

19 June 2009

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

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

Dear Madam, dear Sir

SwissHoldings, the Swiss Federation of Industrial and Services Groups in Switzerland, represents 49 Swiss groups, including most of the country's major industrial and commercial firms. We very much welcome the opportunity to comment on the above-mentioned Discussion Paper (DP). Our response below has been prepared in conjunction with our member companies.

**General Comments**

We welcome and support the work of the Boards to issue a comprehensive DP that addresses the shortcomings of IAS 11 and IAS 18 and considers the issues of the numerous US GAAP pronouncements in order to ultimately arrive at a converged standard on revenue recognition. Such a standard should increase the transparency of the recognition of revenue for the users and result in requirements that are practicable for the preparers. We therefore view the DP as a positive first step but we consider that several issues should be addressed before the Boards can issue an exposure draft and later on a standard with robust requirements.

While we generally support the proposals of the DP and in particular that a single revenue recognition method would be desirable in theory, we question how such a single method would work. We have some doubts concerning the current structure of the DP because it bases the recognition of revenue on control, defined as transfer, which could also be strictly viewed as the physical possession of the goods and the access to services. We consider that defining control as the physical possession of the goods would be rather legalist and would not faithfully represent the way revenue is generated in a variety of entities operating on a project basis either in the manufacturing or service sectors. Our members operating in the construction sector in particular do not fully agree with this proposal. Nevertheless we consider that the Boards can solve these issues by defining control on the basis of its economic substance and by considering that, in contract businesses, control of the goods is deemed to exist by reference to the stage of completion based on the way the accumulation of costs is achieved. We consider that the Boards should further explore these proposals and that they proceed to extensive field tests with entities working on a contract basis as well as with other entities before issuing any Exposure Draft. From this standpoint the proposed publication of an ED during the first half of 2010 as stated in the IASB work programme seems very ambitious and difficult to meet.

These issues and others regarding the definition of performance obligations in case of returns and discounts granted to customers as well as control in international trade situations are further developed in our answers to the specific questions of the DP.

We thank you for the opportunity to contribute to the due process and for taking into consideration our comments.

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

## Specific questions in invitation to comment

### Chapter 1

#### Question 1

*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?*

While we acknowledge the fact that a single revenue recognition principle might be desirable in theory, the Boards should first have examined whether one single method would faithfully represent economic circumstances and provide adequate information to users and help entities' management to communicate with them. We consider that a single principle based on physical possession would introduce a very legalistic view on revenue recognition and that it would induce entities to separate contracts into different phases and to "construct" transfers of assets to their customers in order to be able to achieve a certain revenue recognition pattern. We consider that this contradicts the consistency and neutrality principles of the Framework.

We also consider that the single revenue recognition principle may work for industries which manufacture for inventories and then enter into contracts for selling their inventories. On the other hand, business models in which entities enter into specific construction, manufacturing or service contracts may have different economic characteristics. Unless the Boards address the specific issues of these entities it is difficult to confirm whether the single recognition principle for revenue recognition would actually work. Moreover we also understand from contacts that we have had with users that they require more information on the accumulation of costs in entities working on a contract basis.

We also believe that the current different requirements of IAS 18 and IAS 11 are not inconsistent however we accept that these standards are old as both of them date back to the 1980s with only minor modifications having been made to them since that time. Moreover their scope of application is not clear. IAS 18 refers to goods and services and IAS 11 to construction contracts.

Therefore we recommend that the Boards develop accounting requirements that acknowledge the above distinction between entities that manufacture for their inventories and those which produce goods and services on the basis of specific contracts. We also consider that such an approach may be compatible with the control concept if it can be applied on an economic substance over legal form basis. We understand that construction companies establish firm contracts with detailed cost budgeting and tracking when they organise their projects and that such firm contracts with customers are the basis for determining the stage of completion. The agreement from the customer could be seen as a deemed transfer of control at different steps of the project even if the asset is not physically transferred. In parallel these contracts should be coupled to a proper definition of how the costs are accumulated since we understand that this is a weakness that users have identified in the current standards. We consider that the Boards should further investigate this approach and field test it with the entities concerned by this issue before issuing any exposure draft.

#### 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?*

In this DP the Boards have proposed one single revenue recognition principle based on control. As said in our answer to question 1, we consider that the definition of control should be adapted for the enterprises that work on a contract basis. Therefore we consider that reliable principles should be found to distinguish these entities from those which are active in the business of selling goods out of their inventories (eg. active in consumer goods, pharmaceuticals, chemical sectors, etc.) and rendering immediate services such as transportation, telecommunications, etc. Some companies may have a mixed model. For example a heavy industry company producing say heavy electrical equipment on a contract basis may also have a division producing home appliances.

We would recommend that a future standard on revenue recognition establishes criteria to distinguish entities producing for inventories from those producing on a contract basis. Such criteria for a contract basis could be:

- No production for inventories
- Construction by steps
- Irrevocable commitment to deliver the asset with high cancellation penalties
- A process is in place.

The entities should select the criteria for in-substance transfer of ownership by steps (as mentioned in our answer to question 1), and apply them consistently unless a change in their activities takes place.

In addition, the proposals of the DP would be difficult to apply for companies that work for inventories however currently apply IAS 18 to address accounting issues in the following areas, which affect mainly our member companies operating in the pharmaceuticals sector:

1. Contracts involving licensing of intellectual property
2. Collaboration Arrangements
3. Trade loading
4. Consignment sales.

1. Contracts involving licensing of intellectual property may involve two or more performance obligations, e.g., the transfer of the license and the supply of goods. In our view, these performance obligations are satisfied during different periods. The transfer of a 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 this 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 recognised immediately, whereas revenue from the supply arrangement should be recognised over the supply period. Based on this, we recommend that the future standard should include an additional example to example 7 where immediate recognition of the up-front payment is appropriate.

2. Guidance for collaboration arrangements between two entities should be provided as well to address the notion of protective rights vs. performance obligations. This refers to the case where say a Biotech company out-licenses 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, Biotech participates in the Joint Development Committee. It is essential to differentiate between the protective rights, which are granted to Biotech to protect their future cash flows and which would not require an allocation of the transaction price, and performance obligation, which would result in a deferral by Biotech of the portion of the up-front payment.

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 a customer obtains control, revenue recognition seems to be allowed even in a case of excessive trade loading.

4. Consignment sales: We note 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 partly agree with the definition of a contract and we believe that it is important to make it clear that a contract does not necessarily need to be in writing. Therefore we propose to combine the definition of § 2.11 with the clarification of § 2.18 as follows: "A contract is an agreement between two or more parties that creates legally enforceable obligations. It can be written, oral or evidenced otherwise".

Moreover, since the DP 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. Indirect customers exist in the pharmaceuticals and other industries and could be defined as parties to a contract that never control the goods but are entitled to discounts depending on the use of the products by their consumers. For example, a pharmaceuticals company may sell drugs to pharmacies, which re-sell them to patients who claim the reimbursement from an insurance company. By virtue of a contract between the pharmaceuticals company and the insurance company, the latter is entitled to discounts based on the consumption of drugs by its insured persons.

## **Chapter 3**

### **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.*

It seems to us that the definition is not clear enough and will result in too broad an application in terms of warranties and transfer of an asset to a customer. We have an issue with § 3.7 which states that any enforceable promise, which we understand also encompasses warranties, give rise to an asset to be transferred as a result of entering into a contract. While we agree that warranties that are encompassed in a contract between a manufacturer and its suppliers, such as in the home appliance business, gives rise to a performance obligation, we consider that infrequent major recalls that occur in the consumer goods and other industries do not give rise to a performance obligation and that these liabilities should be recorded when such event takes place (please see also our answer to question 6 regarding returns).

Moreover we consider that the definition of a performance obligation should be clarified and that it should be made crystal clear in a future standard that goods used in the performance of services do not give rise to a performance obligation. In particular we believe that the example of the painter in § 3.11 is confusing especially when it is saying in § 3.12 that (emphasis added) "a

good does not have to be ***promised explicitly*** in a contract to give rise to a performance obligation" which implies that implicit promises should be unbundled.

#### **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?*

We agree that a contract can bundle separate performance obligations and we agree with the arguments of §§ 3.22 and 3.24, that unbundling all separate performance obligations would be unnecessarily complex and that, if different performance obligations are provided at the same time, such as the example of the sale of separate computer equipment of § 3.21, then the different performance obligations need not be unbundled.

Conversely there are contracts where an entity is indeed incurring different performance obligations that should be reported separately but preparers need reliable separation criteria to do this. As stated above, the key criterion should be the faithful representation of economic circumstances. Therefore the unbundling should reflect the business model of an entity; please also see our answer to question 4 and our comment on the example of the painter. Consequently if the entity is offering goods or services separately or in conjunction with other goods and services, then the performance obligations should be separated. Moreover, as said in the previous paragraph, the timing of the transaction is important because an entity would not need to unbundle elements that are provided at the same time.

#### **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 that a right of return generally has the characteristic 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 also 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 for 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 which implies it is a separate performance obligation.

However, we consider that major recalls that occur sometimes in the consumer goods and certain other industries do not give rise to a performance obligation and should be accounted for exclusively in accordance with IAS 37 when such an event gives rise to a present obligation resulting from a past event. In effect, the trigger for such recalls is generally a regulator's decision that is sometimes based on the regulators' interpretation of safety thresholds, which may result in recalling products in one jurisdiction, whereas the same products would continue to be sold in another jurisdiction.

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

In assessing whether rights of returns are performance obligations or failed sales, the Boards should take into consideration that sometimes facts and circumstance (e.g. launch of a competing product) would make the initial return 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 a 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. Such a treatment would result in our view in an understatement of a company's liabilities and an overstatement of sales.

On the other hand, we understand the point of view that a return represents failed sales since 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 inconsistency, inventory related to potential returned sales should be de-recognised 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 gain such control without any intention to return the product so only the occurrence of some future event would make the customer return the product. De-recognition of inventory on sales with a right of return is already a current practice in the pharmaceuticals industry since rights of return are predominantly driven by the safety standards and relate to the shelf-life expired goods which will never be returned to inventory for re-sale.

#### **Question 7**

*Do you think that sales incentives (e.g. 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?*

There is a wide variety of different incentives, which are often industry-specific. Some of these incentives have the characteristics of performance obligations, while others should be reflected in a measurement of the transaction price.

In our view discounts that are part of the general trade terms of an entity and evidenced by a list price or a similar document, because they represent fixed promises (either in cash or in kind) in a contract related to current sales, are performance obligations which are satisfied at the same time as sales. There is therefore no need to separate them, but rather to account for them in the determination of the transaction price as a reduction of revenue.

Discounts on future sales may be seen as having the characteristics of performance obligations, because, from the customer's point of view, an entity has transferred an asset (i.e. an option to make a purchase in the future at a discounted price). However from the company's standpoint no asset has been transferred. Accordingly, discounts on future sales should be reflected in the measurement of the obligation to provide goods to customers only when the future sales occur.

We are in agreement with the Boards' view that sales incentives in a form of customer loyalty points and gift cards, and similar programmes 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.

## Chapter 4

### 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 do not believe that a strict control approach would result in more consistent decisions about when assets are transferred. Assets are transferred when the buyer can dispose freely of them, i.e. re-sell them, pledge them, etc. A strict control approach would not be consistent with the Incoterms that are in use in international trade. If goods are despatched FOB port of shipment, they belong to the buyer when they are loaded onto the ship. The buyer does not physically control them but he could sell them during their transportation.

However we believe that the Boards could solve this issue by defining control as the ability to dispose of or assign the goods, instead of saying as in § 4.5 that the customer controls the goods when it takes physical possession of them. Therefore we recommend that the Boards follow our in-substance control principle as explained in our answer to question 1.

### 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.*

While, on the basis of the proposed model, revenue should be recognised only when a performance obligation is satisfied, this is only the final point of the process. The crux is that certain industries have a business model whereby they generate revenue at different steps of the execution of a contract and the determination of those steps should be determined on the basis of facts and circumstances stemming from the business model of the entity rather than from steps arbitrarily determined in the contract to achieve a given pattern of revenue recognition. As said in our answers to questions 1 and 8 above, we believe that the Boards could address this issue by modifying the notion of control by applying it from an economic substance over legal form point-of-view rather than having a legalist view based exclusively on physical control.

## Chapter 5

### 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 agree that performance obligations should be measured initially at the transaction price which is a simple and relevant method. However please see our remarks in our answer to question 7 regarding discounts. Moreover, the Boards should provide guidance for the 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 agree with the remeasurement of a performance obligation when a contract is deemed to be onerous as this is consistent with the definition of a liability under IAS 37.

- (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 do not consider that there are performance obligations for which the proposed measurement approach would not provide decision-useful information. While we acknowledge that there are contracts that may become onerous on the basis of certain contingent events, we consider that the remeasurement of a performance obligation when a contract becomes onerous as specified in § 5.61 ss. would provide adequate information on how to determine when a contract becomes onerous and to reliably account for this liability.

- (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.*

On the basis of our answer to question 10 (c) above we do not consider that it would be necessary to use 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 (e.g. selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognise 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 with the conclusions of § 5.31 that the costs that an entity incurs to obtain a contract should be recognised as expenses. This method is simple and addresses the economic reality. There is no difference between selling expenses and other expenses of an entity. Moreover, allocating selling expenses to specific contracts would be complicated in terms of creating tracking systems and would create very little benefits if any. Such a process would also not be in accordance with the Framework because, if selling expenses would have to be allocated to the contracts to which they relate, then they would have to be deferred and might create assets that would not meet the definition of an asset in the Framework.

- (b) *In what cases would recognising 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.*

On the basis of our answer to question 11 (a) we do not consider that this would be the case.

## **Question 12**

*Do you 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? 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 an entity's stand-alone price of the goods or services underlying the performance obligations. In other words we consider that no revenue should be recognised at inception of a contract when free goods are delivered to a customer.

## **Question 13**

*Do you agree 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? Why or why not? When, if ever, should the use of estimates be constrained?*

We agree that if an entity enters into a contract providing goods and delivering services that are bundled with each other, that the entity should estimate the stand-alone price of the goods and services. This would occur in particular in contracts where the performance of a service is included in the price per unit. In such cases entities sometimes either perform the service separately or add a mark-up to the unit price of the goods for the services rendered. Therefore the unbundling of the multiple elements should not create undue complexity to the preparers however it should take place only if an entity also sells these goods and services separately.