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October 22, 2010

International Accounting Standards Board (IASB)
30 Cannon Street
London EC4M 6XH, United Kingdom

Comments on IASB Exposure Draft "*Revenue from Contracts with Customers*"

Nippon Keidanren pays all respect to the International Accounting Standards Board (IASB)'s effort to improve the accounting for recognising revenue. We also appreciate this opportunity to comment on the Exposure Draft "Revenue from Contracts with Customers" (ED). Also, the contents of the ED clearly show that the IASB has taken into account Japanese preparers' opinions expressed at the workshops held in Japan in November 2009 and April 2010. We appreciate these outreach activities by the IASB.

In Japan, various efforts toward IFRS adoption in 2015-2016 or early adoption beforehand have been accelerated, such as a study group to support the expected practice of IFRS application. In order to further gain momentum to introduce IFRS, it is necessary for the accounting standard to be feasible for practical use and acceptable for Japanese business community. We would like to continuously communicate with the IASB toward smooth adoption of IFRS in Japan.

Our comments are as follows.

Question 1

While we agree with the proposed principle, we request the provisions regarding contract segmentation to be modified.

Even in cases where a contract can be segmented, if performance obligations in the contract are appropriately identified, it is possible to properly allocate the transaction price and its subsequent changes to these performance obligations without segmenting the contract. Therefore, paragraph BC 38(b) is not valid as a basis for conclusions. Forcing a two-step process made up of segmenting a contract and indentifying performance obligations will unduly increase administrative burdens on preparers and place additional burdens on auditors.

Paragraph 9 states that "an entity shall consider those practices and processes in determining whether a contract exists." We appreciate this provision as it gives due consideration to the reality of corporate management.

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Question 2

We support the proposed principle for determining when a good or service is distinct, but request some modifications.

While the discussion paper published in December 2008 (DP) required entities to identify separate performance obligations, this requirement has subsequently been modified, incorporating the views of interested parties expressed at the IASB's outreach activities and other occasions and considering the reality of corporate management to a certain extent. We appreciate these IASB's efforts. In particular, the following four paragraphs seem to reflect the IASB's efforts to match a unit for revenue recognition with corporate management units: paragraphs BC56 and BC57, as well as paragraph 20 stating that "an entity shall evaluate . . . its customary business practice", and paragraph 22 stipulating that "in some cases, that would result in an entity accounting for all the goods or services promised in the contract as a single performance obligation."

Paragraph 23(a) contains the words "or another entity". As each entity has different management units to make use of its competitive advantages, the segmentation of performance obligations should not depart from the entity's management perspective. Hence, using another entity's units of sales as reference should be stipulated as an option, not as a requirement.

Similarly, regarding paragraph 23(b)(ii), even if a good or service has a distinct profit margin, performance obligations should not be segmented based on that profit margin if the margin does not accord with the entity's management units. We thus request that the phrase "a good or service has a distinct profit margin" in the paragraph be modified to the phrase "a good or service has a profit margin that is separately managed by the entity."

Question 3

Although we support the proposed guidance for determining when control of a good or service has been transferred to the customer, the guidance should be modified to some extent.

Paragraph 31 states that "not one of the preceding indicators determines by itself whether the customer has obtained control of the good or service." This provision makes it unclear how the indicators in paragraph 30(d) should be interpreted. It needs to be clearly stated that whether a customer has obtained control should be determined based on a comprehensive consideration of all the four indicators, not based on one of them alone. If this modification is made, current practices for contracts that meet the indicators in paragraph 30(d) will be maintained. Such practices include the percentage of completion method used for construction and custom-made software development contracts; and a method that recognizes transportation revenue proportionately as shipments move from origin to destination, used for ocean transportation contracts. We understand that at the Tokyo outreach held in August 2010, the IASB also pointed out the necessity to revise paragraph 31. We expect that this issue be addressed in that manner.

In Appendix A, a performance obligation is defined as "an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer." In the case of contracts contingent upon success, it can be said that although the entity's performance obligation has not been satisfied until the successful completion of the consigned task, the entity has the obligation to implement the task so

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as to succeed. It is not clear how this type of contracts should be treated under the ED. We request that the treatment of contracts contingent upon success be clarified.

Question 4

We oppose the proposal that the transaction price should be determined using the probability-weighted amount of consideration the entity expects to receive from the customer.

It is impractical for both preparers and auditors to create multiple scenarios and to estimate and verify the probability of each scenario. In addition, as there remains the room for manipulation in the calculation process of probability-weighted value, the objective of eliminating arbitrariness will not be able to be achieved. Furthermore, the transaction price determined using probability-weighted amounts does not reflect the cash flows that are expected to be actually received, and thus will not be useful for management and users. As with the current practice, revenue should be recognized based on the entity's best estimate.

Question 5

We oppose the proposal that the transaction price should reflect the customer's credit risk.

Any entities engaged in rational business activities, as a matter of course, conclude a contract with the customer on the premise that the consideration of the transaction is certainly collected. At the same time, under a contract, the customer acknowledges that it is obligated to pay the contracted amount. Hence, it is impossible for corporate management to accept the proposal that revenue should be recognized in an amount different from the contracted one. Credit risk should be assessed within the framework of receivables, not as part of revenue recognition. In entities, the sales department and risk control department are separated, and an IT system for revenue recognition and that for credit management are generally independent of each other. Our comment is consistent with these corporate practices.

Paragraph 43 stipulates that "once an entity has an unconditional right to consideration (ie a receivable as described in paragraph 66), the effects of changes in the assessment of credit risk associated with that right to consideration shall be recognised as income or expense rather than as revenue." This implies that when there is a difference between the initial estimate of credit risk and the actual amount received, the difference would be recognized as revenue prior to obtaining the unconditional right, but once such right is obtained, it would be recognized as income or expense rather than as revenue. We regard such treatment inconsistent.

Question 6

We agree with the proposal, but request a modification.

Paragraph 45 stipulates: "The effect of the time value of money is not material to many contracts. However, the effect is material to some contracts because payment from the customer is due either significantly before or significantly after the transfer of goods or services to the customer." At the same time, paragraph BC105 states: "The boards . . . decided to require management to use its judgement to assess whether the effects of the time value of money are material to the contract. The boards observed that the time value of money could be material for short-term contracts with high

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implicit interest rates and, conversely, may be immaterial for long-term contracts with low implicit interest rates.” Based on these provisions, we understand that there may be some transactions to which the effects of the time value are immaterial, regardless of the fact that the payment is due significantly before or after the transfer of goods and services. In order to clarify this point, the contents of paragraph BC105 should be included in the main text as well.

Question 7

We support the proposal, but request a modification.

Paragraph 51 stipulates that “a contractually stated price or a list price for a good or service shall not be presumed to represent the stand-alone selling price of that good or service”. Take, for example, an order-based transaction according to customer-specific requirements. In such a transaction, the good or service is highly unique and has no market to refer. It should be clarified that in cases like this, the contractually stated price may properly represent the stand-alone selling price.

Question 8

We think that the proposed requirements on accounting for the costs of fulfilling a contract are basically operational.

Paragraph 59 includes the costs of “bid and proposal” in the “costs of obtaining a contract”. However, we believe that the costs of pre-order planned design tied to the construction contract (bid and proposal), for example, may fully satisfy the conditions set out in paragraph 57. Thus, it should be clearly stated that the “costs of obtaining a contract” may be recognized as an asset if it meets the conditions in paragraph 57.

Question 10

If costs to preparers and auditors could be totally disregarded and the information could be accurately disclosed, the IASB's objective might be achievable. Nevertheless, we oppose the proposed disclosure requirements as they are unduly excessive.

In order to prepare a reconciliation of contract balances, accounting systems need to be redesigned, which would place a huge burden on preparers. In fact, paragraph BC177 acknowledges the difficulty in presenting contract assets and liabilities on a gross reconciliation basis. It is regrettable that, in spite of such acknowledgment, the boards instead decided to require the disclosure of a net reconciliation (paragraph BC178). Even if “the boards understand that users are mainly interested in a gross reconciliation,” the disclosure requirements that are difficult to meet should be abandoned. Furthermore, as it cannot be said that a net reconciliation will provide useful information, we strongly oppose the proposal.

Paragraph 77 requires an entity to disclose detailed information about its performance obligations. However, given the wide variety of performance obligations to be fulfilled by entities, we doubt that such disclosure will be useful.

Question 11

We do not agree with the proposed disclosure requirement.

The expected timing of satisfying performance obligations is generally uncertain, and it is difficult to eliminate the room for arbitrariness in determining such timing. Thus, the reliability of such kind of disclosure will be questionable. In addition, since

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current accounting systems are incapable of capturing performance obligations as accounting information, huge system development costs will be required to fulfill the proposed requirement.

Question 12

We do not agree with the disaggregation of revenue proposed in paragraph 74, as we believe that current disclosure of segment information is sufficient as detailed revenue information.

Question 13

We oppose retroactive application.

Revenue recognition is an issue that affects the basis of corporate management, and the retroactive restatement would require vast amounts of data to be managed in a duplicate manner. Especially in the case of long-term contracts, it would be very difficult in practice to retroactively apply the new standard to prior years. We request due consideration so that the proposal shall be prospectively applied.

Question 14

The Application Guidance in Appendix B states at the very beginning that “this appendix is an integral part of the [draft] IFRS.” In order to preclude corporate practices from being excessively bound by the examples therein, it should also be clarified that these examples are provided for illustration purposes only.

Paragraph B22 provides five indicators to determine whether the entity acts as an agent or principal. We are concerned that since there are numerous forms of businesses and there are diverse business models as exemplified by trading companies, entities may find it difficult to make judgments when they meet some of these five indicators (in some case, only one or two) but not all. For that reason, we request confirmation that as IFRS is principle-based, individual entities are allowed to make comprehensive judgments on a transaction-by-transaction basis, considering the importance of each indicator and assessing accordingly their fulfillment of the indicators.

Question 15

We believe that the proposed distinction between the types of product warranties is inadequate, and that product warranties should be accounted for as an allowance for warranty expenses.

An entity examines its products before shipping them to ensure certain level of quality, and thus does not recognize that there exist the remaining performance obligations at the time of shipment. Even if a product has a defect, it is appropriate to consider that the entity has fulfilled its performance obligations as the customer had enjoyed the product’s benefits until the defect was found. A warranty that covers defects or faults occurring after the transfer of a good or service to the customer does not constitute a separate performance obligation, and as with the current practice, should be accounted for as an allowance for warranty expenses.

Recognizing product warranties as revenue, per se, contradicts actual business practices. Entities are supposed to make every effort to reduce warranty service costs resulting from defects and faults. Recognizing warranties as revenue may, however,

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prompt entities to do the opposite, i.e., to increase warranty service work.

Furthermore, it is very difficult in practice to distinguish latent defects from faults that arise after the product is transferred to the customer. Also, as a warranty accounts for only a very small fraction of the product's selling price, separately recognizing revenue for it will require complex work compared with its proportion and be impractical.

Others

1. Paragraph 12 of IAS 18 stipulates that “when goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue.” However, the ED does not have this provision, and stipulates in paragraph 6 that the new standard will not apply to “non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (for example, an exchange of oil to fulfill demand on a timely basis in a specified location).” If this ED's provision is adopted and the exchange referred to in IAS 18 is excluded from the scope of the new standard, it will become uncertain how this type of exchanges should be treated. We request that the contents of paragraph 12 of IAS 18 be included in the new standard.

2. We do not agree with the proposal concerning onerous performance obligations in paragraphs 54 to 56. If two or more contracts are deemed to be a single contract, the contracted amount of consideration of goods or service in one contract and that in another contract are interdependent. The general corporate practice is thus to conduct management on the deemed single contract basis, not a performance obligation basis. There is a risk that the proposed provisions may conflict with actual business practices. We request that contract-based accounting for onerous performance obligations be permitted in addition to performance obligation-based one.

3. According to paragraph 86, IFRIC 18 Transfer of Assets from Customers is scheduled to be abolished when the new standard comes into effect. However, it is not clear how the contents of IFRIC 18 have been incorporated in the ED. If the paragraph means that IFRIC 18 will be effectively abolished, explanations on such abolition should be provided. If the paragraph means otherwise, the new standard should incorporate the contents of IFRIC 18 regarding the transfer of assets from customers.

4. Example 13 refers to the risk coverage of loss during transit. We do not think that an element like this which does not have its own profit margin can constitute a separate performance obligation. Revenue should be recognized on the basis of each performance obligation that involves one-off or continuous transfer of control. We therefore do not support the proposal that an entity should recognize part of the revenue excluding the risk of loss, even if the proviso of “subject to materiality” is added.

5. The ED does not have any provisions regarding transactions denominated in foreign currency. As they are an important issue that directly affects accounting practices, we request that necessary measures be taken to prevent any disturbance to business activities.

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Sincerely,

Nippon Keidanren
Business Infrastructure Bureau