

“Open to Comment”
Discussion Papers
Preliminary Views on Revenue
Recognition
in Contracts with Customers
International Accounting
Standards Board
www.iasb.org

June 19, 2009

Dear Sir / Madam,

Comment Letter on Discussion Paper (DP) – Preliminary Views on Revenue Recognition in Contracts with Customers

Novartis appreciates the opportunity to comment on the Discussion Paper (DP) – Preliminary Views on Revenue Recognition in Contracts with Customers. As a large, multinational company which provides healthcare solutions that address the evolving needs of patients worldwide, Novartis realizes the importance of a single accounting model for revenue recognition as a vital element in any accounting framework.

Please find below our comments to the various questions raised in the DP:

Question1:

Do you agree with the Boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We support the objective of having a single criterion for revenue recognition. We agree that changes in an entity’s contract asset or liability is a valid basis for a single revenue recognition principle. It has the potential to significantly improve the current revenue recognition standards as it could bring more consistency among different standards. The focus on a legal contract would also help non-finance users to better understand revenue recognition principles.

However, we consider that a final determination about having changes in contract asset or liability as a basis for revenue recognition should only be done after examining more complicated cases, specifically involving intellectual property and multi-element arrangements. In addition, we consider that a currently missing measurement guideline will be a critical element to include in the final standard. Among others this would help us in resolving issues we had in distinguishing between a performance obligation and measurement of the transaction price in particular with respect to promotional items.



Question 2:

Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

We identified a number of areas where it is difficult to apply the guidance provided by the Boards.

1. Contracts involving licensing of intellectual property:

First of all, we found it is difficult to apply the proposed principle to the contracts involving intellectual property, such as out-licensing agreements or R&D collaboration services. Specifically, applying guidance of the Example 7, and para. 4.56 may point to a prohibition of an immediate income recognition, which, however, could be a valid accounting conclusion in some cases under both control and risk and reward models.

Consider, for example, a pharmaceuticals company which licensed its product to another company over the product's patent life (essentially a majority of the assets useful life) for the following considerations:

- Non-refundable upfront payment
- Profit margin on supply agreement

Based on the proposed guidance, two performance obligations could be identified in this contract:

- transfer of license
- supply of goods

In our view, these performance obligations are satisfied during different periods. The transfer of the license occurs immediately upon contract execution. Customer's control is evidenced by its ability to enter into contracts with distributors, to develop a marketing strategy for the product, to set the price for the product or sub-license the product to another entity. The performance obligation of supplying goods is satisfied continuously over the supply period as goods are shipped to a customer. In this example, revenue from the non-refundable upfront payment for a license transfer should be recognized immediately, whereas revenue from the supply arrangement should be recognized over the supply period.

Based on this we believe that the final standard should include an example, along with Example 7, but where immediate revenue recognition of the upfront payment or a part thereof would be appropriate.

Such an example with immediate revenue recognition in certain circumstances is also consistent with an accounting for a lessor, considered by the Boards in Example 13 and para.10.16 of the DP – Leases, Preliminary Views.

2. Collaboration Arrangements

Guidance for collaboration arrangements between two entities should be provided as well to address the notion of protective rights vs. performance obligations. Consider, for example, a situation, where a Biotech company outlicensed to a major pharmaceuticals entity its development compound for an up-front payment and future royalties on sales. It is customary, that during the development phase, the Biotech company would participate in a Joint Development Committee. From the Biotech's point of view, its participation in the Joint



Committee is a protective right vs. an obligation. Based on this, Biotech would not allocate any of the transactional price to the Joint Committee participation, therefore, in the absence of other performance obligations, all revenue would be recognized upon the transfer of intellectual property to the major pharmaceuticals entity. We suggest that the final standard makes it clear that protective rights are not performance obligations.

3. Trade Loading

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 the customer obtains control, revenue recognition seems to be inappropriately required in a case of excessive trade loading.

4. Consignment Sales

We noted that the notion of control would be challenging to apply to the consignment sales model, where legal ownership of the assets (title) remains with the entity, but physical control over goods is transferred to a consignee.

Question 3:

Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We generally are in agreement with the Boards' definition of a contract. Such a definition is consistent with widely accepted legal and business practices and intuitive enough for general users. However, the standard defines a contract as an agreement between two or more parties that creates enforceable obligations. We believe that the Boards should clarify if the term "two or more parties" includes also indirect customers.

In the pharmaceutical industry contracts are made with direct customers but also with indirect customers such as governmental or private paying agents. In order to properly present net revenues, the entities take into account their relationships beyond contracts with their direct customers and focus on all offerings in the entire distribution chain, as required by EITF 01-9.

The issue that needs clarification is whether contracts with indirect customers imply a performance obligation which results in revenue recognition or whether they are part of the transaction price of a contract with a (direct) customer (see question 4 below).

Question 4:

Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.



The proposed definition of a performance obligation helps entities to identify the deliverables in a contract. However, in order to avoid “revenue management by contract writing” we consider it would be helpful to explicitly state that a performance obligation must be substantial and that the rights received for it must be reasonable in the context of the entire contract. We recognize that this is implicitly stated, but as this guidance is of utmost importance, in particular in long lasting contracts involving milestone payments, we consider it should be addressed explicitly. Moreover, additional and more specific guidance and examples are required in the final standard in order to enable entities to consistently identify the contract deliverables and the respective accounting. In particular, we would like to mention the following points for which further guidance is required.

Contracts with indirect customers

As mentioned above there are many indirect customers in the pharmaceutical industry, especially in the US, as shown in the table below:

Indirect Customers	Contracts/Obligations
I. US State Governments (Medicaid/Medicare)	Obligation to offer discounts to the Medicaid/Medicare eligible population (via reimbursement agreements with US States)
II. Private Healthcare Plans	Obligation to offer discounts to healthcare plans upon achievement of certain performance goals by them
III. Hospitals	Obligation to offer discounts to certain hospitals

Contracts in the pharmaceuticals industry with indirect customers could be viewed as separate performance obligations. The basis for this conclusion is that the discount is “a promise in a contract with a customer to transfer an asset”. This could lead pharmaceutical companies to inappropriately recognize sales to certain customers at different times based on the satisfaction of the deemed performance obligations outlined in the respective agreements. We believe that contracts that provide discounts in contracts whether to direct or indirect customers are not performance obligations but should be considered in the determination of the transaction price.

We believe that our conclusion is aligned with the Boards’ since footnote 8 to para. 3.30 states that “*entities often offer discounts on products as part of a marketing strategy. If those discounts are not part of a bundle of goods and services promised in a contract with a customer, then they would not give rise to performance obligations*”. However, in order to avoid misunderstandings, it would be helpful to add a definition of the transaction price, which clarifies whether it comprises discounts to indirect customers or not.



Reimbursements to customers

The DP does not discuss whether reimbursements to customers for certain services represent a performance obligation, a revenue deduction (i.e. measurement issue) or marketing expense. A clarification of the definition and accounting for fees for services provided would be helpful.

Pay for performance agreements

In the pharmaceuticals industry “pay for performance” agreements are often entered into, in particular with governments who reimburse for the cost of a treatment. Under these agreements the government receives a discount, if certain predetermined medical benefits were not achieved with a contracted product. At the point the product is sold the full price for the product is paid by the direct customer and control of the asset is transferred. However, if the objectives of the treatment are not achieved, the pharmaceuticals company will have to return all or part of the amount received. The question arises whether the company has extinguished its performance obligation at the time it delivers the drug or only once the drug has proven to provide the patient with the promised benefits. One could view the promise of certain benefits as a key feature to the pharmaceutical product and argue that the product is only accepted by the customer, if those benefits are achieved. Under that interpretation, the company would only have fulfilled its performance obligation once the benefits is proven and could only at that point in time recognize revenue. On the other hand one might consider the refundable portion as contingent or variable consideration and address it in the measurement of the transaction price. In such a situation revenue would be recognized only upon delivery of the drug. Clarification of this issue would be useful.

Question 5:

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

In general, we are in agreement that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer for the reason given by the Boards. However, we believe that the Boards should give more guidance on separating contracts which are treated as service contracts and those which are treated as a transfer of assets. The Boards should state that the service transferred must have substance and the revenue recognized must represent a reasonable compensation for that service in light of the entire contract. Otherwise, the contract might be written in a way which allows a certain revenue recognition pattern, for example by fixing milestone payments for items which require little effort to transfer to the customer.

Question 6:

Do you think that an entity’s obligation to accept a returned good and refund the customer’s consideration is a performance obligation? Why or why not?

We consider the right of return has characteristics of a separate performance obligation as the selling entity will have to stand ready to accept any returned goods. In addition to that we consider that although the goods have been transferred to the customer subject to the right of



return, the ownership has been transferred to the customer as he controls the asset until it is returned. A continued recognition of inventory by the seller, as under the failed sales concept, would misrepresent the assets of the seller. This is particularly true in the pharmaceuticals industry, where products may only be returned when their shelf-life has expired. In addition, in some cases customers would even pay higher prices to have a right of return.

However, the measurement of the performance obligation for a right of return should be separately addressed by the Boards. In our view its initial value should be based on the entity's historical experience.

Furthermore, some facts and circumstance (e.g. launch of a competing product, product recall) could make the initial estimate obsolete. Under current practice, such events require an entity to re-evaluate its expected returns provision based on the revised sales trend and product inventory in the distribution channel. The proposed guidance on measurement would not require an adjustment of the performance obligation, if the revised estimate would not result in a loss-making contract. As an expected increase in return would not necessarily make the contract onerous, the original estimate would not get revised. In our view such a treatment would result in an understatement of a company's liabilities and an overstatement of sales.

In addition, current rules preclude revenue recognition on sales with the right of return, if the company has no historical experience, until this right expires. However, an identification of a return right as a performance obligation would not achieve the same accounting treatment.

On the other hand, we understand the point-of-view that returns represent failed sales since the customers have the ability to unwind the transaction without consequence. Such a view is consistent with current industry practice. Additionally, the notion of failed sales would eliminate concerns raised above of under-(over-) estimating return reserve provisions as historic experience would need to be re-evaluated to reflect changes in the marketplace. However, since transfer of control is a key principle in the proposed model, to avoid any inconsistency, inventory related to potential returned sales should be de-recognized upon sale. De-recognition of this inventory could be supported by the entity's intent to transfer control to a customer indefinitely. As a rule, customers would gain such control without any intention to return the product. Only occurrence of some future events would make the customer return the product. De-recognition of inventory on a sales with a right of return is already a current practice of the pharmaceuticals industry since rights of return are predominantly driven by the safety standards and relates to the expired goods which will never be returned to inventory for re-sale.

Question 7:

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

For our analyses on that subject we split the sales incentives which could be provided in a contract with a customer into three groups:

- Cash discounts on current sales
- Cash discounts on future sales



- Gift cards or loyalty points

Also please note that we are using the term “customer” broadly to include an entity’s “indirect customers” as well.

As we concluded in our response to Question 4, contracts that provide discounts in existing contracts with indirect customers are not performance obligations and such discounts should be considered in the determination of the transaction price.

In principle, the accounting treatment of discounts on future sales should be consistent with a treatment of sales incentives which relate to the current sales. The economic substance of both transactions is to generate additional sales by providing an incentive to the customer to enter in to sales transactions.

We noticed that discounts on future sales have characteristics of performance obligations, as from the customer’s point of view, an entity transferred an asset (an option to make a purchase in the future at a discounted price). This could be evidenced by the ability of a customer to sell such discounts to other customers. Under this interpretation from the company’s point of view, only the future margin will be reduced, but no asset has been transferred, as long as the discount does not make the future contract onerous. Accordingly, discounts on future sales should be reflected in the measurement of the obligation to provide goods to customers when future sales occur.

However, we noticed that if the entity would not recognize discounts on future sales as performance obligations it could result in the recognition of additional sales in a current period at the expense of a lower margin in a future. We believe that such a treatment would not provide decision-useful information and even could mislead users of the financial statements. The volume of future discounts granted could be valuable information for investors, and at a minimum should be made available in the disclosures.

We are in agreement with the Boards’ view that sales incentives in a form of customer loyalty points and free goods (such as gift cards) are performance obligations as the entity has to transfer its own assets (goods) in order to fulfil its promise without additional consideration from the customers.

Question 8:

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

We are generally in agreement that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service.

However, there could be some situations, where it is not obvious when control passes (see our example 4 to question 2). Also, consider a scenario where a pharmaceuticals company sells a compound in early development to a third party, but retains a call-back option. The question could arise at which point control of the compound has passed to a customer.



Therefore, in order to ensure a consistent application of the standard, the Board should operationalize its notion of control by some test, which could be similar to the existing “risk and rewards” measurements.

Question 9

The Boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

We are in agreement that an entity should recognise revenue only when a performance obligation is satisfied.

However, we believe that additional clarification is needed about timing of satisfaction of a performance obligation and costs associated with it. We notice that in Example 4: Allocation of revenue over many reporting periods, the Boards only addressed the revenue side of sales with a warranty transaction. Our understanding is that the Boards propose to recognize revenue from performance obligations to provide warranty over the warranty period based on expected claims profiles. We believe that the Boards should include an example of accounting for fulfilment of warranty obligations as well. Under the existing practice, fulfilment of warranty obligations is recorded against the warranty accrual. Our interpretation is that the Boards expect that under the proposed standard an entity would record costs associated with the fulfilment of warranty obligations as a period cost when it occurs and there is no requirement to match revenue recognized from fulfilment of performance obligations with costs of fulfilling this obligation.

In addition, we would like more guidance to para 4.56 which propose the rebuttable presumption that an asset which is used satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation. Even though para 4.57 states that this presumption could be rebutted if the terms of a contract, or operation of law, indicates otherwise, an example to confirm this point would be useful. Consider, for example, a typical out-licensing scenario with an initial upfront payment for a license and a subsequent supply agreement with an arms length margin, as we described in our answer to question 3. A literal interpretation of para 4.56 and Example 7 would suggest a full deferral of the initial milestone and its recognition over the supply period. This approach would not be consistent with the EITF 00-21 guidance.

Question 10

In the Boards’ proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

We are in agreement that performance obligations should be measured initially at the transaction price – the customer’s promised consideration due to the reasons stated by the Boards pattern of revenue recognition and simplicity of measurement (price is observable). We are in agreement that no assets should exist at contract inceptions.



However, we believe that the Boards should provide guidance as to whether discounts offered on current sales should be handled as a reduction of a transaction price. In addition, careful consideration should be given by the Boards on how to incorporate contingent performance obligations into the proposed model. Moreover, the Boards should provide guidance for measurement of contracts denominated in foreign currencies, where contractual rights are received in a currency which is different from the one used by the entity in satisfaction of its performance obligations.

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

We are in agreement that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation as it better reflects the economic model where the margin is intended to provide a buffer for any unexpected unfavourable variances in prices or costs. This is consistent with IAS 11 and SOP 81-1 requirements.

However, if the Boards conclude that right of the returns represent performance obligations, the requirement to remeasure only when performance obligations become onerous would differ from current practice (see our answer to Question 6).

In our opinion it is essential to include in the final standard examples where entities are allowed to evaluate large volumes of homogeneous contracts as a bundle for the purpose of onerous contract identifications.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

We concluded in our answer to question 4 that many discounts offered on current sales should be handled as reductions of transaction prices. Many of these discounts are initially estimated by an entity based on the contractual terms and historic experience and are not settled for a long time period – 6 to 9 months. Under current practice, such revenue deductions are remeasured every accounting period based on new information available. Even though, such remeasurement normally would not result in an onerous contract, such remeasurements are required to present sales and liabilities faithfully at each reporting date. If the Boards agree with our proposal to treat such discounts as a reduction of transaction prices, the Boards should provide guidance addressing remeasurement of the transaction price.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

We have not identified any performance obligations which should be subject to another measurement approach.



Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

We agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations.

(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

We have not identified any examples where recognition of contract origination costs as expenses as they are incurred would not provide decision-useful information about an entity's financial position and financial performance.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

We agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

We do not believe that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price. We believe that similar with a concept of substantive milestones, revenue only should be recognized when a significant deliverable is achieved. If an entity does not sell goods or services separately, there is an indication that one portion of this good or service is inconsequential or has no value to the customer.



We thank you for the opportunity to submit our comments on your proposals. However, we wish to point out that many essential issues for our industry were not covered in this Discussion Paper, such as issues involving intellectual property, contingent considerations or gross versus net presentations of revenue. Without reviewing proposed guidance to all these topics, it is difficult for us to make a final assessment whether or not application of this new standard to the pharmaceuticals industry would result in improvements of decision-usefulness to the users.

We will be glad to take part in the Boards' field visits to further discuss our comments.

Yours sincerely,

Novartis AG

A handwritten signature in blue ink, appearing to read "M. B. Cheetham".

M. B. Cheetham
Chief Accounting Officer

A handwritten signature in blue ink, appearing to read "M. Kaeser".

M. Kaeser
Head of Accounting Principles