



**The Japanese Institute of
Certified Public Accountants**

4-4-1, Kudan-Minami, Chiyoda-ku, Tokyo 102-8264 JAPAN

Phone: +81-3-3515-1130 Fax: +81-3-5226-3355

e-mail: kigyokaikei@jicpa.or.jp

<http://www.hp.jicpa.or.jp/english/>

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30 Cannon Street
London EC4M 6XH
United Kingdom

Comments on the Exposure Draft *Revenue from Contracts with Customers*

To the Board Members:

The Japanese Institute of Certified Public Accountants (“we” and “our”) appreciates the continued efforts of the International Accounting Standard Board (IASB) on the project to improve financial reporting of revenue, and welcomes the opportunity to comment on the exposure draft *Revenue from Contracts with Customers*.

As we describe in detail in our response to Question 3, the proposed guidance in paragraphs 25-31 in this ED, and related application guidance for determining whether control of the promised goods or services have been transferred to a customer, is not clear enough to ensure consistent application in a diversity of practices. We, therefore, believe that the requirements in those guidance should be reconsidered and amended.

The following are our comments

Recognition of revenue

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?

Comment:

We basically agree with the principle, however, more clarification is needed with respect to the following descriptions.

- (1) Paragraph BC52 noted that although requiring a distinct function is consistent with the guidance on multiple-element arrangements in ASC Subtopic 605-25, which requires a delivered item to have ‘value to the customer on a standalone basis’ in order for an entity to account for that item separately, the Boards decided against using the terminology ‘value to the customer on a standalone basis.’ This is because the terminology may suggest that an entity must identify performance obligations on the basis of its assessment of the customer’s intended use of the promised goods or services. However, paragraph 23 (b) (i) states that a good or service is also distinct if it has utility together with other goods or services that the customer has acquired from the entity, so the scope of this requirement is considered to be broader than that in ASC Subtopic 605-25. Therefore it is not clear whether goods or services which may be combined under paragraph 23 (b) (i) are limited to those (or a bundle of those) that are actually traded as required in ASC Subtopic 605-25. Also, it is not clear whether the term ‘utility’ has the same meaning as ‘value’ used in ASC Subtopic 605-25. Therefore, we believe that these issues need to be clarified. If they are different from ASC Subtopic 605-25, we would like to know the specific differences between them.

- (2) Paragraph 23 (b) (ii) requires that a good or service should have a distinct profit margin. However, the meaning of “...if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.” is not always clear. Therefore, as indicated in paragraph BC54, we believe that it is necessary to include an additional explanation such as that in the guidance on construction-type contracts in ASC Subtopic 605-35 that requires an entity to account for elements of a contract separately only if each has a different rate of probability.

- (3) Examples in paragraphs BC56-BC58 indicate that whether an entity may account for each task and part of contract management service as a separate performance obligation depends on the entity's determination on whether the contract management service provided associated with all of those tasks is subject to the same risks as each underlying related task. In this context, we believe that guidance should be provided to ensure the objective judgment when determining whether "a good or service is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service".

Question 3

Do you think that the proposed guidance in paragraphs 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?

Comment:

We believe that the guidance is not sufficient.

- (1) Paragraph 30 provides the following four indicators for the transfer of control of goods or services:
- (a) the customer has an unconditional obligation to pay -...;
 - (b) the customer has legal title -...;
 - (c) the customer has physical possession -...;
 - (d) the design or function of the good or service is customer-specific -....

Since we believe the indicator (d) has a different nature from that explain in (a), (b) and (c), we believe that the interrelationship between (a), (b) and (c), and (d) need to be clarified.

For example, judgment may be difficult in the following situations.

- The building to be constructed on the land of a customer which provides the use value only to the customer meets both of the indicators in (c) and (d). However, if it does not meet the indicators in (a) and (b) contractually, would it be possible to consider that the control is transferred continuously?
- If an entity is manufacturing a product where the design or function is specific to a customer, such as a luxury liner for tourism and sightseeing, or software with unique specifications, by accepting an order from a customer, and been receiving tentative payments such as prepayments or partial payments in consideration of

financing of the project, in certain cases in Japan, indicators in (b) and (c) would not be met either contractually or physically. If it does not meet the indicator in (a), it will only meet the indicator in (d). In this case, are we to understand that the control is not transferred continuously?

- If parts produced for a particular customer that meet the conditions in indicator in (d) (this may apply to many cases of goods produced in a large quantity) do not meet the indicators in (b) and (c) contractually or physically, but basically meet the conditions in indicator in (a) to have an unconditional obligation to pay, would it be possible to conclude that the control is transferred before the delivery is made to the customer? If so, this is likely to lead to a significant change from the current practice. Given that products saleable to multiple customers do not meet the criteria for the transfer of control before the delivery, it is likely that the consistency may be lost. On the other hand, in case it is not believed that the control is transferred, please indicate the way these indicators are applied.

(2) Since there are concerns mentioned in (1) above, we believe that the following requires more deliberation.

- Paragraph BC65 states that "In the case of a construction contract, the customer receives the promised goods or services during the construction only if the customer controls the work in progress." In determining whether the customer controls the work in progress in a construction contract, it should be clarified if we are required to consider whether the customer has the legal title to the work in progress or/and has the physical possession of the work in progress. That is, it should clearly state that, in order to determine that the control is transferred, satisfaction of indicator in (d) in paragraph 30 alone is not sufficient, and satisfaction of at least one of the indicators in (a), (b) or (c) in paragraph 30 would also be necessary in addition to the satisfaction of the indicator in (d). We believe that if proposed paragraphs 30 and 31 are finalized as stated, it would be difficult to decide on the appropriate accounting in practice for the transfer of control, including accounting in a case where the continuous transfer is recognized. Therefore, we strongly suggest to amend the proposed requirements.
- It is difficult to determine the extent to which design or function is specific to a customer in order to meet the criteria in paragraph 30 (d), i.e., 'The design or function of the good or service is customer-specific.' Paragraph 30 (d) states that the ability to specify major changes, rather than the ability to specify only minor changes would indicate the transfer of control. However, the current explanation is insufficient, and we request the development of additional guidance.

- Since it is not clear whether the revenue can be recognized when the costs incurred or to be incurred in respect of the transaction cannot be measured reliably (paragraph 14 (e) and paragraph 20 (d) of IAS 18 *Revenue*), or when the outcome of a construction contract cannot be estimated reliably (paragraph 32 of IAS 11 *Construction Contract*), we believe it is necessary to clearly state the treatment when such circumstances occur.
- With respect to properties and others, among products, it may be difficult to determine the transfer of control with only the proposed four indicators, because multiple continuous involvements may arise (equity investment in the party to which a property is sold, grant of rights to repurchase, etc.). The ED suggests that this should be determined based on the measurement of consideration, however, this appears to be impracticable from both accounting and audit perspective. Therefore, we request to provide additional indicators of transfer of control for properties, when continuous involvements exist.
- For the provision of services, it may be possible to determine the transfer of control based on the indicators in (a) and (d) in paragraph 30. However these indicators are not sufficient to determine when to recognize revenue or when the control is transferred, if the payment or receipt of consideration for the service is made before the provision of the service. Therefore, a relevant indicator needs to be added.

Measurement of revenue

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?

Comment:

We agree with this on the premise that performance obligation is appropriately identified (see our responses to Question 2).

Contract costs

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, IAS2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise 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?

Comment:

We believe that the proposed requirements are operational and sufficient.

It is reasonable to include only the costs that relate directly to a contract in the costs of assets. Since paragraph 58 provides examples of costs that relate directly to a contract, we believe that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient.

Question 9

Paragraph 58 proposes the costs that relate directly to a contract for the purpose 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?

Comment:

We agree with the basic concepts. However we believe that the following points require further deliberation.

- (1) For those costs where reason are unclear to include them in illustrative examples of costs incurred in fulfilling a contract that are capitalized (e.g., direct labor costs, other costs that were incurred only because the entity entered into the contract), we believe it is necessary to clearly indicate the basis for such inclusion in the application guidance, etc.

(2) We believe that relevant illustrative examples should also be provided with respect to:

(d) "costs that are explicitly chargeable to the customer under the contract"; and

(e) "other costs that were incurred only because the entity entered into the contract".

Disclosure

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 the proposed disclosure requirements will meet that objective? If not, why?

Comment:

We believe that the objective of the proposed disclosure requirements has, basically, been achieved. However, unless the costs exceed the benefits, the requirements should be finalized after carefully comparing and considering the usefulness of disclosed information in making an investment decision, and related total costs, including incremental costs incurred by preparers, as well as and additional burden incurred by auditors.

The proposed disclosures include such as the information related to an oral contract with an expected original duration of more than one year; this may be difficult to identify objectively. We therefore believe that each situation should be carefully considered after analysis of practices to understand and identify the content of contracts or performance obligations in entities, as well as the verifiability of their audit.

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?

Comment:

We do not agree with the proposed requirements.

For any contracts whose expected timing of the fulfillment of the remaining

performance obligation exceed one year from the end of the reporting period, there may be situations where the timing of the fulfillment is highly uncertain, and as a result, the timing of the fulfillment may change significantly after its disclosure. Therefore the disclosure of such information may lead to giving misleading investment information to users of financial statements. In addition, contracts can be written, oral or implied due to the entity's customary business practices, and the contents of the contract may include some items which are changed and clarified as the performance obligations are fulfilled. Thus, we believe that there are some concerns relating to the verifiability concerns in the audit.

Effective date and transition

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.

Comment:

We agree with the retrospective application of the proposed requirements if the disclosures relate to cases where benefits exceed the costs and verifiability of the disclosed information is ensured in audit. In addition, enough time should be provided, after the finalization of the standard, for the preparation of the retrospective application, including related the modifications and improvements to systems.

Application guidance

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?

Comment:

It is not sufficient. We believe that the following guidance should be added.

(1) Principal versus agent considerations (paragraphs B20-B23)

Paragraph B21 explains the indicator of principal in the context of control, i.e., if an

entity obtains control of the goods or services of another party before it transfers those goods or services to the customer, the entity is acting as a principal.

On the other hand, paragraph B22 explains the indicators of agent from the perspective of risks and rewards.

The concept of control and the concept of risks and rewards are intermixed and the priority between paragraphs B21 and B22 is not clear. In practice, there may be some confusion on the determination of principal or agent. More appropriate organized indicators will be required.

(2) Shipment of a product with risk of loss (paragraph B46 and Example 13)

Paragraph B46 and Example 13 describe the case of free on board shipping point and risk of loss. This example illustrates the case that, in accordance with the entity's past business practice to replace a damaged product, the entity has a performance obligation to cover the risk of loss during transit. In practice, however, it is rare that the entity covers significant risks, and therefore this example does not seem to be appropriate.

Rather, we believe that it is more useful to provide an example that clarifies the interrelation between the trade terms (FOB, CIF, DDP, etc.) based on the INCOTERMS and the transfer of control of the product to a customer. Regardless of whether or not the trade terms are based on the INCOTERMS, the ownership of the product is considered to be transferred to the customer through the transfer of bill of lading (B/L). Therefore, we believe that the timing of the transfer of B/L represents one of the significant indicators of the transfer of control in export transaction and that the developing an example and explanation clarifying this point will be useful.

(3) Sale and repurchase of an asset (paragraph B52 and Example 14)

Paragraph B52 states that if a customer has the unconditional right to require the entity to repurchase the asset (a put option), the customer obtains control of the asset and the entity shall account for the agreement similar to the sale of a product with a right of return (as discussed in paragraphs B5-B12). Meanwhile, paragraph B10 provides that if an entity cannot reasonably estimate the probability of a refund to the customer in accordance with paragraphs 38–40, the entity shall not recognize revenue when it transfers the product.

As an illustrative example of these requirements, Example 14 assumes that an entity estimates a 50 per cent probability that the asset will be returned. In addition to clearly stating this assumption, we believe that it is desirable to clarify that when the probability of return cannot be reasonably estimated, the entity would recognize revenue only when the entity has past experience with similar types of contracts and the entity's experience are relevant to the contract because the entity does not expect in the future significant changes in circumstances.

(4) Consideration payable to the customer (paragraph 48 and Example 23)

Paragraph 48 (b) of the ED states that a payment for a distinct good or service that the customer supplies to the entity shall be accounted for in the same way it accounts for the purchase from supplier, and it requires to refer paragraph 23 for determining whether the good or service is distinct. Furthermore, Example 23 indicates that the slotting fees paid to a reseller should be accounted for as a purchase (recognizing expense) rather than a reduction of revenue, as the entity has received a service distinct from the sale of the products to the reseller.

However, the payment of such slotting fees has clear and inseparable relationship with the sale transaction of the products to be displayed, and we believe that accounting for these two transactions (sale of the products and display of the products) separately would result in accounting that does not represent the economic substance of the transaction.

Moreover, we are concerned that the transactions reflecting such payment as the slotting fees into the original sales prices (by reducing the transaction price) may be accounted for differently due to the various forms of contracts, even though they have the same economic substance as the transaction in Example 23, in that the entity substantively bears the slotting fees.

We believe that in order to avoid inappropriate treatment from the economic substance, or different accounting depending on the form of a contract, it is necessary to add criteria to determine whether an entity has received a distinct good or service from a customer, such as "sufficiently separable" or "the vendor could have entered into an exchange transaction with a party other than a purchaser", as provided in ASC Topic 605-50-45-2a.

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?

Comment:

We agree with the proposal that an entity should identify insurance warranty as a separate performance obligation. However, with respect to the distinction between quality assurance warranty and insurance warranty, it is impracticable to assess the type of product warranties when any defects (warranties) actually take place. In addition, the interaction between paragraph B18 of the ED illustrating those criteria and paragraph 23 requiring the identification of separate performance obligations is not clear. We believe that clearer explanation is required for insurance warranty to be separated, including the explanation about the interaction with paragraph 23.

At the same time, quality assurance warranty is accounted for as failed sales. However, in many cases the products subject to quality assurance are expected to be only a small portion of the entire products sold. Therefore, the incremental information provided to users by such accounting may not justify the related complexity or costs. Thus, we believe that the Boards should consider permitting a simplified accounting such as an approach to account for all the types of warranties as a separate performance obligation (insurance warranty) or as separate liabilities (provisions).

Question 16

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

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

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

Comment:

We basically agree with the proposal. However, more detailed discussion should be provided as to whether it is considered to be a sale of an intellectual property or a grant of a license, and any issues arising when it is considered to be the sale should be explained in more detail.

Related to (a) above

The grant of an exclusive license does not always provide the rights similar to those to dispose of the intellectual property, including the ability to grant a sub-license. Thus, we should not determine whether the grant of a license is the sale of an intellectual property or a grant of the rights to use depending only on whether or not the use period relates to the entire economic life. The determination of the use period, including a renewal of a contract, is also an important factor to consider, and some guidance or examples should be added that illustrate the case where a customer has a renewal option or those that distinguish the case depending on the existence of renewal fees. We believe that, even if the license is considered to be the sale of intellectual property, it should be emphasized that the issues on uncertain consideration or non-refundable prepayment or other performance obligations are same as those on goods or services.

Related to (b) above

The ED states that if an entity grants a customer a non-exclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license. In this respect paragraph BC226 explains that licensing intellectual property on a

non-exclusive basis is often the only way the entity can distribute its product and protect its intellectual property from the unauthorized duplication. However, there may be situations where the entity needs to retain a patent over the licensing period, for example when it has a patent attached to the intellectual property granted on a non-exclusive basis. Thus, in accordance with paragraph B37, the grant of non-exclusive license may be considered to satisfy the obligation at a given time. However, recognizing revenue over the period for which the customer benefits from the license will often be more appropriate from the perspective of economic substance. The scope of the licenses discussed in the ED is very wide and requirements should be developed for several patterns of the non-exclusive license grants.

Consequential amendments

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?

Comment:

We agree with the proposal subject to the consideration of the following.

- (1) IFRIC 12 *Service Concession Agreements* is not always consistent with the recognition and measurement principles of the proposed revenue model. Therefore, the requirements of IFRIC 12 need to be re-considered.

- (2) Contracts for intangible assets within the scope of IAS 38 *Intangible Assets* vary, and it is often impracticable to determine whether the contract permits a customer to use the intangible asset or transfers control. Further, when a joint operation is undertaken using an intangible asset, it may become more difficult to identify the portion subject to transfer of control. Therefore, additional guidance should be developed as to the criteria for the transfer of control of intangible assets.

- (3) Property, plant and equipment subject to IAS16 *Property, Plant and Equipment*, especially properties, may give rise to multiple continuing involvements and it appears to be extremely difficult to measure these at its consideration. Therefore, we believe it is appropriate to add relevant indicators as to the transfer of control from the perspective of “transfer of risks and rewards”, limiting its use to the sale of a property, plant and equipment.

- (4) The recognition and measurement of dividends subject to IAS 18 *Recognition of Revenue* should be clarified in IFRS 9 *Financial Instruments*.

Yours faithfully,

Keiko Kishigami

Executive Board Member - Accounting Practice (IFRS)

The Japanese Institute of Certified Public Accountants