variable amounts and the application of the standard on the transfers of non-financial assets that are not a part of entity's ordinary activities.
- We do not support the proposal regarding presentation of credit losses on trade receivables. We believe that those should be presented as operating costs.
- We believe that the test for onerous performance obligations should be applied to all performance obligations. We also believe that the onerous test should be made at the contract level, not at the performance obligation level.
- We believe that the IASB should allow for price allocation based on margins and not only on stand-alone prices.
- We believe that the proposed disclosure requirements are far too excessive, especially for quarterly reports.

We have answered the six questions raised by the Board. We also have added some other comments on issues that we believe are important to take into account in order to adopt a high quality standard.

#### **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 recognizes 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 have the following comments to paragraphs 35 and 36 in the revised ED.

The customer control criteria are not particularly relevant criteria for performance obligations satisfied over time. In reality the customer seldom has control, unless you start applying a very wide and blurry interpretation of control. What is said in paragraph 32; "Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset." is an indication of how far the IASB needs to stretch the definition in order to save the control criteria. This means that paragraph 35 (a) has limited relevance.

We are missing the time element as a criterion when satisfying performance obligations over time. Nothing in paragraphs 35 and 36 talks about time. This means that as long as for instance paragraph 35 (b) (ii) is satisfied the performance obligations are seen as satisfied over time although they may in fact be satisfied instantaneously.

Paragraph 35 (b) is good as a concept, but the qualifications (i), (ii) and (iii) makes it almost impossible to apply. We recommend to delete (i), (ii) and (iii) and just keep the first part: "the entity's performance does not create an asset with an alternative use to the entity." Such a definition is a very good reflection of how a typical performance obligation satisfied over time looks like in reality.

Paragraph 35 (b) (i) is not a common situation, except for service contracts. Paragraph 35 (b) (ii) is hardly possible to understand considering the wording "the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset (for example, work in progress) presently controlled by the entity." Let us assume that a ship is built over time at a ship yard. It makes sense to recognise the revenue over time considering the fact that the performance obligations are fulfilled over time. If the entity suddenly would stop any further construction on the ship, it does not make any sense that another entity could not benefit from the work already performed, at least as long as the ship can be moved to another dry dock at another ship yard. The current wording in paragraph 35 (b) (ii) makes it impossible to apply revenue recognition over time for e.g. ship building. When reading the latter part of BC 98 this becomes even more obvious.

Paragraph 35 (b) (iii) is not a very good reflection of how payments flow today. The use of advance payments, progress billing and payment upon final approval do not reflect the satisfaction of performance obligations as well as the IASB seems to think. This would result in entities having to renegotiate their contracts with customers just to satisfy IFRS

requirements. Would it not be more logical if IFRS defines how to treat existing contract models rather than to force the establishment of new contract models just to satisfy accounting requirements? We believe that in order to recognise revenue over time an entity should be reasonable assured of being entitled to payment if fulfilling the performance obligations in the contract.

We support paragraph 36, which seems to provide an option to overrule the qualifications in paragraph 35 (b) (i), (ii) and (iii). Is this the intention? If paragraph 35 (b) (i), (ii) and (iii) can be easily overruled by paragraph 36, why is there a need for (i), (ii) and (iii) in paragraph 35 (b)?

## **Proposal**

Due to the above comments, we recommend the IASB to replace the current paragraph 35 with a revised paragraph 35.

## Performance obligations satisfied over time

- An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognizes revenue over time if the following three criteria are met:
  - (a) the entity's work to satisfy the performance obligation involves a clear time element, meaning that the performance obligations cannot be satisfied more or less instantaneously and
  - (b) the entity's performance does not create an asset with an alternative use to the entity and
  - (c) the entity is entitled to payment if the performance obligation in the contract is fulfilled

Paragraph 36 can be kept as it is as an explanation of how paragraph 35 b) shall be interpreted.

As an example of the importance of the introduction of the time element in paragraph 35 a), let us assume that a customer orders a company logo from a manufacturing entity. The logo is to be cut out of massive aluminum. The production takes 4 hours. This is obviously an asset that has no alternative use to the manufacturing entity (unless it is sold as scrap) and paragraph 35 b) would be satisfied. But since the performance does not involve a time element, paragraph 35 a) would not be satisfied and it is instead a performance obligation satisfied at a point in time. If this time element is not included in the definition there is a clear risk that lots of performance obligations that just fulfills the requirement of "not creating an asset with an alternative use to the entity" would end up as being satisfied over time in the current wording of the revised ED, although they are in fact satisfied instantaneously.

Additional comments in relation to the question of identifying separate performance obligations

In paragraphs 23-30 of the ED, guidance is given for the identification of separate performance obligations. The principle is that an entity shall identify which goods or services (or which bundles of goods or services) are distinct and, hence, that the entity shall account for as a separate performance obligation. In paragraph 28 it is stated that, except as specified in paragraph 29, a good or service is distinct either if

- (a) the entity regularly sells the good or service separately; or
- (b) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer

The exception in paragraph 29 is that goods or services are not distinct, notwithstanding the requirements in paragraph 28, if both the following criteria are met:

- (a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- (b) the bundle of goods or services is significantly modified or customised to fulfill the contract

In the basis for conclusions, the identification of separate performance obligations is discussed to a significant extent. In BC 36 it is stated that the criteria in paragraph 29 were developed in response to feedback received largely from the construction industry, but the criteria are intended to apply to other industries and transactions with similar features. According to BC 36, for example, some software development contracts will similarly have promised products and services that meet the criteria in paragraph 29 and, hence, would be accounted for as a single performance obligation.

In the illustrative examples, there are two examples for how to interpret the ED. The first example (4) is on significant customisation of software, the other example (5) is on a contract to design and build a hospital.

Our impression is that the IASB put in the exception in paragraph 29 in order to address concerns raised mainly by the construction industry that construction contracts might have to be broken down into multiple performance obligations (nails and bricks). We understand those concerns. But the proposed solution raises questions about how to interpret what is "highly interrelated, a "significant service of integrating goods or services", and also when a bundle of goods or services is "significantly modified or customised". In BC 79 it is stated that the criteria in paragraph 29 are typically met when an entity uses goods or services as inputs into a single process or project that is the output of the contract. But it is also stated that a single process or project can comprise more than one phase, element or unit of output.

We find this somewhat confusing. Our concern is that the criteria for when the exception in paragraph 29 shall apply are not robust enough. Many goods or services provided in a contract are interrelated to each other and might require some degree of integration. Also, many bundles of goods and services might be customised to a varying degree in a specific customer contract, even if they can be sold separately by the entity. We therefore believe that

it would be helpful to further develop the guidance in order to avoid that contracts that from a business perspective today are viewed as multiple element contracts might be viewed as single performance obligation contracts.

#### **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?

As already stated in our comment letter to ED/2009/12, we prefer credit losses on trade receivables to be presented as operating costs rather than as revenue reductions. Presenting the amounts on a separate line item adjacent to revenues is not a good presentation model for all entities. We are concerned that this will add complexity for non-financial entities. We also question the need to present credit losses on receivables as a separate line item if such losses are not material.

We would also like to reiterate that subject to the entity's business model, the expected loss model is not always suitable for normal trade receivables. We agree with the view expressed in a recent IASB staff update that different accounting treatments would be appropriate for trade receivables with or without a significant financing component. We would recommend the incurred loss model to be the general rule, but with a possibility to use an expected loss model for trade receivables with significant financing components and for other cases where this fits with the entity's business model. We agree with the suggestion made in the staff update to allow a company to make a policy election to use the "three buckets impairment model" or a simplified model.

## **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.

#### **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 recognize 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?

We agree there should be a liability and a corresponding expense recognized for onerous obligations. However, an onerous test should be applied to all obligations satisfied over time and not only be subject to those exceeding 12 months. There should not be a difference if the obligation is 11 or 13 months. The recognition of the liability and expense should be treated according to the same principle. This would limit the practical problems that could arise as a consequence of obligations being delayed from being within the time limit to exceeding the time limit.

We do not agree with the view of performing the onerous test on a performance obligation level. Our assessment is that for a profitable contract as a whole there should not be any need for impairment for a part of the contract. Therefore we suggest that the onerous test should be performed at the contract level. This is in accordance with the existing principle of IAS 37 Provisions, Contingent Liabilities and Contingent assets, which is applied at contract level.

We also have difficulties seeing how an onerous performance obligation within a profitable contract could result in a liability for the company. It does not seem to be in accordance with the Framework's definition of a liability.

We disagree with the Board's argument that the onerous test on contract level would add complexity. This is what exists today. It is well understood and well-functioning. To perform the test on a performance obligation level would instead add complexity. It would also be inconsistent with a management approach and be difficult to understand not only for users, but also for preparers. It could also be added that this might be a cost-benefit issue. If the test required by the IASB does not match the test that the entity uses in the management of its operations, then the test will be performed doubly and this will lead to extra costs.

## Additional comments in relation to the question of transaction price allocation

The main principle in the ED is to allocate based on stand-alone prices (top-line allocation) without any reference to margins. According to the BC this "brings rigour and discipline". In a further comment, the boards are concerned that different cost treatments could affect allocation of revenue if a margin approach is applied. Only if stand-alone prices are not directly observed other allocation methods may be applied, estimating a stand-alone price but with no references to margins.

Discounts may, however, according to the ED be allocated to one (or some) performance obligations if certain conditions are met (if the price of some promised goods or services in the contract is largely independent of the price of other promised goods or services, see paragraph 74).

SEAG would like to make the following comments. It is our experience that industrial companies have standard cost allocation procedures that, among other aspects, are the basis for inventory valuation. Cost allocation is therefore not an area that can be used for "smoothing purposes".

In many entities different segments are according to IFRS 8 reported with the purpose to present size, profitability, performance etc. per segment. Since combined offers from different segments (performance obligations) are given to customers it is critical that the allocation between the segments/performance obligations fairly represents the economic substance of the customer contracts. Different segments and related performance obligations might have significantly different profit margins in a reporting entity. This should be reflected in IFRS principles for revenue allocation. By not reflecting differences in margins a correct picture is not given of revenue and margin per segment. By not taking margins into account this will also lead to an incorrect timing of total revenue and margin.

Under IFRS 8 entity specific principles can be applied per segment but that is impractical and confuses users in relation to the understanding of the reconciliation to IFRS in the entity total column that will be required. We therefore strongly recommend the IASB to reconsider a margin approach for revenue allocation purposes, at least in situations where it is obvious that normal margins differ between business segments. Such differences might be evidenced by reference to margins in different business sectors and those margins may serve as a kind of fair-value/third party evidence for different margins to apply for different performance obligations.

Discount allocation according to paragraph 75 would, if the defined conditions are met, result in an allocation that might be similar to an allocation that would be the result from the application of a margin approach. We would be happy to provide the IASB with further information if needed in order to enable the Board to develop a margin approach and a discount allocation model based on margins.

## **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:

- 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 recognized from the costs to obtain or fulfill a contract with a customer (paragraph 128).

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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 cost, please identify the disclosures that an entity should be required to include in its interim financial reports.

Our general comment is that it is essential that proposed disclosures should be based on general materiality principles and criteria as defined in IAS 1 and the present IAS 34. When considering the balance between benefits and costs of disclosures, we believe that the risk of information overload for users should be considered on the "cost side".

We have the following specific comments to the proposed disclosure requirements.

# Paragraphs 114 and 115

Present IAS 34 paragraph 16A (g) refers to segment reporting under IFRS 8. Our recommendation is that the link to IFRS 8 should be kept also in the future revenue standard. Our recommendation is that the IASB should not change IAS 34 paragraph 16A (g). The break-down per segment under present IFRS 8 and IAS 34 well meets the disaggregation need, both from an annual and interim report perspective. Paragraph 115 in the ED lists 7 categories as examples. Our view is that this is too much to present in an interim report.

#### Paragraph 117

As stated in our answers to questions 10 to 12 in our comment letter to the initial exposure draft on revenue, our view was then, and still is, that the disclosure requirements in general are too extensive. If disclosure should be given according to paragraph 117 it should only be made on a yearly basis in the annual report.

Some of the requirements are currently required to be disclosed, for example (b) cash received and (c) amounts transferred from/to receivables, based on presentation in the Cash Flow Statement. The other requirements would in most periods be so insignificant that a yearly disclosure would meet the needs of users.

#### Paragraph 119

This paragraph would require an entity to disclose order backlog and timing of revenue related to the backlog for contracts with an expected duration of more than one year. We have the following comments to this, regardless of yearly or interim disclosure.

## Renegotiations and cancellations

Long term contracts often become renegotiated due to requests from customers, resulting in the order backlog as per reporting date having in effect a lower value than present contract value. In practice, reported amounts would tend to be overstated. There are also examples of that a vendor has to accept order cancellations during a down turn.

## Expected duration

There are examples of service contracts that have lasted and will probably continue to last for many more years. Examples are retail companies leasing real estate in attractive areas of large cities. What is the value of disclosing an order backlog related to the coming decades?

We therefore propose that qualitative disclosure requirements are defined in IAS 34 in relation to significant changes of order backlog with such examples as the signing of large, new orders, significant renegotiations and terminations.

## Paragraphs 122 and 123

Our starting point here is that we do not agree that a profitable contract should identify onerous performance obligations. Even if we can understand that in theory an onerous performance obligation may be identified under a profitable contract this would appear to be illogical for a person not familiar with IFRS. An onerous performance obligation, identified under a profitable contract, is rather an indication that allocation principles need to be improved, please see our comments under question 4.

Assuming that a contract as a whole is onerous we agree that it should be disclosed. This should, however, be based on qualitative requirements as recommended by us in relation to paragraph 119.

# Paragraph 128

We have no specific comment.

## 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?

Yes, we 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.

## Additional comments in relation to asset recognition criteria

We recommend the Board to consider updating the asset recognition criteria in IAS 16 and IAS 38, ensuring reasonable alignment between revenue recognition (based on the new standard) at vendors and asset recognition at buyers.

# Other issues not covered by the six questions raised by the Board

## Accounting principles in relation to software

Revenue recognition is a complex issue for the software and technology industry. We foresee that technology development will become more complex in the future and this will affect also sales connected to related products and services. This creates new issues regarding revenue recognition. We have noted that important differences could arise between US GAAP and IFRS relating to the software and technology industry, which shows the need of more guidance from the Boards in this area. While we agree that the standard should be principle-based and not rule-based, we are concerned that a lack of guidance in the new revenue recognition standard might result in non-comparable and non-transparent financial reporting. This might lead to a situation where US companies will continue to apply the old US GAAP standard in the absence of other guidance.

#### Presentation of contracts

Contracts within the scope of the ED are described in paragraph 13 of the ED. There is guidance in article in paragraphs 104-108 for how contracts with customers should be presented in the financial reports. An important question is whether a contract with a customer gives rise to an asset or a liability at contract inception. This question is not clearly answered by the ED. According to BC 35, one could come to the conclusion that the answer in principle is that once the entity has entered into a contract that fulfills the requirements in paragraph 13, an asset and a corresponding liability should be shown in the balance sheet. An indication of this is that it is stated in BC 35 that the asset and the liability would offset each other, when the contract is wholly unperformed.

But this conclusion might be modified by reading example 17. Our interpretation of this example is that a contract with a customer would not in principle create an asset or a liability for the entity until one or the parties to the contract starts to perform. We therefore ask the IASB to clarify this issue in order to avoid confusion.

| We are pleased to | be at your | service in | case furth | er clarifica | ntion to ou | r comments | will be |
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| needed            |            |            |            |              |             |            |         |

Yours sincerely,

# CONFEDERATION OF SWEDISH ENTERPRISE

Dr Claes Norberg Professor, Director Accountancy Secretary of the Swedish Enterprise Accounting Group

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