SwissHoldings

Verband der Industrie- und Dienstleistungskonzerne in der Schweiz
Fédération des groupes industriels et de services en Suisse
Federation of Industrial and Service Groups in Switzerland

22 October 2010

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

Exposure Draft Revenue from Contracts with Customers

Dear Sir / Madam,

SwissHoldings, the Swiss Federation of Industrial and Services Groups in Switzerland, represents 50 Swiss groups, including most of the country's major industrial and commercial enterprises. We very much welcome the opportunity to comment on the above-mentioned Exposure Draft issued in June 2010. Our response below has been prepared in conjunction with our member companies. We outline some general comments below and answer the specific questions of the ED in the appendix to this letter.

General comments

While the ED represents some clarification compared to the Discussion Paper published in 2008, we believe that it still comprises too many unresolved issues concerning construction contracts, separation of performance obligations and licensing agreements and above all it does not demonstrate that the principle of control is superior to that of the risks and rewards. Finally, as the ED stands, the future IFRS on Revenue Recognition runs the risk of becoming rule based.

The Board has now clarified that it is not its intention to require a completed contract method for construction contracts but its proposal of determining whether the customer controls the construction when the contract refers to goods of a specific design does not reflect the economic substance of many contracts in the construction and service industries. Those criteria are subjective and would be very difficult to apply. The Board should determine other principles to allow the recognition of revenue by stages and we reiterate our proposal made in our comment letter to the DP on revenue recognition to allow the recognition of revenue by stages when the following criteria are met:

- the absence of production for the inventories,
- a construction by steps evidenced by a process, and
- an irrevocable commitment to deliver the asset with high cancellation penalties.

While we agree with the principle of the separation of performance obligations, we consider that the Board has pushed this principle too far when it requires consumer goods companies to identify separate performance obligations when they deliver promotions goods under proof of purchases. In such deals the customers do not enter into an ongoing contract like in customer loyalty programmes but just receive promotional goods against proofs of purchase. Such promotional goods do not have the nature of performance obligations but of marketing and promotional costs that have to be expensed in accordance with current IFRSs.

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Under the proposed guidance of the ED, royalties and other milestones payments that are common in contracts for the development of drugs in the pharmaceutical industry have to be estimated and recognised upon the transfer of control if they can be reliably estimated. We consider that this principle contradicts the existing requirements of IAS 37 whereby a contingent asset shall not be recognised unless it is virtually certain. We also consider that the upfront recognition of milestones payments would not be beneficial to users for understanding how and when revenue is recognised on these contracts.

The concept of control would also have adverse consequences in case of trade loading because under the current requirements of the SEC and other regulators, shipments made in excess of the customers' needs cannot be recognised as revenue on the basis of the risks and rewards model whereas they could under the ED.

Last but not least, the application guidance of the ED is a mix of principles, requirements and illustrative examples which are all considered as being an integral part of the standard. Since making the example compulsory would render the standard rule based, we strongly recommend that the principles and requirements be moved to the body of the standard and that the examples be defined as being illustrative only.

Yours sincerely,

SwissHoldings
Federation of Industrial and Service Groups in Switzerland

Dr. Gottlieb A. Keller
Current Chair of SwissHoldings,
(General Counsel Roche Holding AG)

Dr. Peter Baumgartner
Chair Executive Committee

cc SH Board

ANNEXE

ANSWERS TO SPECIFIC QUESTIONS IN INVITATION TO COMMENT

Recognition of revenue

Question 1
We generally agree with the principles for combining or separately reporting the revenue from contracts with the customers.

However, we think that it could be a practical difficulty to determine among contracts which would require combination due to interdependence of prices and contracts, where such combination is not required per paragraph 14 (i.e. discount was offered to a customer as a result of an existing customer relationship arising from previous contracts). An example illustrating this concept would be helpful.

In addition, we found it is extremely difficult to apply current guidance on segmentation for out-licensing contracts in Pharmaceutical industry. Firstly, it is not clear if research and development or manufacturing services could be segmented, based on the "identical or similar goods or services concept". Secondly, it is not clear based on the criterion identified in paragraph 16 and the example 1 if variable transaction price components (royalty, milestones) have to be allocated to manufacturing or research performance obligations, even though such services are often performed on the basis of cost plus arrangements. We are asking the Board to include an example how segmentation is performed if contract includes variable components.

We also have some concerns regarding the reference to the fact that another entity sells identical or similar goods or services per paragraph 15 (a). We consider that the reference to another entity may sometimes be misleading, for example if the other entity sells a product only in connection with a promotion while the reporting entity sells it regularly (or vice versa) either as a standard product or in combination with other products / services.

Question 2
Generally, we are in agreement with the principle proposed by the Board for determining when a good or service is distinct. However, we do not believe that the criterion requiring a good or service to have "utility on its own or in combination with other goods or services or to be sold separately" was well illustrated. We would like to better understand how the Board reaches the conclusion in the Example 10 that the licence has no distinct function as it does not provide utility on its own or together with other goods or services. It could be a view that a licence has a utility together with research and development services acquired from the entity. In addition, the profit margin on research service is distinct as it is subject to distinct risks and the entity can separately identify resources required to perform research. We are asking the Board to provide another example where licence and research could be separated into two performance obligations. We would also recommend that the Board clarifies how the separation principle should be applied in long term contracts.

Apart from this, paragraph 23 (b) (i) repeats the reference to another entity which could be misleading as mentioned in point 1 above.

Question 3
While the Board has improved the definition of control compared to the discussion paper, in particular when it considers in paragraph 30 (b) that the customer has the ability to resell a good, which demonstrates that control does not necessarily mean the physical possession of the goods, we still have serious doubts about whether a single control approach would be

practicable in construction and service industries.

In paragraph 30 (d) the Board has established the principle of a customer specific design or function that would allow it to recognise revenue by stages as illustrated by example 15 of paragraph B66. In scenario 1 of that example, the entity would recognise services continuously because the customer controls the construction and has the legal title on it whereas, in scenario 2, the entity merely provides the customer with an equipment because the customer does not control it before its delivery. This is in line with BC64ss that consider that a continuous recognition approach when the customer controls the work progress.

We do not believe that the principles of the basis for conclusions have been carefully field tested and we doubt that they could easily be made operational because their application would be very difficult in industries producing machines, aircraft or aerospace equipment, railway rolling stock, ocean vessels, etc. In these industries, the customer may be, e.g., heavily involved in the planning phase but very little in the construction phase which would take place at the works of the manufacturer. In addition to the specific design, the Board has also said that the control criteria should be combined by taking into account the legal title, the physical possession, etc. The combination of those criteria would be very difficult to apply, first because the degree of customisation would be subjective and could rapidly become rule based (especially in industries which manufacture the same type of equipment albeit only on demand of a customer) and second because construction companies operate in very different environments and legal frameworks.

We are aware that the users are concerned with the percentage of completion method and the ability of management to correctly account for it but we do not consider that the proposed ED has established sufficiently robust principles to replace it. The ED fails to consider the business model of the entities and we are disappointed that the Board has not considered the proposal made in our comment letter of June 19, 2009 concerning the discussion paper (DP) on revenue recognition. These criteria were :

- the absence of production for the inventories
- a construction by steps evidenced by a process, and
- an irrevocable commitment to deliver the asset with high cancellation penalties.

The Board should recognise that construction companies work by milestones, that are clearly identified and documented in the construction file. Those steps should provide reliable assurance to the investors that the entity is not manipulating its revenue. Moreover those steps could be audited. The Board even mentions those milestones in paragraph 33 (a) but, in accordance with paragraph 32, they could be applied only when the entity has established that the performance obligation should be recognised continuously in accordance with paragraph 30. By simply making the milestones a criterion of paragraph 30, the Board could easily allow a recognition by steps in the machine and construction industries.

Another issue relates to the “Principal versus agent determinations” described in paragraph B20 where an agent/principal relationship should be considered not only in identification of performance obligations, but also to assess timing of revenue recognition (transfer of control). In our view, the inclusion of this additional criterion in the “Satisfaction of performance obligations” section is very important. When a principal transfers goods for re-sale to an agent, it is possible that all indications listed in paragraphs 30(a) through (d) are satisfied, however, because the distributor is acting as agent, current practice is to defer sales until it sells-through to the end customers. Should the Board decide to retain the proposed guidance, we would recommend to include an example of how to treat agent relationship in a context of the control criteria.

Finally we believe that the concept of control could have adverse consequences in case of Trade Loading because all the control criteria would be satisfied and fictitious sales would be recorded. Our comment in the DP regarding this issue is still valid as the proposed guidance seems to

contradict the view of the SEC and other regulators on the issue of trade loading, which got critical attention in the past. Under the “risk and rewards” model shipments made at the instance of the selling company and in excess of a customer’s ordinary needs (trade loading) are not recognized as revenue. Such sales contracts could be legally enforceable and would transfer control of assets to the customer. Since the proposed model requires the recognition of revenue based on the satisfaction of a performance obligation which occurs when a customer obtains control, revenue recognition seems to be allowed even in a case of excessive trade loading. We consider that an accounting standard should not open the door to transactions that contradict the entities’ best practices and that are condemned by the regulators.

Measurement of revenue

Question 4
We would generally agree that that an entity should recognise revenue from satisfying a performance obligation only if the transaction can be reasonably estimated. However, the application of the proposed principle to variable considerations in form of milestones and royalties could fundamentally change accounting practice in the pharmaceutical industry.

Under the proposed guidance of paragraph 24, royalty and milestones which could be reasonably estimated, have to be included in the amount of revenue upon transfer of control and recorded as contract assets. This is inconsistent with the current IAS 37 guidance which does not allow recognition of a contingent asset unless realisation of income is virtually certain.

Furthermore, the point at which an entity could reasonably estimate probability of receiving development and approval milestone payments is a significant area of judgement and recognition of income earlier than when payment is received may result in income statement volatility, including negative revenue in certain reporting periods, compared to the current practice.

We believe that despite the fact that recognition of estimated royalties is supported by the principle outlined in the proposed standard, such accounting treatment would not be beneficial for users of our financial statements; therefore, we suggest to retain the current accounting practice for royalty income recognition, i.e. when the underlying sale is made.

In addition, we would like to suggest a clarification related to variable transaction price outlined in the paragraph 36. To avoid inconsistency, it is important to state that in order to determine the transaction price, an entity should consider discounts, rebates, refunds, etc., offered not only to direct customers, but also to all customers and end users in the distribution chain. Paragraph 48 already expanded the scope, including other parties that purchase the entity’s goods or services from the customer. The definition of a “Customer” in Appendix A should also be expanded to include indirect customers and end users.

We are also concerned by the complexity of the use of probabilities and we do not consider that it would lead to superior results compared to the current use of best estimates. We propose that both probabilities and best estimates should be allowed inasmuch as they are explained in the entity’s accounting policies.

Question 5
Since the Board proposed an expected loss model for all financial instruments including trade receivables in its ED on Amortised Cost and Impairment, it now logically proposes that the transaction price should encompass the effects of the credit risk of the customer and that the credit losses would be deducted from revenue (paragraph B16 of the previously mentioned ED). In our comment letter on that ED we said that trade receivables should be scoped out from the expected loss model. Consequently we also disagree with the proposal to reflect the customer credit risk in the transaction price.

In proposing to deduct the credit risk from the transaction price, the Board considers that an entity should measure revenue at the amount that it would cash, i.e., by deducting probability weighted estimate of the consideration that it expects to receive (BC100). We consider that this comes to the same thing as considering credit losses as sale allowances but, while the first are granted by the entity on the basis of its selling policy and should logically be deducted from revenue, the second one reflects the inability of the customer to settle his debt and is a subsequent event that is by no means related to the trade terms and conditions. As we said in our comment letter on the ED on Amortised Cost and Impairment, trade receivables are the product of an already concluded revenue process and as such the margin from the goods and services has already materialised – which justifies the recognition of revenue excluding any potential credit losses. The Board has considered the materialisation of the revenue but concludes that any subsequent modification of the credit losses would be expensed because they reflect an impairment of the trade receivable (BC101).

Question 6

We would generally agree with the proposal of taking into account the time value of money but we consider that the Board should state that management should exercise judgement on whether the time value of money should be taken into account in a given contract.

We have also an issue about increasing the consideration payable when the customer pays in advance. Since an advance payment is economically similar as borrowing from the customer, we consider that the “reverse discounting” on this transaction should be recognised as interest income.

Question 7

While the general requirement makes sense we consider that the Board has gone too far when defining the meaning of a separate performance obligation. In BC44, the Board contends that all goods and services give rise to performance obligations even those which are qualified as marketing [or promotional] incentives. We disagree with this interpretation and especially with the assertion that it would be difficult to develop criteria in practice (BC44 in fine). On the contrary, marketing and promotional activities are facts of the economic life of the entities that cannot be commingled with performance obligations. Such activities are documented and the products remitted can be easily identified.

The application guidance of the ED (which will become an integral part of the future IFRS) considers that promotional campaigns may result in a performance obligation when an entity offers coupons or enters into similar promotional schemes. Therefore the Board assimilates these promotional campaigns to customer loyalty programmes.

The aim of a customer loyalty programme is to retain consumers by allowing them to accumulate points (or miles in the airline industry) that could be redeemed into products or services of the entity or of another entity. Actually when consumers pay for their goods or services, they are financing their future free goods or services. It is therefore economically logical to defer part of the revenue because, otherwise when the consumers redeem their points the company would incur the cost of the goods or services sold and no revenue.

Conversely as a promotional action the entity offers free goods against proofs of purchases as described in example 5 of paragraph B25 and in example 25 of paragraph B87. Sometimes the consumer also receives another product of the entity or even a completely different product against the vouchers (i.e., a promotional gift such as a T-shirt or a toy). The Board sees these transactions as performance obligations but this does not reflect their economic nature. In such cases the entity is not trying to retain its consumers, it is just inducing them to buy more products on the basis of a short term strategy or to establish brand presence (very often the promotional gifts carry the logo of the entity). We consider that the proposed treatment creates an inconsistency with the trade deals that are paid in cash of with free

goods that are remitted upon the sale of the products. The fact that the consumer has to remit a proof of purchase is not evidence of a performance obligation but just a marketing strategy. The consumer does not enter into a contract with the entity as is the case in a customer loyalty programme.

All promotional actions of an entity should be recognised when incurred either as reduction or revenue or an expense depending on their nature. Moreover IAS 38 has already been modified in May 2008 to state that expenditure incurred for advertising and promotional activities should be expensed as incurred. The proposed requirements of the ED would create an inconsistency with this IAS 38 requirement.

Contract costs

Question 8
While we understand the principle that if costs incurred in fulfilling a contract do not give rise to an asset in other standards, they should be recognised as assets only if they meet specific recognition criteria, we believe that the Board should address this in a revision of IASs 2, 16 and 38.

Question 9
It is not clear whether all the costs related to paragraph 58 should be capitalised even though it is what we understand from the reading of that paragraph. Moreover the list of paragraph 58 seems to be different from that of IAS 11 paragraph 16 ss. We consider that the Board should clarify this point.

Disclosure

Question 10
While we agree that the purpose of the disclosures is to allow the users to understand the nature of the contracts with the customers, we do not believe that all disclosures of paragraphs 69 to 83 achieve this purpose and we are concerned by their complexity: for example types of goods and services and types of contracts and the movement of contract balances. These could give rise to increased costs of compliance in terms of system changes and audit and add several pages in the reports of multinational companies. In addition it is not clear on how the disclosures of the future IFRS on revenue would overlap with those of IFRS 8. In this context, the explanations of paragraph 72 stating that the information should be presented in a way that shows how it relates with other IFRS do not appear to be very helpful. We recommend that the IASB should clarify that this should be based on the business model of the entity and we would recommend that all disclosures that are related to other IFRS be required in those IFRS as consequential changes of those standards (e.g. IFRS 8).

Question 11
As said in our answer to question 10, we have concerns about the complexity and the disclosure of the remaining performance obligation and their expected timing is an example of this. Moreover we are not clear on whether the Board would like entities to disclose revenue or cash flows or both of them. As they are stated, we doubt that the disclosures of paragraph 77 would add value to the users.

Question 12
In principle the requirements make sense but we would like to reiterate the concerns expressed about complexity expressed in our answer to question 10.

Effective date and transition

Question 13
We do not agree with the retrospective application because we do not believe that the cost of the restatement would justify its benefits because entities would have to undergo a cumbersome exercise of converting the data of the previous year when the systems are not upgraded to collect the information under the new standard. This would require manual interventions to retrieve the data of several contracts. Therefore we recommend that the choice between the prospective and retrospective information be left to the entities but those which apply the future IFRS prospectively explain the reason thereof in the notes.

Should the Board however retain the existing guidance, we recommend a modified retrospective approach which would only be applicable for contracts with the effective date on or after publication of standards as the terms of some contracts, in particular out-licensing contracts continue over long period of time. In addition, the Board should consider the effective date that allows adequate time for entities to implement a system to meet the requirements of the proposed standard.

Application guidance

Question 14
While we consider that application guidance is useful, we are concerned that it is an integral part of the standard and that the 31 examples would render the future IFRS rule based. We recommend that that, subject to our comments made elsewhere in this letter, the basic requirements regarding warranties, agency relationships, options for goods, licensing and sales and repurchase be moved to the standard and that the examples be qualified as being illustrative only.

Question 15
As said in our answer to question 14, the issue of warranty is more a question of principle than application guidance. Therefore we recommend that the distinction between the latent defects at the time of sale and coverage for defaults that occur after the sale should be explained in the standard and not in the application guidance.

In BC203 the Board justifies the treatment as an unsatisfied performance obligation by the fact that the margin should not be recognised on an unsatisfied performance obligation as per the example 4. Thus the entity should defer sales and cost of goods sold until the performance obligation is satisfied. While we would agree to defer the revenue, we would not agree to defer the costs to the balance sheet because that would result in an asset that does not meet the definition of the Framework. It will not generate any future economic benefits and would just be a deferral of costs that have been already incurred. When the defective product is returned then, the cost of the replacement product should hit the income statement and the sales related to this performance obligation should be released.

As regards the warranty for defaults occurring after the sale, we would agree that this results in a performance obligation because the customers are paying for the repair service at the time they purchase the products while they would receive the service at a later date. This is consistent with the Framework requirement that expenses are recognised on the basis of direct association between the costs incurred and the earning of specific items of income (paragraph 95).

Question 16
We do not consider that the distinction between exclusive and non-exclusive licenses is applicable in the pharmaceutical industry. Sometimes pharmaceutical companies enter into transactions whereby they license certain substances to several various entities either located

in different countries or to develop different types of drugs. These contracts have rather long maturities and the upfront recognition of the license revenue would be very difficult because it would trigger the estimation of milestones payments that are going to be received in the future.

Question 17
While we agree that IAS 16, IAS 38 and IAS 40 have to be modified in conformity with the future IFRS on revenue recognition, this does not imply that we agree with the inclusion of the concept of control in these standards.

Question 18
Issues of non-public entities are not relevant to our members.

Other points

Returns
We consider that the clauses of paragraphs 37 and B12 have the same drawbacks as those of warranties, i.e., to create an asset for the cost of the potential missed sale, which as explained in our answer to question 15, does not meet the recognition criteria of the Framework. Consistent with our comments on warranties we agree that the consideration should be deferred but we would not agree that cost should be deferred. The cost of goods sold should be credited only when the product in good condition, is sent back to the inventory. If the product is not returned in good condition, then its cost has already been incurred (i.e. a loss) and the performance obligation will be satisfied by the release of the sale against the replacement product.

In our comment letter on the DP we raised the issue of infrequent major recalls that occur in the consumer goods and other industries and we said that these recalls could not be estimated. We therefore recommend that the future IFRS clarifies that the consequences of these recalls should be accounted for only upon their occurrence by reversing the sales and the cost of goods sold.

Onerous performance obligations
If a package of products with varying gross margins is being sold with an overall discount, the requirement to apply the relative fair values method based on stand alone selling prices (ED paragraph 50) could mean recognising a loss on lower margin products at the start of the contract, even if the contract as a whole is profitable. While we accept that this is a prudent approach, we nevertheless believe that upfront recognition of a loss, followed by reversal of that loss when the products are delivered later, might not reflect the economic substance of the contract. We therefore recommend that the future IFRS should allow greater flexibility over how the transaction price is allocated, or at least foresee a rebuttable presumption in favour of the relative fair values method unless the entity shows that an alternative method of allocating the transaction price to the performance obligations represents the economic substance of the contract more faithfully.

Slotting fees
Example 23 explains that slotting fees would result in an entity recognising an expense for the fair value of the placement service because it has a different profit margin. We disagree with this assertion because slotting fees are negotiated between trade chains and retailers and are not subject to distinct transactions from which a fair value can be derived. Conversely allowances granted by the manufacturers to the retailers for joint advertising campaigns have

a fair value because the manufacturers can assess it from the quotations of advertising agencies. The Board should take this example of the application of the fair value of a service rendered to the entity by its customer.