EFRAG
European Financial Reporting Advisory Group

EUROPEAN FIELD-TEST OF THE IASB'S EXPOSURE DRAFT REVENUE FROM CONTRACTS WITH CUSTOMERS

PHARMACEUTICAL COMPANIES

Preparation of the feedback statement

Summary of the input received from pharmaceutical companies

This note summarises the input received from European pharmaceutical companies' field-tests of the IASB's Exposure Draft *Revenue from Contracts with Customers* ('the ED'), published in November 2011.

This feedback statement has been prepared for the convenience of European constituents by EFRAG's secretariat. It has been reviewed by participants in the field-test.

About the field-test

Focus on application issues, the effect on financial statements and cost of applying the proposal

The purpose of the European field-test of the ED was to:

- identify potential implementation and application difficulties;
- assess the potential effect of the proposals on the financial statements;
- estimate the effort required to implement and apply the proposals.

The field-test did not assess whether the requirements proposed in the ED represent an improvement to current accounting practice. The field-test only provides some input for such an assessment.

The participants in the field-test were asked to select some of their contracts, apply the requirements proposed in the ED on these contracts and report their findings at workshops.

All European entities expressing a wish to participate in the field-test were invited to participate. The entities participating in the field-test do therefore not constitute a representative sample of the entities that will be affected by the proposals. Similarly, the assessed directions and changes in elements of financial position and performance only reflect the outcome of the selected contracts based on the accounting practice currently chosen for those contracts.

Participating companies

Eight companies participated in the field test

The following companies participated in the field-test:

- AstraZeneca
- Bayer
- Bial
- GlaxoSmithKline
- Novartis
- Roche
- Sanofi-Aventis
- Siemens

The results of each company's tests were presented at workshops on 10 January and 16 February 2012 in Brussels.

Results of the field-test – implementation and application

A member of the IASB staff was present at the workshops where the results of the field-tests were presented. She provided explanations on many of the issues raised by participants. The issues listed below reflect implementation and application problems that were identified by participants before the additional explanations were provided.

Scope

Participants were unsure about whether a contract, where one entity was the supplier of a drug in one region but the buyer in another, would be within the scope of the standard – and if it would not, how it should be accounted for

According to paragraph 9 of the ED, the ED shall be applied to contracts with customers with a few specified exceptions. Paragraph 10 of the ED defines a customer as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities. The ED specifies that an entity shall only apply the ED to a contract if the counterparty to the contract is a customer. For some contracts, the counterparty to the contract might not be a customer but rather a collaborator or a partner that shares with the entity the risks and benefits of developing a product to be marketed. Such contracts are not in the scope of the ED.

Participants at the workshops were uncertain about whether a particular contract (as outlined below) was within the scope of the ED, and if it was not, how it should be accounted for.

In the contract considered entity P1 licensed rights of a drug to P2 for use by P2 in the US. P1 had the right to commercialise, set prices and sell to the final customer in the US, whilst entity P2 had the right to manufacture and supply the drug to P1 in the US. In the rest of the world, P2 had the right to commercialise, set prices and sell the drug and P1 had the right to manufacture and supply the drug.

The setup did not involve any joint steering committee and each entity was fully liable for its part of the agreement. However, the agreement fixed the sales price of the drug from the supplier to the seller as a percentage of the net sales price to the final customer. In addition, if the supplier made a higher margin than an agreed percentage from manufacturing the drug, this would result in a true up in that supplier's purchase price of the drug on the market where that entity acted as the seller to the final customer.

Identifying separate performance obligations

Participants were uncertain about how to identify separate performance obligations in contracts where a customer could not benefit from a licence without other goods or services from the same entity

Paragraph 28 of the ED states that except as specified in paragraph 29 of the ED, a good or service is distinct if either of the following criteria is met:

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

Paragraph 29 explains that a good or service in a bundle of promised goods or services is not distinct if both of the following criteria are met:

- the goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services; and
- the bundle of goods or services is significantly modified or customised to fulfil the contract.

Paragraph B36 of the ED states that if an entity grants a licence

that is not distinct because the customer cannot benefit from the licence without an additional service that the entity promises to provide, the entity shall account for the combined licence and service as a single performance obligation satisfied over time.

Participants in the field-test:

- were unsure about how to account for contracts where on transfer of the licence, the customer could not benefit from the licence without additional services promised by the entity (for example continued supply of related compound for regulatory reasons, until the licensee obtained regulatory approval to manufacture such compound itself);

- were uncertain about what circumstances could result in an entity not being able to benefit from the licence without an additional service. For example, participants were in doubt about which of the following circumstances would result in the customer needing additional service in order to benefit from the licence:

    - contractual requirements that the customer would have to buy ingredients from the entity when producing the pharmaceuticals covered by the licence (even when the ingredients could be purchased from another company);

    - lack of know-how, requiring the customer to learn from the entity how to produce the resulting pharmaceuticals;

    - lack of approved production facilities, resulting in the customer having to pay the entity to produce the pharmaceuticals until the customers' production facilities were approved;

- were unsure about to what extent the customer's ability to resell a licence would result in the customer being able to benefit from the licence on its own;

- found it unclear whether the fact that the customer's competitors could not use the licence if the rights were provided to the customer (blocking) would result in the customer being able to benefit from the licence on its own.

Participants were uncertain about whether a service provided to the end customer

Participants were also uncertain about how to account for the costs an entity promised to reimburse for administering (i.e. infusion) of a drug. In the particular case, an entity sold a drug to

by the entity should be considered as a separate performance obligation

a wholesaler that then sold it to pharmacies that, in turn, sold the drug to the end customer (i.e. a patient). The government in the related jurisdiction reimbursed part of the cost of the drug sold to patients by the pharmacies.

As a condition for the approval of the drug, the government required that the pharmaceutical company (the entity) offer to pay for the service of having non-governmental, third-party providers, or the pharmacy infuse the drug, should the end customer (i.e. the patient) wish to make use of that offer.

Participants were unsure about whether the infusion should be considered to be a separate performance obligation because the end customer (i.e. the patient) who would benefit from the infusion was not the 'customer' of the contract.

If the infusion was to be considered as a separate performance obligation, participants were uncertain about how the related performance obligation should be measured and when the pharmaceutical company had satisfied its obligation (as the patient was not involved in the sale contract between the entity and the wholesaler or pharmacy).

If the infusion was not to be considered as a separate performance obligation, some participants assessed that the costs could be accounted similarly to a warranty that assures that the product complies with agreed-upon specifications (i.e. as a cost accrual).

Satisfaction of performance obligations

In the case of a licence agreement of intellectual property, participants were in doubt about what asset to consider when assessing whether control had been transferred to the customer

According to paragraph 31 of the ED, an entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

Paragraph 37 of the ED includes the following indicators an entity shall consider when assessing when transfer of control has taken place:

- the entity has a present right to payment for the asset;
- the customer has legal title to the asset;
- the entity has transferred physical possession of the asset;

- the customer has the significant risks and rewards of ownership of the asset;
- the customer has accepted the asset.

Paragraph B34 of the ED states that if an entity grants to a customer a licence or other rights to use intellectual property of the entity, those promised rights give rise to a performance obligation that the entity satisfies at the point in time when the customer obtains control of the rights.

Participants were in doubt about what 'asset' to consider when assessing whether control had transferred. For example, the participants did not think a brand name had been transferred to the customer in the case where a customer had been granted right to use the brand name for a period much shorter than the remaining useful life of the brand name. In this case the customer would not receive legal title to the brand name and the significant risks and rewards of ownership of the brand name would remain with the entity. Participants considered whether a 'right to use' had been transferred. However, in that case they were unsure about whether the transfer should result in any derecognition and what the effects on the financial statements would be (particularly whether the transfer of the right to use would result in any impairment of the brand name).

Performance obligations satisfied over time

In the light of the Basis for Conclusion, participants found it unclear how to account for the transfer of assets with an alternative use

Paragraph 35 of the ED includes criteria for when an entity transfers control of a good or service over time.

It states that an entity transfers control of a good or service over time if at least one of two criteria is met. One criterion is that the entity's performance does not create an asset with an alternative use to the entity and at least one of three other criteria is met.

Paragraph BC93 of the Basis for Conclusions of the ED explains:

"[...] The boards decided that an entity's performance would not result in a transfer of goods or services to the customer if the entity's performance creates an asset with an alternative use to the entity [...]"

Participants found the criterion about an alternative use unclear in the light of paragraph BC93. Participants considered that paragraph BC93 meant that assets with an alternative use were

not transferred to the customer at (any) point in time, and revenue should accordingly be recognised over time for those assets. This, however, seemed to contradict paragraph 35 of the ED. Participants suggested that if the meaning of paragraph 35 of the ED should be reflected in paragraph BC93, paragraph BC93 should state:

"[...] The boards decided that an entity's performance would not result in a transfer of goods or services to the customer over time if the entity's performance creates an asset with an alternative use to the entity [...]"

Determining the transaction price

A participant was unsure about whether contracted future sales should be considered when determining the transaction price

Paragraph 50 of the ED states that an entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.

A participant provided its customers with a diagnostic instrument including maintenance service for free for a specified period of time if the customer agreed to purchase a minimum amount of reagents produced by the participant. The instrument could only be used with these specific reagents. Sometimes, but not always, the contract included a penalty clause if the customer's purchases did not cover for the minimum amount, but it was business practice not to enforce this penalty payment. In addition, the requirement related to the minimum reagent purchase in the contract was sometimes not legally enforceable.

The participant was unsure whether the future expected sale of reagents should be considered when determining the transaction price, or the transaction price related to the contract would be nil at contract inception according to the ED.

Measuring progress towards complete satisfaction

Participants considered it difficult to measure progress towards complete satisfaction of a performance obligation when the quantity of the output to be provided was uncertain

Paragraph B36 of the ED states that if an entity grants a licence that is not distinct because the customer cannot benefit from the licence without an additional service that the entity promises to provide, the entity shall account for the combined licence and service as a single performance obligation satisfied over time.

According to paragraph 38 of the ED, for each separate obligation

that an entity satisfies over time, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of a performance obligation. The objective when measuring progress is to depict transfer of control of goods or services to the customer.

Participants noted that where a customer paid a separate price for a licence that the customer could not benefit from without purchasing some active ingredients from the entity for additional consideration, the result of the ED could be that the licence and the ingredients should be considered as one performance obligation satisfied over time (instead of two separate performance obligations). In that case the transfer of the ingredient could depict the transfer of goods or services to the customer and therefore the progress towards complete satisfaction. This would, however, result in entities having, as part of the licence fee allocation, to estimate how many doses of active ingredients the customer would purchase. Participants found that such an estimate could in some cases be uncertain.

Contract modifications

Participants suggested simplifying the wording on contract modifications

Paragraphs 21 and 22 of the ED specify how to account for contract modifications. Participants found these paragraphs complex to read and understand and that a simpler wording would be helpful.

Consideration payable to the customer

Participants were uncertain about whether US GAAP should be considered when interpreting the proposed requirements

Paragraph BC160 of the ED notes that "the boards think that the principle in the proposed requirements for assessing whether a good or service is distinct is similar to the existing guidance in US GAAP". Participants were uncertain about whether that meant that current US GAAP should be considered when interpreting the proposals.

Presentation

Participants were in doubt about whether the effects of customer's credit risk should be reflected in a separate line item before or after factoring arrangements

Paragraph 69 of the ED requires an entity to present the effects of a customer's credit risk in the profit or loss as a separate line item adjacent to the revenue line item.

The participants considered an example were an entity entered into a factoring agreement for trade receivables. The participants were in doubt about whether the credit risk to be reported in the separate line item should reflect the original risk or the risk after

entering into the factoring agreement.

Results of the field-test – effects on financial statements

The test identified the following potential effects on the financial statements:

The ED could change revenue recognition for participants' contracts for a licence and related services, when the customer cannot benefit from the licence without the additional service

- Currently, pharmaceutical companies participating in the field-test considered the sale of a licence and subsequent production and/or supply of ingredients necessary to produce the product for which the licence regard, as two performance obligations. However, in the cases where the customer cannot benefit from the licence without an additional service that the entity promises to provide, the ED would require the entity to account for the combined licence and service as a single performance obligation. This could result in revenue being recognition only when the additional service is delivered.

The ED would result in revenue for brand names being recognised as soon as the customer is able to use the brand name

- Currently, when participants granted a customer the right to use a brand name for a fixed period, they recognised revenue over that period of time. The ED would require the participants to recognise the (total) revenue to which they are reasonably assured to be entitled at the time the customer would be able to use and benefit from a distinct brand name.

The ED could affect the pattern of revenue for a participant for certain types of contract modifications

- Sometimes the customers of one of the participants wished to modify a contract as the customer would not need the full quantity of items ordered. In those cases, the customer would pay the original agreed transaction price, but would receive a discount on future purchases that would equal the amount paid in excess of the quantity delivered. Currently, the participant applied IFRIC 13 to account for the future discounts. This meant that the total transaction price (including the discount granted in the modified contract) was reallocated to the delivered items and to the elements to be delivered in the future. However, participants assessed that under the ED, the performance obligation related to offering the discount would be a distinct good or service (as it would provide a material right to the customer in accordance with paragraph B21 of the ED). Participants therefore assessed that under the ED revenue already allocated to delivered items should not be updated.

Results of the field-test – Costs of implementation

Participants considered the reconciliations of contract balances and onerous performance obligations costly

Participants considered that it would be costly to provide the reconciliation of contract balances and the reconciliation of onerous performance obligations required by the ED as the existing systems could not prepare these reconciliations.