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Der Standardisierungsrat

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Sir David Tweedie
Chairman of the
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30 Cannon Street
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Berlin, 22 October 2010

Dear David,

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft ED/2010/6 'Revenue from Contracts with Customers' (herein referred to as 'ED'). We appreciate the opportunity to comment on the ED.

The GASB appreciates the efforts of the IASB and the FASB to develop a standard that uses a single revenue recognition approach for all transactions. As already stated in our comment letter on the Discussion Paper 'Preliminary Views on Revenue Recognition in Contracts with Customers', we disagree with an approach based on satisfaction of performance obligations. Instead, we prefer a continuous approach under which revenue is recognised continuously over the course of the contract as work progresses, because such an approach provides more decision-useful information to users of financial statements about the activity and performance of the reporting entity. However, we understand that the proposals in the ED follow the basic principles already set out in the Discussion Paper. Hence, we will focus our comments on the questions raised in the ED and not constantly repeat our general disagreement.

Having said this, we believe that the proposals have to be assessed whether they represent an improvement compared with the current requirements in IAS 11 and IAS 18. Taking into account all the concerns mentioned below, the GASB comes to the conclusion that this is not the case. Therefore, we are of the opinion that IAS 11 and IAS 18 should be retained.

The GASB is concerned that the proposed concept of control might place too much emphasis on the legal structure of transactions resulting from contracts with customers rather than considering the economic substance in an adequate manner. From this perspective, we believe that a continuous transfer of control might in practice take place in significantly fewer cases than intended by the Boards.

In regard of control being the single criterion in this ED we notice inconsistencies with ED/2010/10 *Leases*. The ED *Leases* uses both a 'control' and a 'risks and rewards' approach in determining whether a contract represents a sale or a lease.

We have also concerns regarding the identification of separate performance obligations as in our view the principle of 'distinct' goods or services is unclear, the criteria developed are impractical and some of the examples in the application guidance are confusing rather than helpful. We agree with a necessary differentiation between 'quality assurance' warranties and 'insurance' warranties as the latter represent a separate performance obligation. While acknowledging the challenge to adequately draw a line, we anticipate major difficulties in practice with the proposed distinction.

The GASB generally agrees with considering variable consideration in determining the transaction price but sees several difficulties. In this context, we wonder why the proposals in the ED assume that a reliable estimation of a stand-alone selling price would always be possible whereas this would not always be the case for estimating variable consideration included in the transaction price.

Furthermore, we believe that the proposed disclosure requirements are overly excessive which raises doubts whether the proposed new revenue recognition model can be regarded as being superior.

Finally we agree with the rationale for proposing full retrospective application but question if the desired comparability can really be achieved as we assume that the new requirements will result in adjusting future contracts with customers. Thus, retrospective application will result mainly in a huge burden for entities with numerous construction contracts currently accounted for under IAS 11.

Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix

Question 1

Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether.

(a) to combine two or more contracts and account for them as a single contract;

(b) to segment a single contract and account for it as two or more contracts; and

(c) to account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

The GASB agrees that price interdependence is an important factor in determining whether to combine two or more contracts or to segment one contract into several components. However, using price interdependence as the only criterion may lead to cases, where two or more contracts with independent prices are treated as separate contracts, even though economically they represent one contract due to other contractual agreements (e.g. one element is essential for the other).

We also think that the application of this principle to master agreements is unclear, i.e. whether the master agreement itself or the actual exercise represents the contract, as only the latter results in a transfer of a good or service while it may be executed without further negotiation. Additional questions arise when the customers calls up goods or services under the master agreement and at the same time enters into another contract to purchase additional goods or services from the entity.

Regarding the treatment of contract modifications we anticipate difficulties in practice determining whether the prices of the existing contract and the contract modification are interdependent. In this context, it is our impression that Example 2 in the application guidance does not clearly depict the underlying principle.

Question 2

The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

The GASB has strong concerns with the proposed notion of 'distinct' for identifying separate performance obligations because the criteria for this concept of distinction are ambiguous. The examples in B41 and B42 are not consistent with the principle set out in par. 23 of the ED. In Example 9 in B41 the installation service is distinct because it could be performed by other entities in the industry, while in Example 10 in B42 the licence is not distinct because it has no distinct function without the research and development services, which are not sold separately – however, if comparable services were sold separately by other entities, the licence would have a distinct function. This poses the question whether the entity has to inquire if a good or service is actually sold separately by another entity (in the same market, the same country or worldwide?) or is it sufficient if there is a hypothetical possibility that another entity could sell the good or service separately. We believe that this explicit reference to other entities is problematic. Current requirements in US GAAP focus on whether a good or service would have stand-alone value to the customer. Within this approach the fact that another entity sells a good or service separately is only an indicator suggesting that this good or service could have stand-alone value to the customer. To our knowledge, this approach has not resulted in significant application problems in practice. In our view, adopting this approach, i.e. a good or service is distinct if it provides stand-alone value to the customer, appears to be a superior way to define practical criteria for the concept of distinction.

We agree that on the one hand the proposals should not result in the identification of innumerable single performance obligations, e.g. in the case of construction contracts or complex service contracts. On the other hand, we do not believe the rather simple example in B43 covers all instances. Thus, in practice an entity has to review all various tasks included in the contract to aggregate those into separate performance obligations sharing similar risks and/or profit margins, which would be a challenging burden for entities with large complex contracts. We believe that using the approach of ‘stand-alone value to the customer’ can help here too as it would avoid separation of elements in many instances.

For two reasons the GASB disagrees that for revenue recognition purposes it is only necessary to identify separate performance obligations if the promised goods or services are transferred to the customer at different times:

- For classification purposes it may well be necessary to separate performance obligations even if they are delivered in the same period. The ED itself and IFRS 8 require disaggregation of revenues into categories (e.g. IFRS 8.32: revenue for each group of products or services). These disclosure requirements can only be met if performance obligations are separated even if delivered in the same period.
- The ED requires the onerous test to be performed on the level of the individual performance obligations. Such onerous tests on the level of the individual performance obligations can only be performed if revenues are allocated to the individual performance obligations regardless of whether they are delivered in the same period or different periods.

Question 3

Do you think that the proposed guidance in paragraph 25-31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

The proposed concept of control transfer – especially if the indicators listed in par. 30 of the ED are taken into consideration - seems to set the focus on the legal structure of the transactions resulting from contracts with customers. We see the risk that this might result in the economic substance not being taken into account in an adequate way.

In addition, we have noted inconsistencies in the underlying principles between this ED and the Exposure Draft ED/2010/9 *Leases*. In contrast to this ED, the ED *Leases* in par. 8 (a) uses both a control and a risk and rewards approach in determining whether a contract represents a sale or a lease. From a conceptual standpoint, such inconsistencies should be avoided.

Another general point of concern we have is whether this principle of transferring control to the customer is suitable for services and intangible assets at all.

The GASB acknowledges the intention of the Boards to retain the percentage of completion method when the goods or services are continuously transferred to the customer, i.e. the customer owns the work in progress while it is built or developed. However, we believe that the legal environment in some jurisdictions (as in Germany) will often prevent such successive transfer of control in practice. This is caused by the fact that for many such contracts defined under the German Civil Code the indicators listed in par. 30 of the ED would not be met, except for the indicator (d) (customer-specific design or function). During the execution of the contract the customer has no unconditional obligation to pay. The customer obtains legal title not until the work is finished and approved or accepted by the customer. The customer does not get physical possession before the work is completed likewise. As a result, revenue could only be recognised if meeting indicator (d) alone is sufficient to assume control transfer. If meeting indicator (d) alone is not sufficient revenue recognition would be based on a jurisdiction's legal rules and regulation rather than based on the economic substance of the construction contract. Similar problems occur with certain service contracts, e.g. audit of financial statements, including the issuance of an auditor's long-form report, where the work is not completed before handing over the report. Furthermore we wonder whether, as a consequence of the proposal, the customer would have to recognise a corresponding work in progress asset reflecting the continuous control obtained. To our understanding, that is not intended.

While par. 30 (d) of the ED, if applied in isolation, would oftentimes allow percentage of completion revenue recognition it appears to follow a different concept than the other indicators as it does not deal with the actual transfer of control but with facts and circumstances that make it "likely that the entity would require the customer to obtain control". Thus is appears to look at the probability of a future transfer of control.

We acknowledge the Boards' intention to develop a revenue recognition standard that only uses one revenue recognition approach. We do, however, believe that the Boards' decision to rely on the critical events approach (i.e. revenue recognition upon delivery) and the Boards' intention to retain - under the critical events approach - the percentage of completion method can hardly be aligned without severe conceptual inconsistencies. As already noted in our comment letter to the IASB's Revenue Recognition Discussion Paper and the PAAinE Discussion Paper on Revenue Recognition, the GASB believes that the continuous approach under which revenue is recognised continuously over the course of the contract as work progresses is the superior approach in a revenue recognition standard that intends to only use one revenue recognition approach. As a second best solution we would prefer retaining the current models of IAS 11 and IAS 18 which use the continuous approach for construction and service contracts and the critical events approach for all other transactions. While we are aware that it is in some instances difficult under IAS 11 and IAS 18 to determine which of the two models are to be applied we believe that the ED's approach results into very similar difficulties in the determination of whether control is transferred continuously or not.

Question 4

The boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

The GASB generally agrees that a variable consideration should only be considered in the transaction price as far as it can be reasonably estimated. We believe that the hurdles included in the proposal are sufficient to prevent an overstatement or premature recognition of revenue by applying overly optimistic estimates. However, we are concerned by the proposed approach to recognise variable considerations based on probability-weighted amounts. Let us assume that an entity can reasonably estimate that it will receive an additional consideration of CU1,000 with a 20% probability, while it is 80% probable that it will not receive any consideration. According to the proposals in the ED, the entity would recognise additional revenue in the amount of CU200, even though it is more probable than not that it will not receive anything and therefore would be forced to adjust revenue in the following reporting period. We believe that such accounting would only provide useful revenue numbers if the reporting entity has in the same period a large number of similar transactions with similar terms on contingent consideration. We doubt that this is the case in most instances in which variable considerations are agreed upon. We therefore think that a best estimate approach would result in more adequate accounting for contingent considerations.

We would like to further point out a possible unintended interaction of the ED with the measurement requirements in IAS 39 or IFRS 9. According to par. 41 of the ED an entity shall not recognise a variable consideration as long as it cannot be reasonably measured. As soon as the entity has satisfied all of its performance obligations under a contract, any amounts outstanding to be received by the entity will meet the definition of a financial asset which apparently falls under the scope of IAS 39 or IFRS 9 (explicitly stated in par. 66 of the ED). If the outstanding amount of consideration is still variable at that point in time, the result is that the measurement proposed in the ED is likely to be different from the fair value as required on initial recognition under IAS 39 or IFRS 9. It is our understanding that it is not intended to exclude those variable considerations from the scope of the revenue standard. Thus, we believe that corresponding clarification or application guidance is necessary.

Inconsistencies with IFRS 3

Finally, we would like to mention a more general point. The ED requires considering variable considerations only when they can be reasonably estimated while IFRS 3 includes no exceptions for contingent considerations at all. We disagree with such inconsistent assumptions in different standards and recommend including congruent guidance for variable considerations that cannot be reliably measured in IFRS 3.

Question 5

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather then *whether* the entity recognizes revenue? If not, why?

The GASB generally agrees with the proposal to consider the customer's credit risk as part of the overall principle of reflecting variable consideration in the transaction price, because in line with the IASB – we believe that an entity shall only present the amount as revenue that it expects to receive. As a consequence, all differences between expected and actual amounts represent revenue as well. However, we agree with the proposal in par. 43 of the ED to recognise effects of changes in the assessment of credit risk as income or expense rather than as revenue once a contract asset becomes a receivable as set out in par. 66 of the ED.

We believe that including the customers' credit risk on a probability-weighted basis is only conceptually sound if the population of similar transactions in one period is large. We do not believe that this is always the case. We therefore believe that credit risk should be considered on a best estimate basis. Such approach would also be closer to current practice and may need less IT system and process adjustments to be implemented by the preparers, particularly to reconcile the invoiced amounts to the amounts recognised as revenue. Therefore, we would prefer a best estimate approach and the possibility to use a portfolio method where adequate (e.g. large number of homogenous customers).

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

The GASB generally agrees with the proposal to adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Nevertheless, we have doubts that all entities will be able to easily determine the discount rate “that would be reflected in a separate financing transaction” as proposed in B82 because many if not most entities subject to the revenue recognition standard simply do not enter into separate financing transactions with their customers. We would like to suggest introducing a practical expedient as a fall-back option for these entities unable to determine a customer-specific discount rate.

Par. 44 of the ED requires time value of money adjustments only if “the contract includes a material financing component”. We believe additional clarification is needed in this context, because materiality in IFRSs generally relates to the financial statements as whole but we do not believe that time value of money should only be considered if the financing component of the individual contract is material to the financial statements taken as a whole. We suggest that the standard uses the term ‘major’ financing component and that it provides additional guidance on how to determine whether a financing component is major.

In addition, we would like to propose to clarify the presentation requirements in par. 45 of the ED. As currently written, par 45 requires presentation of the financing effect “separately from the revenue from goods and services”. We believe the standard should clarify that the financing effect is to be presented as interest income or expense rather than as a separate item within revenue. Such explicit guidance would bring the requirements in the standard in line with example 22 in B84 of the ED which we think is appropriate.

Question 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

The GASB agrees with the proposal to allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling prices of the good or service underlying each performance obligation. We also agree that if a stand-alone selling price is not directly observable, an entity shall estimate it.

We do, however, not agree with the ED's assumption that standalone sales prices are always estimable. We believe that there are circumstances in which a stand-alone selling price cannot be estimated reliably, neither based on the pricing of similar products or services (which may not exist) nor based on cost-plus-margin calculations which, for instance, do not provide adequate price estimates when the to-be-sold good is an intangible or other product the production of which does not result in significant direct cost.

The GASB, therefore, believes that standalone selling prices should only be used for allocation of the transaction price if they are reliably estimable. Consequently, additional guidance is needed on how to allocate the transaction price to the individual performance obligations if the standalone transaction price of one or more performance obligations is not reliably estimable. We believe that for scenarios in which the standalone sales price of only one performance obligation is not reliably estimable the future IFRS should foresee the application of the residual method, under which the transaction price would be allocated based on the estimated sales prices to all performance obligations for which standalone sales prices can be estimated reliably. For scenarios in which the standalone sales prices of more than one performance obligation are not reliably estimable we believe the future IFRS should require to evaluate whether other measures exist that allow a reasonable allocation of the transaction price. As far as this is not the case the future IFRS should provide that the performance obligations for which neither a standalone sales price is estimable nor other reasonable allocation measures are identifiable should be accounted for as one performance obligation.

Limiting the use of standalone sales prices to scenarios in which they are reliably estimable would bring the transaction price allocation requirements in line with the contingent consideration requirements for which the ED provides for a ‘reliably estimable’ limitation.

In the case of contingent considerations, allocating the transaction price to all individual performance obligations leads to the unintended consequence that a variable portion of the transaction price that is directly linked to one specific performance obligation is also allocated to all performance obligations. Take, for example a contract for the sale and installation of a piece of hardware where the hardware sale and the installation represent separate performance obligations (but not separate contracts) and where the customer promises to pay, in addition to the agreed upon price, a defined bonus if the installation is completed earlier before a certain date. If the vendor is confident that he can complete the installation before the deadline he would include, by applying the ED’s guidance on variable consideration, the bonus in the transaction price. Thus a portion of the bonus would be recognized as hardware revenue upon delivery of the hardware although the bonus is unrelated to the hardware. We believe that variable consideration should be allocated to only specific performance obligations in a contract if they clearly relate to only these specific performance obligations.

Another point relates to cost-benefit aspects. Several industries have a multitude of contracts with customers containing plenty of performance obligations (e.g. various different tariffs offered by telecommunication companies to millions of customers). Even though the stand-alone selling prices of these performance obligations might be observable or reliably estimable, applying the allocation mechanism would be costly and operational challenging.

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 *Intangible Assets* or ASC Topic 985 on software), an entity should recognize an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

The GASB welcomes the proposal to capitalise costs incurred in fulfilling a contract which do not give rise to an asset eligible for recognition in accordance with other standards when specified criteria are met because this proposal enhances the matching principle. We believe that the proposed requirements are operational and sufficient.

In regard to the costs specified, the guidance relating to distinguishing whether costs can be capitalised (because they relate directly to a contract, par. 58 (e) of the ED) or have to be expensed (because they relate to obtaining the contract, par. 59 (a) of the ED) is unclear.

As currently written, the ED (par 59) does not allow capitalisation of the costs of obtaining a contract. We believe that this is in contrast to the ED on Insurance Contracts which allows capitalisation of such cost. We believe that matching the direct cost of obtaining a contract with the revenues from the respective contract provides useful information and therefore propose that direct costs of obtaining the contract should be capitalised in the same manner than cost of fulfilling a contract (i.e. under the guidance in par 59 of the ED).

Question 9

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

The GASB agrees that the same cost definition should be used for recognising a contract asset and for performing the onerous performance obligation test.

We would also like to add some comments on the onerous contracts here, as the ED poses no specific question. We understand par 54 of the ED to require that the onerous test has to be performed on the level of the individual performance obligation.

A majority of the GASB has major concerns regarding the proposed principle because it may result in onerous performance obligations

a) either at contract inception when the entire contract is profitable and no performance has been started, or

b) during the contract performance when the remainder of work to be carried out, i.e. the part not yet recognised as revenue, is still profitable.

As an example assume that an entity sells separately good A for a selling price of CU900 (with cost of sales CU600) and service B for a selling price of CU100 (with cost of sales CU95). If the entity now sells good A and service B together as a bundle for CU900, the transaction price allocated to service B (CU90=100/(900+100)*900) is below its cost of sales resulting in an onerous performance obligation to be recognised at contract inception. We believe that this is not just a theoretical example but reflects a management approach where management believes to increase total revenues by bundling the good and the service.

Those GASB members believe that the principle in IAS 37 to recognise only expected losses at the contract level is superior to the one proposed in the ED because the ED's proposal can result in expenses in one year on an 'onerous performance obligation' whereas the original profit margin on the other performance obligation(s) realised in the following or next year is retained. It might be argued that our proposed view is inconsistent with the overall concept of performance obligations as expressed in the ED. However, those GASB members believe that the latter might be the appropriate principle for revenue recognition (amount and timing) as well as classification but not for the special situation when a contract becomes onerous.

In contrast, a considerable minority within the GASB agrees with the proposals in the ED to perform the onerous test on the level of the individual performance obligation for the following reasons:

- conceptual consistency (individual performance obligation as the level for both, separate revenue recognition and separate onerous test)
- lower burden to the reporting entities (if the onerous test is performed on the contract level, performance obligations cannot be managed separately by the delivering units of the reporting entity but need continuously be evaluated together for purposes of onerous tests)
- no cost classification issues: If an entity that presents in its P&L more than one revenue line item (e.g. product revenue and service revenue) and consequently more than one cost of revenue line item performed the onerous test on the level of the contract the expense from recording an onerous contract liability would need to be allocated to the different cost of revenue line items and consequently would impact the gross margin of all revenue areas although only one incurred a loss.

Question 10

The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think that the proposed disclosure requirements will meet that objective? If not, why?

The GASB appreciates the inclusion of the objective(s) for requiring disclosures in a standard, although we believe that an overall disclosure framework would be preferable to having the objective(s) in each standard.

However, we have concerns that there is a tendency that converting these objectives into concrete disclosure rules always results in additional disclosure requirements which appears especially true for this ED. We wonder why a proposal for a revenue recognition model supposed to be superior compared to the current model needs such excessive additional disclosures.

We believe that for diversified entities certain of the proposed disclosures (e.g. in par. 77 of the ED) will either result in boiler-plate statements (e.g. “goods and services promised to transfer comprise goods and services from all areas of our product and service offering” or “payment terms reach from cash upon delivery to multiple years depending on the goods or services transferred and the type of customer”) or in lengthy note disclosures that describe the entity’s product and service portfolio, sales channels, legal warranties in different countries, payment terms etc. . We believe that this neither represents decision-useful information nor is justified in cost-benefit terms.

Question 11

The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

The GASB generally agrees that the proposed disclosures are useful if contracts with an original duration exceeding one year represent the majority of an entity’s ordinary activities. When determining the timing of the expected satisfaction of the outstanding performance obligations, we think that a best estimate approach would be more appropriate than applying a probability-weighted model.

If, however, such long-term contracts form only a smaller part of an entity’s ordinary activities or are even of a lower overall significance, we question the relevance of the proposed disclosures.

Question 12

Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

The GASB generally agrees that disaggregation of revenue is leading to useful information. However, it is not clear to us whether it is sufficient that the entity disaggregates revenue into the one category it believes to be the most appropriate one or whether disaggregation into several categories (each being appropriate) is required. We believe that this requirement needs further clarification.

Question 13

Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

The GASB agrees that comparability and preserving trend information about revenue is important for users of financial statements and therefore understands the proposed retrospective application of the new requirements. As the proposals represent quite a fundamental change to the current revenue recognition model, a fully retrospective application would also prevent revenue being recognised twice or not at all.

On the other hand, we see huge burdens in retrospectively applying these requirements for entities which have non-standardised complex contracts and/or are currently applying the percentage of completion method in IAS 11 to a large extent, which in our opinion will decrease under the proposed requirements.

Furthermore, we think that entities with more complex revenue recognition models will adjust their future contracts with customers to the new requirements. Thus, retrospective application will result in applying the new requirements on contracts that will not be concluded in the same manner in the future anymore so that the desired comparability and trend information will not be achieved.

As a result we favour applying the new requirements prospectively.

Question 14

The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

The GASB generally supports the approach to provide application guidance to assist preparers in applying the principles of a standard. However, we do not believe that the application guidance in the ED is sufficient in this respect. It is our impression that several of the examples given in the application guidance are inconsistent with the principles set out in the main body of the ED rather than clarifying them (please refer to our answers to Questions 1 and 2 above). Overall, the examples appear to be very simplistic and not very close to reality. We would like to propose reviewing the extensive examples in US GAAP literature and adopt suitable examples which are more realistic or industry specific.

Question 15

The boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

The GASB generally agrees with the underlying concept of drawing a line between product warranties that assure the quality of the product and those that provide insurance against later faults. But we also anticipate difficulties in practice when differentiating between the two types based on the proposed distinction in the ED. In many instances it would be very difficult if not impossible to determine whether a fault that arose after transferring the good to the customer already existed at the transfer date, i.e. represents a latent defect. Furthermore, in case of products of higher value or complexity (e.g. machines, cars, TV sets, etc.) the defect often relates to a component only rather than the whole product being defective. The warranty required under German law for example obliges the manufacturer to repair those products rather than replacing them in the first instance. In this context, we think that Example 4 in B16 is too narrowly focussed on low value mass production items (e.g. electronic spare parts).

In regard to the proposed accounting for the first type of product warranties – quality assurance warranties – we understand that the ED envisages in B15 a sort of a partial failed sale approach. When the entity is required to repair defective products, it does not recognise revenue for the portion of the transaction price attributed to the product's components expected to be replaced in the repair process, even though the defective components do not represent separate performance obligations. We acknowledge that this approach avoids any difficulties in distinguishing whether a product still has functionality for the customer or the functionality is not significantly limited because only a component of the product is defective, so that assuming a full failed sale (and correspondingly no revenue recognition) would be inappropriate. Hence, we believe that this is a reasonable approach but ask the Board to confirm our understanding by clarifying B 15 accordingly.

Besides, we see an operational issue. Assuming that the 1,000 products in Example 4 are not sold at once but one at a time during the reporting period, the necessary journal entries are unclear (CU1,000 invoiced amount versus CU990 revenue). This will at least result in a need for system adjustments to reconcile the accounts receivable subledger amounts to the revenue figures.

Regarding the insurance warranties we agree that these represent separate performance obligations and agree with the proposed accounting.

Question 16

The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and

(b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence.

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

The GASB understands the reasoning behind the proposed distinction of exclusive and non-exclusive licences and the related accounting as laid out in BC 223 et seq.

We do not anticipate insurmountable difficulties in distinguishing the type of licence in practice.

From a conceptual standpoint, however, one could argue that subsuming under this revenue standard the accounting for exclusive licences in a way similar to a lease just because the ED *Leases* scopes out intangible assets is not very convincing. In addition, the underlying control criterion does not support the proposed revenue pattern for exclusive licences, because the customer obtains control – as defined in the ED – of the right to use intellectual property, irrespective whether this is exclusive or non-exclusive. In other words, the customer perspective provided in the ED to determine whether the promised good or service has been transferred (par. 25 and the following) is not followed for licences not to be considered a sale of intellectual property.

Question 17

The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

The GASB agrees with the proposal to apply the recognition and measurement principles of the proposed revenue model to the sale of non-financial assets which does not represent an output of the entity's ordinary activities. We do, however, believe that additional clarifications are needed with regard to the presentation:

a) Currently, revenue-generating transactions are recorded gross by recording in the statement of comprehensive income both, the revenue and the cost of revenue while sales of non-financial assets are recorded net by only recognising the gain in the statement of comprehensive income.[1] We recommend a clarification that this should be continued.

[1] Imagine an entity sells an asset (book value CU 100) for CU 120. If the transaction is a revenue-generating one, the entity would record in its P&L revenue of CU 120 and cost of revenue of CU 100. In contrast, if it was a non-revenue generating sale the entity would record in its P&L a gain of CU 20.

b) It is our understanding that the ED's proposal will not result in presenting the gains from such sales as revenue in the statement of comprehensive income. Thus, we suggest a clarification in this respect.