

Accounting Standards Board of Japan (ASBJ)

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22 October 2010

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

Dear Sir or Madame,

Comment on the Exposure Draft ED/2010/6 **Revenue from Contracts with Customers**

We appreciate the longstanding efforts of the International Accounting Standards Board (IASB) on the Revenue Recognition project and welcome the opportunity to comment on the Exposure Draft “Revenue from Contracts with Customers” (hereinafter referred to as the “ED”).

General Comments

1. We agree with the objective of the project to develop a single revenue recognition model that would apply to a wide range of industries to improve the financial reporting of revenue. The development of a consistent and robust framework for revenue recognition would improve financial reporting because revenue is a crucial number to users of financial statements.
2. The ED proposes to identify the performance obligation in the contracts and to recognise revenue when the identified performance obligation is satisfied, namely, when control of a good or service is transferred. We generally agree with that core principle because it would result in more consistent accounting for economically similar transactions than the risk and reward approach. We greatly appreciate the improvement from Discussion Paper, including clarification of the focus on recognition and measurement of revenue rather than on those of contract and additional guidance on identifying separate performance obligations and transfer of control of goods or services. Nevertheless, we still have concerns about some aspects of the proposals. Our main recommendations, of which details are described in responses to individual questions, are as follows:
 - (a) Transfer of goods or services
The proposed principle is unclear about what cases would be determined as continuous transfer of control. Therefore, a principle should be established for determining whether

goods or services are transferred continuously or at a point in time. In addition, a transfer of a completed asset and a continuous transfer may have different indicators and thus those indicators should be specified for both cases respectively. The indicators of a continuous transfer should include, in addition to those described in paragraph 30, a customer's obligation to pay for the progress to the date in case it cancels the contract. This is because such an obligation of the customer would indicate that it has obtained control of the work in progress, even when the design or function of the good or service is not customer-specific.

(b) Customer's credit risk

Customer's credit risk should not be reflected in the amount of revenue but in other income or expense arising from measurement of the receivable.

(c) Product warranties

We agree with the proposed distinction of product warranties and treating insurance warranties as separate performance obligations. However, quality assurance warranties should be treated as liabilities to repair or replace defective products rather than as unsatisfied performance obligations.

Comments on questions

Our comments on the questions set out in the ED are provided below.

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 principle to determine whether to combine or segment contracts

3. We agree with the proposed principle to determine whether to combine contracts, which would continue the existing treatment, but disagree with that to determine whether to segment a single contract.
4. The ED proposes a “two step approach”, which requires segmentation of contracts first and then identification of separate performance obligations within those segmented contracts.

However, since the initial transaction price approximates the total of the stand-alone selling prices of goods or services, it may be unclear whether subsequent changes in the price relate to some parts of the segmented contract or to the contract as a whole. Therefore, we suggest that how to reflect subsequent changes should be determined depending on whether the prices of identified separate performance obligations are interdependent, rather than using the “two step approach”.

The contract modification

5. We agree that it should be determined based on interdependency of prices whether a contract modification should be accounted for as a separate contract or a part of the original contract. As mentioned above, this judgment should be based on the interdependency of the prices of identified performance obligations in the contract.

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?

Reference to “another entity”

6. We disagree with reference to another entity in paragraph 23(a), because it might result in identifying too many separate performance obligations than would be identified by the criterion 23(b) and would not necessarily generate faithful representation of the transfer of goods or services. For example, rivets used in a construction would meet the criterion in paragraph 23(a) when another entity sells them separately. Although those rivets do not have a distinct function under a construction contract nor a distinct profit margin and therefore would not meet the criterion in paragraph 23(b), they would be regarded as distinct under the proposal of the ED. We suggest that separate performance obligations should be identified only when the entity sells an identical or similar good or service separately or could sell the good or service separately.

Distinct Function

7. The description of a “distinct function” in paragraph 23(b)(i) does not seem helpful in distinguishing a good or service that has a distinct function and a good or service that does not, because almost every good or service could have utility together with other goods or services.
8. We also note that the ED states that “requiring a distinct function is consistent with the guidance on multiple-element arrangements in the FASB 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” (paragraph BC52 of the ED). Paragraph 605-25-25-5 of the Codification states:

... the delivered item or items have value to the customer on a standalone basis. The item or items have value on a standalone basis if they are sold separately by any vendor or the customer could resell the delivered item(s) on a standalone basis. In the context of a customer's ability to resell the delivered item(s), this criterion does not require the existence of an observable market for the deliverable(s).

9. We acknowledge that the boards decided against using the phrase “value to the customer” because it could 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 (paragraph BC52). However, we believe that identifying performance obligations from the customer’s perspective would be consistent with the ED’s proposed indicators of the control that are specified from the customer’s perspective. What “distinct function” or “utility” means should be clarified so that the “distinct function” concept can determine the situations where a good or service could be sold separately as the “value to the customer” concept determines.

Distinct Profit Margin

10. The description of the case that a good or service is subject to distinct risks (paragraph 23(b)(ii))is insufficient. Paragraph BC54 of the ED states that “the proposed requirement of a distinct profit margin is similar to the guidance on construction-type contracts in FASB ASC Subtopic 605-35 that results in an entity accounting for elements of a contract separately only if each has a different rate of profitability.” FASB ASC Subtopic 605-35 provides a more specific explanation of the criterion for segmentation as follows:

The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments. (ASC 605-35-25-13c)

11. The ED’s concept of “distinct profit margin” does not seem to require different profit margins, but it is unclear how to treat the case of distinct risks with the same profit margin. Therefore, so as to practically facilitate the judgement of whether there is a distinct profit margins, it is necessary to add explanations of the case that a good or service is subject to distinct risks.

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?

12. Paragraph 30 of the ED shows four indicators that the customer has obtained control of a good or service, including subparagraph (d) stating that “a customer’s ability to specify major changes to the design or function of the good or service would indicate that a customer obtains control of the asset as it is created”. It appears that subparagraph 30(d) shows an indicator for the case of a continuous transfer of an asset, but the ED is not clear about when a transfer of a good or service would be regarded as continuous.

13. Therefore, in our view, the following principles should be provided:

(a) if a customer has the ability to direct the use of , and to receive the benefit from a completed asset, the performance obligation is a transfer of a completed asset; and

(b) if a customer has the ability to direct the use of, and to receive the benefit from a work in progress, the performance obligation is a continuous transfer of goods or services.

In addition, a transfer of a completed asset and a continuous transfer may have different indicators and thus those indicators should be specified for both cases respectively. Furthermore, the indicators of a continuous transfer should include the case that the customer has an obligation to pay for the progress to the date in case it cancels the contract. This is because such an obligation of the customer would indicate that it has obtained control of the work in progress, even when the design or function of the good or service is not customer-specific.

Question 4:

The boards propose that if the amount of consideration is variable, an entity should recognise 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?

14. We agree with the proposal in paragraph 38, but disagree with measuring at the probability-weighted amount of consideration in all situations as proposed in paragraph 35, because we believe that estimation at the probability-weighted amount would not be

appropriate where it is probable that the entity will receive one of the several possible consideration amounts.

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 recognises when it satisfies a performance obligation rather than whether the entity recognises revenue? If not, why?

15. We believe that the customer's credit risk should not be reflected in the amount of transaction price (revenue) but in the amount of other income or expense arising from measurement of the receivable, except for the case of Question 6. The reasons are as follows:
- (a) Transfer of a good or service and collection of the consideration from a customer should be considered as separate transactions, just like the two transaction perspective in accounting for foreign currency transactions.
 - (b) Under the proposal of the ED, the effects of customers' credit risk would be differently accounted for before and after the entity has obtained an unconditional right to consideration. Whereas the effect of the changes after that would be recognised as income or expense other than revenue, the effects of changes occurring before that would be included in revenue even when they occur after recognising a contract asset.
 - (c) Some users of financial statements states that it would provide more decision useful information to present revenue at the transaction price promised with the customer, with the effect of the credit risk presented as other losses, rather than to present revenue after deducting the effect of the customer's credit risk.

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?

16. We agree with the proposal. When a contract includes a material financing component because of significant difference in the timing between performance by an entity (satisfaction of performance obligations) and payment from a customer, the transaction price would reflect

the financing component. Therefore, the amounts of revenue recognized when a performance obligation is satisfied should be the amounts after adjusting the financing component and the financing component should be recognised as interest income or expenses.

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?

17. We agree with the approach regarding the allocation of the transaction price at contract inception, on the condition that performance obligations can be appropriately identified (see our comment on Question 2), because under the proposed requirements, entities allocate the transaction price only to separate performance obligations for distinct goods or services rather than to every potential performance obligation in the contract (paragraph BC117).
18. However, we disagree with allocating changes in the transaction price to all performance obligations on the same basis as that at contract inception, because the price modification may relate to only some of promised goods or services in the contract. Paragraph BC128 of the ED states that if an entity has evidence that a discount relates only to some goods or services in a contract, the contract may meet the criteria in paragraph 15 for segmentation of the contract. However, as mentioned in the paragraph 4 of this letter, only judgment of whether the price at inception of the contract was interdependent would not be enough for determining whether the changes in the transaction price relate to the whole contract or only to some of goods or services in the contract. Therefore, we suggest that how to reflect subsequent changes should be determined depending on whether the prices of identified separate performance obligations are interdependent, rather than using the “two step approach” of segmenting a contract and indentifying performance obligations.

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 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?

19. We agree with the proposal in paragraph 57, but we have concern about the proposal in paragraph 62 that an entity shall classify an asset recognised in accordance with paragraph 57 on the basis of the nature or function of the costs that gave rise to the asset (for example, intangible or work in progress). Such an asset should be presented separately because it would be inconsistent to include it in the asset such as intangible or work in progress even though it is not eligible for recognition as such.

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?

20. We agree with the proposal in paragraph 58. It is appropriate to use the costs that relate directly to a contract consistently with the definition of an onerous contract in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. It is inappropriate to include a margin in measuring onerous performance obligations, because it would increase complexity of measurement and result in recognising profit at the time of satisfaction of the onerous performance obligations.

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?

21. Some of the proposed disclosure requirements do not seem to necessarily meet their objectives. We have concern about the disclosure of a maturity analysis of performance obligations, as we mentioned in our comment on Question 11.

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?

22. We suggest that the ED should provide the disclosure requirement to cover the case where the amount of remaining performance obligations or the amount of the transaction price allocated to the performance obligations that are expected to be satisfied in each period cannot be reasonably estimated.
23. If an entity has the contracts that provide same services each year for fixed fee, the amounts required in paragraph 78 are readily determinable. However, when the expected timing to be satisfied the performance obligations and the amounts allocated in each year are variable, an entity may be unable to reasonably estimate those. Thus, it would be appropriate that the ED provides other disclosure requirement to enable such entity to disclose the useful qualitative information.
24. Additionally, some Japanese preparers make a comment that proposed disclosure requirements may be burdensome for entities that have contracts identified as continuous transfers of goods or services, such as contracts of construction or software development. Therefore, in considering disclosure issues, it is necessary to make a careful judgment based on consideration of the balance between benefits of providing the useful information to users and the cost to preparers.

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?

25. We agree with the proposal of disaggregation of revenue in accordance with paragraph 74. However, we disagree with requiring disclosure of the relationship with information required by other IFRS, as proposed in paragraph 72.
26. Paragraph 72 requires an entity to present and disclose the additional information in accordance with the [draft] IFRS in a way that shows how it relates to information required by other IFRSs, whereas it states that the entity need not disclose information in accordance with this [draft] IFRS including the disclosure requirement of disaggregation of revenue if it has provided the information in accordance with another IFRS. Disclosures required by this

[draft] IFRS and those by another IFRS have different objectives and we believe that disclosure of the relationship between them would be an excessive requirement.

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.

27. We agree with the retrospective application of the proposed requirements. However, as noted in paragraph BC232, retrospective application could be burdensome for some entities preparing financial statements. In addition, some entities might find it difficult to estimate stand-alone selling prices at contract inception and variable consideration throughout the contract without using hindsight. Therefore, sufficient consideration should be given in deciding the effective date of the final standard so as to give entities as much lead time as possible and thereby reduce the necessity of using hindsight in applying it.

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?

28. As mentioned in our comment on Question 3, how to determine whether goods or services are transferred continuously should be specified as principles rather than as guidance. In addition, we suggest some modification or clarification of some guidance, including that for segmentation of contracts and product warranties, as mentioned in other paragraphs of this comment letter.
29. Paragraph 37 of the ED treats the accounting for sale with a right of return similarly to measurement of variable consideration. However, we are of the view that sale with a right of return should not be addressed by the guidance on determining the transaction price. Uncertainty in the transaction price can be divided into:

- (a) uncertainty in the unit price of the goods or services transferred; and

(b) uncertainty in the number of the goods or services transferred.

We consider that the treatment of (a) is a measurement issue but that of (b) is a recognition issue. Variable unit price would have no effect on the transfer of control of the good or service to customers and impose no additional obligations on an entity. On the other hand, sale of uncertain quantity, such as sale with a right of return or a put option, would give rise to the entity's obligation of a refund or repurchase and its right of recovery from the customer, when control of the goods is transferred to the customer.

30. Therefore, a principle for sales of uncertain quantity, such as sales with a right of return or a put option, should be provided in addition to the principle related to variable consideration.

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?

31. We agree with the proposed distinction of product warranties and treating insurance warranties as separate performance obligations. However, we disagree with the proposed accounting treatment for quality assurance warranties.
32. The IASB and the FASB decided to view a quality assurance warranty as an unsatisfied performance obligation (the "failed sale approach"), after having considered viewing it as either (a) a liability to replace or repair a defective product or (b) an unsatisfied performance obligation because the entity has not provided the customer with a product that is free from defects at the time of sale. However, we are of the view that a quality assurance warranty should be accounted for as a liability to replace or repair a defective product rather than as an unsatisfied performance obligation, for the following reasons;

- (i) The accounting for quality assurance warranties need not be consistent with that for rights of return. Although paragraph BC202 explains that IASB and the FASB adopted the failed sales approach in the light of consistency with the accounting for rights of return, rights of return and quality assurance warranties have quite different natures. Whereas rights of return provide the customer with an option to return the good after its transfer, quality assurance warranties guarantee the transfer of the promised good. In addition, considerations received from the customers also differ between them. Whereas rights of return require the entity to refund the consideration of the returned good to the customer, quality assurance warranty does not require the entity to refund of the consideration of the good to be replaced or repaired.
- (ii) The proposed treatment of replacement in paragraph B15 would not necessarily reflect the reality of the transaction. Paragraph B15 states “If the entity would be required to replace defective products, it does not recognise any revenue for those defective products when it transfers them to the customer. If the entity would be required to repair defective products, it does not recognise revenue for the portion of the transaction price attributable to the products’ components expected to be replaced in the repair process.” However, even when replacement is expected, the economic substance would be the almost same as the case of repair if the entity can resell the refurbished products as in Example 4 of the ED (that is, the difference may be just owing to the entity’s choice in order to fulfil the promise with the customer sooner). In such a case, deferring all of the revenue at the time of transfer might not reflect the reality of the transaction.
- (iii) Under the failed sale approach, the entity would continue to recognise the goods as inventories even when the customer has obtained control of them. Unless the defect is detected immediately after the transfer, quality assurance warranties would not hinder the customer’s ability to direct the use of, and receive the benefit from, the good or service and therefore the customer obtains control of the good or service.

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?

33. We agree with the proposal for the case that a license is not considered to be a sale of intellectual property.
34. A license may give rise to two types of obligations that have entirely different natures. One is a partial transfer of the intellectual property and the other is a grant of the right to use the intellectual property. In our view, the difference between them lies in whether the entity has granted exclusive rights to the customer.
35. If the entity grants the exclusive right to use the intellectual property (which is not a sale of that intellectual property), the customer would exclusively obtain the right to use the licensed part of the intellectual property. In this case, the entity would have transferred to the customer the present right to obtain substantially all of the potential cash flows from using that part of the intellectual property over the license period.
36. On the other hand, a non-exclusive license can be freely granted to more than one customers and the entity retains the right to freely use the intellectual property it possesses. Therefore, under a non-exclusive license, the entity has no performance obligation other than that to make a license available to the customer, regardless of whether there is a license period or not.
37. Consistency between this project and the Lease project should be ensured about recognition of revenue arising from derecognition of assets, considering the decision by the IASB and the FASB that an entity should account for a promise to grant an exclusive right to use intellectual property (which is not a sale of that intellectual property) consistently with their tentative decisions on how a lessor would account for the promise to grant a right to use a tangible asset (paragraph BC224).

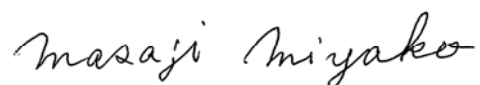
Question 17:

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?

38. We agree with the proposal. A contract for the sale of real estate that is an output of an entity's ordinary activities meets the definition of a contract with a customer and, therefore, would be within the scope of the proposed standard (paragraph BC250). Therefore, the principles in the proposed model should be applied to the gain or loss on the sale of intangible assets and property, plant and equipment that are not an output of the entity's ordinary activities, consistently with revenue from contracts with customers.

We hope that our comments will contribute to the forthcoming deliberations in the project.

Yours sincerely,

A handwritten signature in cursive script that reads "Masaji Miyako".

Masaji Miyako

Board Member of the Accounting Standards Board of Japan and
Chairman of the Revenue Recognition Technical Committee