“Open to Comment”
Exposure Draft
Revenue from
Contracts with Customers
International Accounting
Standards Board
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October 22, 2010

Dear Sir / Madam,

Comment Letter on Exposure Draft (ED) – Revenue from Contracts with Customers

Novartis appreciates the opportunity to comment on the Exposure Draft (ED) – Revenue from 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.

While we generally support the model proposed by the boards and find the Exposure Draft to be a great step forward from the Discussion Paper in addressing a lot of our concerns, we are surprised to find out that the Exposure Draft introduces fundamental changes in the accounting for royalties and milestone payments which were not envisioned in the Discussion Paper. In our view, which we also express specifically in the answers below, these fundamental changes increases complexity, subjectivity and therefore could reduce reliability and comparability of the financial information even across one industry.

However, we believe that the boards could remedy these issues by developing further segmentation criteria and guidance, specifically, by explicitly excluding the requirement of allocation of the variable transaction prices in the form of royalties and milestone payments to such components of the contracts as research or supply-manufacturing services in cases when such components are distinct and priced independently.

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

Question1:
Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether:
(a) to combine two or more contracts and account for them as a single contract;
(b) to segment a single contract and account for it as two or more contracts; and
(c) to account for a contract modification as a separate contract or as part of 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?

Generally, we are in agreement with the price interdependence principle.

We support the idea of segmentation of a single contract in two or more contracts as it would eliminate the allocation of a transaction price to the segment of a contract to which it does not relate (paragraph 15-16).

However, we think that it could be a practical difficulty to determine among contracts which would require a 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 extremely difficult to apply the current guidance on segmentation for out-licensing contracts in the Pharmaceuticals industry as it leaves a lot to management judgement. 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 paragraph 16 and 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 ask the boards to include an example of how the segmentation is performed if the contract includes variable components.

Question 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 are in agreement with the principle proposed by the boards for determining when a good or service is distinct. However, we do not believe that the criterion requiring a good or service to provide “utility on its own or in combination with other goods or services or to be sold separately” was properly illustrated.

For instance, we would like to understand better a conclusion reached in 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 a research service is distinct as it is subject to distinct risks and the entity can separately identify
resources required to perform research. We ask the boards to provide an example where the licence and research could be separated into two performance obligations.

In Example 9, a conclusion about distinct services could be reached by applying criterion 23 (a) only, as installation services are sold by other entities separately and paragraph 23 requires meeting of either of the specified two criteria for goods or services to be distinct (sold separately or having distinct function and profit margin).

**Question 3:**

*Do you think that the proposed guidance in paragraphs 25-31 and related application 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?*

Generally, we believe that the principle and the proposed guidance are sufficient for determining when control of a promised good or service has been transferred to a customer. However, we would like to make the following suggestions.

Paragraph 27 indicates that the customer’s ability to direct use of a good or service refers to the present right to use the asset for its *remaining economic life*. To ensure that this guidance applies to all types of contracts, we suggest the following change: replace “remaining economic life” with “remaining economic life or contractual life (for non-exclusive licences)”.

We recommend including the “Principal versus agent determinations” described in paragraph B20 in this section as agent/principal relationships should be considered not only in the 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 30(a) through (c) are satisfied, however, because the distributor is acting as agent, current practice is to defer sales until it sells-through to the end customers. We ask the boards to include an example of how to treat an agent relationship in the context of a control criterion.

In addition, we would like the boards to include an example illustrating application of these principles in the case of trade loading. Regulators and the SEC in particular, would not welcome revenue recognition in circumstances where a customer controls inventory considerably in excess of its normal requirements (perhaps as a result of inducements from the supplying entity). We disagree with the proposed standard in such situations which would basically require revenue recognition with only an estimate of return liabilities.

**Question 4:**

*The boards propose that if the amount of consideration is variable, an entity should recognise 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 recognise 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 recognising revenue when the transaction price is variable and why?

We are in agreement with the boards’ proposal that an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Generally, the criteria outlined in paragraph 38 provide a reasonable basis for an entity to make such an assessment. We also agree that an entity should recognize revenue on the basis of an estimated transaction price.

We do not foresee any issues in applying this concept to the variable transaction prices in the form of reductions from selling prices such as discounts, rebates, and returns. While we are in agreement with the measurement of refund liability at the probability-weighted amount of consideration that the entity expects to refund to the customer, we propose to permit an application of historic experience in situations when refund liability relates to a large volume of homogeneous transactions. We suggest including in the example 3 an illustration of an alternative approach, specifying that if an entity has historic experience that e.g. 3% of its products are returned and there is no evidence indicating that such experience is not relevant, the entity could apply historic rate of 3% in determination of its return liability as a surrogate to a probability-weighted approach. We are of the opinion that the application of historic experience as a surrogate for the probability-weighted approach could be the most appropriate for other refund liabilities in our industry, such as coupons, co-pay cards, etc.

The boards should explicitly state that application of historic experience as a surrogate for the probability-weighted approach in situations when the refund liability relates to a large volume of homogeneous transactions is an acceptable practice.

In addition, the application of the proposed principle to variable considerations in the form of milestones and royalties could fundamentally change accounting practice for our industry.

Under the proposed guidance, royalty and milestone payments 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 did not allow recognition of a contingent asset unless realization of income is virtually certain. We acknowledge that this proposal is partially aligned with a treatment of contingent considerations prescribed in the business combination accounting in IFRS 3(R) but the inconsistency between standards would be very noticeable for our industry. To illustrate our point, assume the following scenario:

An entity acquired a small Biotech Company, which has two compounds in development, in a business combination transaction. As per IFRS 3(R), the entity establishes a contingent consideration provision for milestone payments related to the development and regulatory approval of each of the acquired compounds. If the entity subsequently, but before regulatory approval, outlicences one of the acquired compounds it would not include the development and regulatory approval milestones capitalized as part of the original acquisition in the
determination of revenue upon transfer of the licence on the grounds that it is highly susceptible to external factors (judgement of 3rd parties i.e. regulators).

The point at which the entity could reasonably estimate probability of receiving development and approval milestone payments is a significant area of judgement. Some preparers may conclude that since the consideration amount is highly susceptible to external factors (judgement by 3rd party i.e. regulators, uniqueness of each molecule), the consideration could not be reasonably estimated, and therefore it would be excluded from the revenue determination until satisfaction of the performance obligation.

Other preparers might assign a probability of receiving regulatory approval based on their entity’s experience. However, it will be difficult for our industry to establish whether contracts involving milestones would be considered sufficiently “similar” to estimate an outcome reliably. It is not clear if “similar” could be viewed as say a therapeutic area or experience with a certain market.

Recognition of income earlier than the payment is received may result in income statement volatility, including negative revenue in certain reporting periods, compared to the current practice.

The point at which an entity could reasonably estimate royalty streams could be a matter of judgement as well. For example, it could depend on whether a product is marketed already or still in development. Some preparers may conclude that since uncertainty about the amount is not expected to be resolved for a long time, revenue upon transfer of licence to a customer would only be recognized based on a fixed portion of the transaction price per paragraph 41 (i.e. up-front payment; minimum royalty obligations). Additional variable considerations would only be included in revenue when the uncertainty is removed. Others may determine that they could reasonably estimate royalty for the next two years. As demonstrated by the example, such a determination involves a considerable degree of judgement; different conclusions could be reached by different preparers for the same transactions which would result in different amounts of revenue recognized upon transfer of control. This could create diversity in practice even within one industry that would defeat the boards’ objective to improve comparability and reliability of revenue recognition practices.

Therefore, we ask the boards to provide an example with a case where the royalty income under a licence agreement which is treated as an outright sale can not be estimated.

In addition, we believe that despite the fact that the recognition of estimated royalties and milestone payments is supported by the principle outlined in the proposed standard, such an 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 to when the underlying sales are made.

In addition, we would like to suggest a clarification related to variable transaction prices outlined in paragraph 36. To avoid an 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.

**Question 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 recognises when it satisfies a performance obligations rather than whether the entity recognises revenue. If not, why?**

We believe that reflecting credit risk in the transaction price would introduce greater complexity to the measurement of revenue and would not improve the usefulness of information. We also specifically disagree with a classification of amounts subsequently collected as a gain, even though it was earned as part of fulfilling the performance obligations. Therefore, we suggest retaining current practice that customer risk should only affect whether the entity recognises revenue.

**Question 6:**
**Paragraph 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?**

We are in agreement with the boards' proposal 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.

**Question 7:**
**Paragraph 50 proposes that the entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligation. 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 are in agreement with the boards' proposal that the entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated when necessary) of the goods or services underlying each performance obligation.

**Question 8:**
**Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.**

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

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 boards should consider if assets recognized in accordance with the criterion outlined in paragraph 57 would not be in conflict with IASs 2, 16 and 38.

**Question 9:**
*Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for recourses that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligations.*

*Do you agree with the costs specified? If not, what costs would you include or exclude and why?*

We are in agreement with the boards’ proposed definition of the costs which directly relate to a contract.

**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?

While the proposed disclosure requirement could achieve the set objective for some, it would not be particularly informative for all industries. For example, as a Pharmaceuticals manufacturer, we rarely have a contract asset (normally customers’ obligation to pay are unconditional after we deliver goods, therefore are classified as receivables). In addition, the vast majority of our contracts would not give rise to a contract liability, as they would consist of one performance obligation to deliver goods to customers and payments are received after delivery of goods. Only a few contractual obligations arising from consignment arrangements would exist all of which will be settled within a relatively short period of time. Therefore, reconciliation between beginning and ending contact assets and contract liabilities would not provide the users of our financial statements with valuable information to help them to understand the amount, timing and uncertainty of revenue and cash flows.

On the contrary, it is the uncertainty in our business that relates to the transaction price determination that would be more useful to disclose. As we stated in our comment letter to the DP, we identify customers broadly to include those that are direct, indirect and end users. Some of the discounts and rebates offered are settled after several reporting periods. The refund liabilities are much more material for our business than a contract liability.

Therefore, we think that our practice of providing revenue reductions (i.e. refund liability) roll forwards would be sufficient to meet the boards’ requirement to help users of our financial statements to understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

In addition, we would like to bring to your attention the fact that Paragraph 77 (d) requires an entity to disclose information about performance obligations, including returns, refunds and other similar obligations. However, our interpretation of the Measurement Section and
Example 3 is that returns and refunds are not performance obligations but adjustment to the transaction price. We do not object disclosing such information. We think that a requirement for this information should not be listed as an example of a performance obligation.

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 are in agreement with the proposed requirement.

Question 12:
Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

We are fully in agreement with the proposed requirements.

Question 13:
Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements 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.

While we agree that retrospective application preserves meaningful comparatives, we have major concerns. As the terms of some outlicensing contracts continue over a long period of time, we do not believe that the cost of the restatement would justify its benefits because entities would have to do a cumbersome exercise of converting the data of the previous years when the systems are not upgraded to collect the information under the new standard. This would require manual interventions to retrieve the data of many contracts.

Therefore, we recommend a modified retrospective approach which would only be applicable for contracts with an effective date on or after publication of the new standard. In addition, the boards should consider the effective date to ensure that it allows adequate time for entities to implement a system to meet the requirements of the proposed standard.
Question 14:
The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

While we consider that the 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.

Question 15:
The boards propose that the entity should distinguish between the following types of 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 obligations 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 products specified in the contract.

Do you agree with the proposed distinction between the types of products 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 are in agreement with the proposals.

Question 16:
The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligations over the term of the licence; and

(b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence.

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why and why not?
We appreciate the clarification introduced by the board (B33) that distinguishes between licences which are in substance outright sales and those that have to be accounted for as licences.

However, we disagree with the proposed conclusion that timing of revenue recognition should depend on whether the licence is exclusive or not. Once the intellectual property has been licenced and customer obtains control over it (e.g. able to market and receive economic benefits), the entity fulfilled its obligations and revenue should be recognized. Whether licence is exclusive and over the economic life of the asset or over a shorter period of time or non-exclusive determines only the value of the licence and should not determine the pattern of revenue recognition. The determining factors should be based on whether licence is distinct (in situations when other services are offered to a customer), and whether control has been transferred to a customer. In cases where both of these criteria are met, revenue should be recognized upfront, irrespective of the length of licence agreement or its exclusivity.

Question 17:
The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

We are in agreement with the proposed requirement.

Other Comments:

Onorous contracts:

Generally, we are in agreement with the boards' proposal to apply the test of onorous obligations at the performance obligation level vs. contract level in order not to offset losses due to adverse change in circumstances in one part of the contract against the positive margin in other parts of the contract.

However we would like the boards to state that if an entity has a contract with a customer to deliver fixed quantities of product over a fixed period of time (e.g. entity has one performance obligation which its satisfies continuously), onerous test should be performed taking into account all remaining deliveries of this product in the contract.
Collaboration Arrangements:

It is unclear whether the scope of the proposed standards includes collaborative arrangements. If the boards conclude that the proposed standards should cover collaborative arrangements, we urge the boards to include a broad example illustrating the application of these standards by both partners. We find it very challenging to apply current exposure draft guidance to collaborative arrangements, specifically due to the fact that both partners could be viewed as a customer for a portion of the arrangement, however shared costs, in some instances, are not revenue generating activity.

If considered necessary, we would be glad to take part in the boards’ field visits to further discuss our comments.

Yours sincerely,

Novartis AG

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