

1820-100 Comment Letter No. 245

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Via email: director@fasb.org

Leslie Seidman, Acting Chairman Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

File Reference: No. 1820-100, Exposure Draft: Revenue from Contracts with Customers

Dear Ms. Seidman:

Medtronic, Inc. ("Medtronic," "we,") appreciates the opportunity to provide the Financial Accounting Standards Board (the "FASB," or the "Board") with our comments on the Board's Exposure Draft regarding Accounting for Revenue from Contracts with Customers dated June 24, 2010 (the "Proposed Standards Update"). Medtronic is a global leader in the medical technology industry.

Summary

We understand and support the Board's efforts to simplify and improve the accounting and disclosures for revenue recognition. We also support the Board's objective, together with the International Accounting Standards Boards ("IASB"), (collectively referred to as the "Boards") towards the goal of achieving a single set of high-quality global accounting standards specific to revenue recognition. While we are generally supportive of the revenue model proposed, we believe the Boards have proposed several requirements that companies will struggle to implement and that are not indicative on how businesses operate and are managed. Our most significant concerns with regards to the Proposed Standards Update include the following:

- We do not support the probability weighted approach to determining the transaction price. We believe probability weighted estimates could result in a transaction price that is not indicative of the actual amounts expected to be received due to the fact that it is a weighted calculation of all possible outcomes. We believe the Boards should allow companies to measure the transaction price based on management's best estimate.
- While we agree that collectibility should be a revenue recognition threshold, we do not believe that a customer's credit risk should be reflected in the probability weighted approach to determining the transaction price and result in a revenue deferral. We believe a customer's credit risk should subsequently be accounted for as an adjustment to receivables through bad debts expense.

- We do not support a retrospective transition method of adoption. We recommend that the Boards implement a transition alternative similar to that allowed in Update No. 2009-13 Revenue Recognition: Multiple Deliverable Revenue Arrangements (Topic 605).
- We do not agree with how the Boards have drawn distinction between warranties for latent defects that exist when the product is transferred to the customer and for warranties that arise after the product is transferred to the customer (standard warranty coverage), and the resulting accounting that is required for each. We believe that most companies do not distinguish between these two types of warranties. We do not believe standard warranty coverage should result in a deferral of revenue. We believe the current method of accounting for such warranty obligations (ie identifying a separate warranty obligation that is booked up front (along with standard product cost, selling/commission expenses, etc.) when such costs are probable and reasonably estimable based on historical trend information) is effective.
- We do not support the approach in the Proposed Standards Update that there should be different revenue recognition rules based on intellectual property license exclusivity. We believe the determining factor for revenue recognition should be based on an entity's performance obligations in the contract arrangement and that revenue should be recognized immediately once the performance obligation has been fulfilled.

Our Responses to Select Questions for Respondents

Ouestion 1

Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

In general, we support the concept of using price interdependence as a key determinate. We believe a key determinate that should carry more weight than others is the negotiated business intent at the time the contract is consummated. (ie is the contract negotiated with a single business objective or multiple business objectives with regards to pricing?)

We concur that if the prices of the contract modification and the existing contract are not interdependent, the entity shall account for the contract modification as a separate contract.

Ouestion 2

The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

Generally, we support the Boards' proposal that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. However, as stated in our response to question 15, we do not agree that standard warranties are performance obligations. We believe the best evidence that a good or service is distinct is when the good or service is sold separately (either by the entity, or another entity sells an identical or similar good or service separately).

Question 3

Do you think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

We support the proposed guidance in paragraphs 25-31 for determining when control of a promised good or service has been transferred to a customer.

Question 4

The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

We agree that if the amount of consideration is variable, an entity should include it in the transaction price that is allocated to performance obligations if it can be reasonably estimated. However, we do not believe that the amount of variable consideration should be determined using a probability-weighted approach. We believe the Boards should allow companies to measure the transaction price based on management's best estimate.

It is our assumption that if an entity is not able to estimate revenue for performance obligations that are subject to variable consideration, we would expect that those performance obligations would be bifurcated from the other performance obligations in the arrangement so that no revenue is allocated to them until management can reasonably estimate the variable consideration.

Ouestion 5

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

We do not support the probability weighted approach to determining the transaction price. We believe probability weighted estimates could result in a transaction price that is not indicative of the actual amounts expected to be received due to the fact that it is a weighted calculation of all possible outcomes. We propose that the Boards allow an entity to measure the transaction price based on management's best estimate. We do not believe that a customer's credit risk should be reflected in this estimate. While we agree with the Boards that collectibility should be a revenue recognition threshold and that revenue should be recognized when the customer obtains control of the good or service as currently proposed, we do not agree that collectibility should affect the measurement of revenue on the date of sale but believe a customer's credit risk should be subsequently accounted for as an adjustment to receivables through bad debts expense.

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

While conceptually we can understand the Boards' proposal, we believe the guidance does not consider the economic substance and intent of the parties when entering into these arrangements. We recommend that the Boards develop more of a principles based requirement that would allow companies to determine if their contracts include a material financing component. In the event that there is a material financing component which includes a length of time of more than one year, an entity should account for the time value of money accordingly using an appropriate discount rate.

Ouestion 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

We generally support the allocation of the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis). We support the Boards' decision against specifying a hierarchy of acceptable estimation methods. We agree that as long as the method is consistent with the basis of a standalone selling price and maximizes the use of observable inputs, that no method should be precluded or prescribed to determine an estimated standalone selling price. However, we recognize that this approach may be difficult for some entities that have not yet adopted ASU No. 2009-13 *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements* and/or where an entity is not able to estimate a standalone selling price.

We believe a "hypothetical what if" question as to can the good or service be sold separately (ie if it were the only product a company sold) adds significant complexities and can become highly subjective to assess. When a good or service is not sold separately in the normal course of business, its selling price is not observable, which can make it more difficult for an entity to determine whether it has a distinct profit margin or not.

We noted in BC125, the Boards confirmed that the residual method should not be used to allocate the transaction price to separate performance obligations but that "a residual or reverse residual technique may be an appropriate method for estimating a standalone selling price if there is a directly observable price for one performance obligation but not the other." These statements appear contradictory. It is unclear if the residual method would be allowable under the proposed guidance and under which circumstances. The standard should clarify intent of use of the residual method.

Question 10

The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

We generally believe the majority of the disclosure requirements in the Proposed Standards Update meet the Boards' objective to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. However, we do not believe that the requirements to disclose a reconciliation of contract

balances, and a reconciliation of onerous performance obligations would provide significant enough benefit to the user to outweigh the costs to administer.

We believe that the reconciliation of contract balances and onerous performance obligations are not necessary to meet the Boards' disclosure objective to enable users to understand the magnitude, the potential timing, and uncertainty of revenues and cash flows arising from contracts with customers. We believe that for many companies much of the information required to complete the reconciliations would be tracked in multiple off-line systems. Therefore, aggregation of this information would require significant administrative effort and significant costs to update systems to provide the necessary information.

Question 11

The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

We believe that the proposed requirement to disclose the total amount of performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year would not provide meaningful information to the financial statement user or add to the users understanding of the amount, timing, and uncertainty of revenues and cash flows. Due to many outside factors that could affect the amounts in the disclosure (such as currency fluctuations, contract amendments/cancellations, contracts with a duration less than one year, etc.), we question the value of the disclosure to the users of the financial statements.

Question 13

Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

We do not agree that an entity should apply the proposed guidance retrospectively. We recommend that the Boards implement a transition alternative similar to that allowed for in Update No. 2009-13 *Revenue Recognition: Multiple-Deliverable Revenue Arrangements* (Topic 605). This transition alternative would require prospective application for all new arrangements entered into and those materially modified after the date of adoption with the requirement to disclose comparative information for either the period of change or the period immediately

preceding the change. Retrospective application would be permitted. We believe that providing at least one period of comparative information about the change in accounting for revenue recognition provides sufficient information to investors about how the change affects a particular entity.

We recommend the Boards consider conducting adequate field trials to understand the complexity and lack of existing system capabilities to support retrospective application and we strongly recommend the Boards undertake a comprehensive cost/benefit analysis before concluding that retrospective application is required.

Question 14

The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

We believe that based on the current guidance provided, there is a risk that some financial statement preparers may develop varying interpretations of the guidance or utilize their independent auditors to help define the appropriate accounting when circumstances occur that are not specifically addressed in the implementation guidance. We would expect that the Boards recognize the possibility that this could result in financial statements that are not comparable.

We provide standard warranty coverage (which is not separately priced or sold) on certain products for faults that arise after the product is transferred to the customer but these warranties are typically granted on a sliding scale basis from the date the device implant was initially made. In such instances, it is very common to receive incremental revenue on the upgraded warranty unit. The current implementation guidance does not clearly state as to if/how this potential incremental revenue should be taken into account when estimating the performance obligation at the date of initial sale (ie this warranty represents a discount off future product replacements). We would find additional examples in the implementation guidance to be helpful.

Question 15

The Boards propose that an entity should distinguish between the following types of product warranties:

- (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.
- (b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

We do not agree with how the Boards have drawn distinction between warranties for latent defects that exist when the product is transferred to the customer versus warranties that arise after the product is transferred to the customer, and the resulting accounting that is required for each. We believe that most companies do not distinguish between these two types of warranties. We believe most companies distinguish warranties between those that are incurred in connection with the sale of goods and services and those warranties sold separately.

Because entities do not currently differentiate between latent defects that exist when the product is transferred to the customer and those defects that arise subsequent to a sale, this distinction would be very difficult to implement. In practice, we believe it would be difficult to make the distinction between whether a defect existed at the date of transfer or occurred at a later date. Companies generally provide base warranty coverage for a specified period of time in which the manufacturer is willing to fix a defective product; however, no distinction is made as to whether the defect existed at the product shipment date or developed thereafter. The Boards' proposed differentiation between these two types of defects will be difficult to apply since the data to make this distinction is not captured in financial systems and in most cases, would unlikely be determinable.

We support the concept of a quality assurance warranty and believe that this type of warranty should be covered by normal "right of return" accruals. We believe that revenue should be reduced by the estimated likelihood and extent of latent defective products that has been sold to customers and a corresponding right of return liability should be established. However, we believe that usage of a historical performance metric is sufficient to provide a reasonable estimate of such costs. We do not believe requiring the usage of probability weighted modeling is practical as the costs exceed the benefits.

As stated in the response to question 14, we provide standard warranty coverage (which is not separately priced or sold) on certain products for faults that arise after the product is transferred

to the customer but these warranties are typically granted on a sliding scale basis from the date the device implant was initially made. In such instances, it is very common to receive incremental revenue on the upgraded warranty unit. The current implementation guidance does not clearly state as to if/how this potential incremental revenue should be taken into account when estimating the performance obligation at the date of initial sale (ie this warranty represents a discount off future product replacements). We would find additional examples in the implementation guidance to be helpful.

The Proposed Standards Update would identify these standard warranties as performance obligations and would require revenue deferral. We do not agree that standard warranties are performance obligations. Standard warranties provide customers with a contractual right which guarantees that the delivered product will function according to specifications for a certain period of time. The contractual promise embodied in the arrangement, in our view, is a functioning product. (ie the product guarantee does not provide the customer with an asset above & beyond the original delivered product). We believe that the proposed guidance in the Proposed Standards Update does not accurately reflect the economic realities associated with entities' obligations to their customers, and will not necessarily result in more decision-useful information to users of the financial statements. We strongly believe the current method of accounting for such warranty obligations (ie identifying a separate warranty obligation recorded at the time such costs are probable and reasonably estimable based on historical trend information) is effective. We do not believe that identifying a separate performance obligation and deferring a portion of revenue for standard warranties would provide sufficiently useful information to readers of financial statements to justify the increased complexity, efforts, and cost.

Ouestion 16

The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

With respect to the pattern of revenue recognition for licenses of intellectual property that are not considered to be sales, we disagree with the proposed conclusion applied broadly that the pattern of revenue recognition should depend on whether the license is granted on an exclusive basis. We believe exclusivity affects the perceived value of a product or service and does not have bearing on when revenue should be recognized.

As such, we do not support the approach in the Proposed Standards Update that there should be different revenue recognition rules based on license exclusivity. We believe the determining factor for revenue recognition should be based on an entity's performance obligations in the contract arrangement and that revenue should be recognized immediately once the performance obligation has been fulfilled.

Conclusion

We respectfully ask you to carefully review and evaluate all comment letters received, and specifically to consider carefully the issues identified in this comment letter. We also urge the Boards to conduct proper field testing to identify and understand the full consequences of the proposed guidance.

Very truly yours,

Gary L. Ellis

Sr. Vice President & Chief Financial Officer

Mary Wilcox

Vice President & Chief Accounting Officer