Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing

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Paragraphs 606-10-25-14(b) through 25-15 include guidance on accounting for a series of distinct goods or services as a single performance obligation. Should the Board change this requirement to an optional practical expedient? What would be the potential consequences of the series guidance being optional?

Question1: According to the March 2015 TRG meeting summary, some TRG members expressed the view that the intent of the series provision is to simplify application of the revenue guidance, but this is not always going to be the result in practice. Therefore, although TRG members agreed with the staff that the requirements of the standard are clear, some TRG members requested that the Boards consider whether the series provision could be amended to be a practical expedient, rather than a requirement.

We agree with the view that a simplification feature should not be imposed and lead to changes in accounting treatments that would be compliant with IFRS15 / Topic 606 without the said provision.

Our understanding was that the series provision relates to contracts which include repetitive services, such as cleaning services or energy contracts or mobile phone airtime services as mentioned in BC 79.

The application of the series provision to contracts related to delivery of goods leads to very different accounting impacts as compared to the situation if the series provision was not applied. This is evidenced in the example C of the TRG Agenda paper 27 discussed presented at the March 2015 TRG.

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The application of the series provision to contracts related to delivery of goods to one customer seems to bring into IFRS15 / Topic 606 mechanisms equivalent to what exists currently under US GAAP with “program accounting” and “learning curve effect” and smoothens the margin.

We consider that the series provision should be at a minimum an optional practical expedient. Additionally, we wonder if the series provision shouldn’t be limited to services which do not involve delivery of goods.

Paragraph 606-10-25-16A specifies that an entity is not required to identify goods or services promised to a customer that are immaterial in the context of the contract. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.

Question 2: We consider that the same conclusion could be reach by applying the general principle of materiality. For that reason we consider that this election would not increase the risk of significant diversity in practice between US GAAP preparers and IFRS preparers.

Paragraph 606-10-25-18A permits an election to account for shipping and handling as an activity to fulfill a promise to transfer a good if the shipping and handling activities are performed after a customer has obtained control of the good. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.

Question 3: We consider that this policy election in not necessary as in many cases shipping and handling activities would be considered not material and would be covered by the election proposed in question 2: namely, an entity is not required to identify goods or services promised to a customer that are immaterial in the context of the contract.

Besides, introducing a policy election for US preparers to account for shipping and handling as an activity to fulfill a promise to transfer a good (when the shipping and handling activities are performed after a customer has obtained control of the good) rather than as a performance obligation, regardless of the materiality, means introducing a rule that will give rise to divergence between US GAAP and IFRS.

Thus this policy election seems contrary to the objective set in this ED to maintain or enhance the convergence that was achieved with the issuance of Update 2014-09 and IFRS 15 by reducing the risk of significant diversity in practice. We would recommend not to add it in Topic 606.
Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606):
Identifying Performance Obligations and Licensing

Question 4:
- Amendments proposed for the drafting of paragraph 606-10-25-21 (IFRS15 par 29)

We consider that the revisions to paragraph 606-10-25-21 (IFRS15 par 29) improve the operability of Topic 606 /IFRS15 by better articulating the separately identifiable principle and better linking the factors to that principle. In particular the new drafting of paragraph 606-10-25-21 (IFRS15 par 29) which defines the indicators of non-separable POs (whereas the original standard is structured the other way around, defining the indicators of separable POs) is not only much clearer but also more in line with the general presumption of topic 606 /IFRS15 where the rule is to distinguish POs if they are capable of being distinct, and where bundling distinct POs is an exception.

- Example 10 - Goods and services are not distinct – Case B - Significant integration service (multiple items)

We consider that Example 10 - Goods and services are not distinct – Case B - Significant integration service (multiple items) (par 606-10-55-140A, B & C) does not fit well with the principles for separating performance obligations. The discussion in the example should mention the series provision and explain whether series provision applies or not. If it does not apply, the conclusion reached in this example is not clear and we would suggest not retaining this example.

- Example 56 Identifying a Distinct License

We are particularly sensitive to this example being a Pharma company.

We agree with the Case A - License is not distinct and Case B - License is distinct but would like to draw your attention on the fact that there might be an interest to present a Case C - Transfer of Regulatory Authorization: this is the case where temporarily (period spanning from a few months up to two years) only the seller can manufacture the drug because the regulatory authorization has not yet been obtained to the buyer. If it was not for the market authorization several other entities could manufacture the drug for the customer, as the manufacturing process used to produce the drug is not unique or specialized.

In our view, and consistent with the definition of separable performance obligations, the license is distinct from the manufacturing services. This is because the two promises are distinct and the risks related to those two performance obligation are different. This example is a sub example of Case B.

- Vocabulary

We note that words “inputs” and “outputs” are used in the ED to help identifying a bundle of promised goods and services. Because the same words are used in IFRS3 Business combination (where a business “consists of inputs and processes applied to those inputs that have the ability...
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<th>Question 5</th>
<th>In general we consider the revisions and additions improve the operability of the implementation guidance about determining the nature of an entity's promise in granting a license. In particular we welcome the inclusion in the “stand ready obligation” case as discussed in the related January 2015 TRG staff paper. Although the “stand ready” terminology is not used as such in the ED, we see the reference to these obligations in the mention of “activities that will substantively change the functionality of functional intellectual property without transferring a good or service to the customer in the decision tree” and in the decision tree.</th>
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| The revisions to paragraph 606-10-55-57 that state an entity should consider the nature of its promise in granting a license of intellectual property when accounting for a single performance obligation? Does this revision clarify the scope and applicability of the licensing implementation guidance? If not, | We consider that the distinction of symbolic and functional is useful; however we consider that the definition of “symbolic IP” should be completed with a mention that the value of a symbolic IP could be impaired by actions external to the licensor or the licensee. For instance, the value of a trade name could be harmed by a third party misusing it (such as another licensee or other stakeholders using the name for another purpose than what the licensor and licensee had agreed on). The possible loss of value of symbolic IP as a consequence of actions that are not under the control of the licensor or the licensee is an important difference between “functional” and “symbolic” IP in our view. |
| Would the revisions to paragraphs 606-10-55-54 through 55-64, as well as the revisions and additions to the related examples, improve the operability of the implementation guidance about determining the nature of an entity’s promise in granting a license? That is, would the revisions clarify when the nature of an entity’s promise is to provide a right to access the entity’s intellectual property or to provide a right to use the entity’s intellectual property as it exists at the point in time the license is granted? If not, what alternatives do you suggest and why? | Completed |

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<td>We welcome the drafting changes made in the ED to the guidance on sales-based and usage-based royalties but would like to draw your attention on another issue related to sales-based and usage-based royalties. This is the issue related to the scope of the so-called &quot;royalty exception&quot;. This issue has not been raised at the TRG, but triggers many discussion in our industry. We propose to present below the state of our analysis in that area, being understood that we hold view B.</td>
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**Issue**

Is the royalty exception applicable to licenses which might be analyzed as in-substance sale of IP?

**Background**

In the pharmaceutical and life science industry, it is quite
why? common for a company who has partially developed a compound to outlicense the IP to another company who will complete the development and will market and sale the drug. In many instances, the Performance Obligation to which the license belong will qualify for Point In Time recognition, or will at least be satisfied before the sales royalty stream begins (because the licensor has no further obligation, or because the license is distinct from the ongoing manufacturing services that the licensor will provide, and because the license qualifies as a “right to use” a static IP).

A royalty arrangement is a shared economic interest between the licensor and licensee in the IP and indicates that the licensor may be expected to undertake ongoing activities that will affect the functionality or value of the license. Nevertheless, §B59 is clear that this is an indicator that is not determinative in itself, and, in the pharma and life science industry, it may by typical to have a license for a mature drug that qualifies for Point In Time recognition while a portion of the consideration is in the form of royalties.

IFRS 15/ Topic 606 requires an entity to make estimate of variable consideration and to recognize the minimum amount that is highly probable of not being reversed in the future. §B63 provides for an exception to that rule, applicable only to usage-based or sales-based royalties from license of intellectual property. In that specific situation, the general guidance on variable consideration does not apply and the entity must recognize revenue when sales or usage occurs or when satisfaction of performance obligation occurs, whichever is later.

However, the new standard does not define what a “license” is and what “intellectual property” is.

In the pharma and life science transaction discussed above, it often happens that the license is exclusive, global, for a term that is close to the patent protection period, and with limited restrictions on use. These features could result in the licensor surrendering some, if not all, control over the underlying IP.

In these situations:
• Does IFRS 15/ Topic 606 require to apply the general model on Variable Consideration, which would require to estimate the minimum amount of future sales-based royalties that is highly probable ?, or
• Should the royalty exception apply, in which cast the royalty revenue will be recognized as licensee’s sales occur?
**View A - the exception does not apply to in-substance sale of IP**

§BC421 is quite clear that the Boards did not intend to apply the royalty exception broadly and insists that “because it is a specific requirement intended for only limited circumstances, entities should not apply it by analogy to other types of promised goods or services or other types of consideration”.

In certain circumstances, due to the exclusivity, perpetual term, and lack of restrictions to use of the IP imposed to the licensee, the substance of the transaction might be that the seller has not transferred a “right to use the IP” but has in fact surrendered the control of the whole underlying IP, and therefore the transaction is in substance a sale of IP.

Under view A, a license that is in substance a sale of IP is a “different type of promised good or service” than the one contemplated in the narrowly defined scope of the royalty exception.

**View B - the royalty exception applies to licenses that are in-substance sale of IP**

The reasons identified by the Boards for the application of the royalty exception are fully applicable to the pharma and life science transaction discussed above, including licenses in which licensor may in substance surrender control over the underlying IP.

- BC415 acknowledges that it would not provide relevant information to users of financial statements if an entity had to constantly report, throughout the life of a long-term license (such as a pharma license), significant true-up adjustments to the revenue recognized at the inception of the contract, as a result of changes in circumstances which are unrelated to the entity’s performance.

None of the objections identified by the Boards to a wider application of the royalty exception are applicable to view B:

- When the boards rejected a wider application of the royalty exception, they considered constraining to zero all estimates of variable consideration when the variable consideration depends upon customer’s future actions (BC417-418).

- They also considered embedding the royalty exception into a more general model that would achieve broadly the same results (the idea was that, if the Performance Obligation qualifies for Point In Time, but, at the date of transfer of control, the variable consideration fails the general constraint, then the entity should not subsequently reassess the constraint until the contingency is resolved) (BC419-420).

- Both of these approaches were rejected generally because they would have added complexity and created unintended
• However, view B does not have any of the features of the models contemplated and rejected in BC416-420. In fact, applying view B has the merit of simplicity rather than complexity and therefore is not inconsistent with the intent expressed in BC421.

In addition, when the Staff articulated the reason why the exception should be limited to licenses of IP (in the Supplement to Agenda Paper 7A for the October 2013 Boards meeting), it referred to three arguments: (i) the long term nature of license of IP, (ii) significant uncertainty and (iii) cost profile. The first two arguments are applicable to an in-substance sale of IP as much as for a regular license of IP. Regarding the third argument (the cost profile), the application of the royalty exception to an in-substance a sale of asset could, in theory, create tension if the asset has a significant carrying value, because the entity would have to derecognize the cost of the asset when control is transferred while it would not be allowed to recognize royalty revenue at this stage. However situations in which developed IP has a carrying value that is higher than the upfront payments received at the inception of the arrangement may be quite rare in practice.

The Boards have extensively discussed the implications of exclusivity, as well as restrictions of time, geography or use of IP (B62, BC411-412). Nothing in these discussions is suggesting that an exclusive license, or a license with “weak” restrictions, should be excluded from the license guidance in IFRS 15 / Topic 606.

Based on §37-38 of Agenda Paper 7A submitted to the October 2013 Boards meeting, it seems clear that, when the royalty exception was contemplated, it was expected to apply to a “license of a mature, approved drug”. §48 of that Staff paper also indicates that biotech licenses were expected to be in the scope of the exception.

View B approach is much more practical to implement than view A, as view A creates the following issues, which do not exist in view B:
• It puts pressure on the assessment of the nature of the license (whether it is Over Time versus Point In Time, and, in making that determination, the importance to be given to the existence of a shared economic interest in the form of royalties).
• It puts pressure on the assessment of the minimum amount that meets the “highly provable” threshold, which is extremely critical under this view while it is based on projections and estimates which are substantially judgmental.
• It requires making an assessment as to what legal license
is a “true” license versus an in-substance sale of IP. Due to the wide diversity of license arrangements (in terms of scope of exclusivity, term, and various restrictions attached to the use of the IP), that assessment could be complex and could result in diversity in practice.

Moreover, the validity of the first two concerns were acknowledged in the Staff paper 7A discussed above ($50 and Supplement) and were part of the reasons why the Staff recommended the royalty exception.

Also, even for a license arrangement that might have the characteristics of an “in-substance” sale of IP, there are still substantive differences with an outright sale of IP: for example a license will often include an obligation of the licensee to make its best efforts in developing and commercializing a compound, and will include termination provision that may allow the licensor to recover the IP rights if the licensee fails to perform or decide to opt-out. Analogizing certain licenses with an outright sale of IP might be going beyond the intent of the Boards.

Sanofi, a leading global pharmaceutical company welcomes the opportunity to comment the FASB Exposure Draft (ED) on Revenue from Contracts with Customers (Topic 606) – Identifying Performance Obligations and Licensing.

Sanofi is an IFRS prepare its Financial Statements under IFRS. We are appreciative that IFRS15 / Topic 606 create common revenue guidance. We understand that the amendments in the proposed Update are not identical to the amendments the IASB is considering for IFRS 15. We understand also that the FASB expects the proposed amendments would maintain or enhance the convergence that was achieved with the issuance of Update 2014-09 and IFRS 15 by reducing the risk of significant diversity in practice.

The objective of our comment letter is not to answer to all questions exhaustively but to comment on areas where we see that the proposed amendments could create divergence with IFRS15 in spite of the above mentioned objective to maintain convergence. We also propose to comment on topics related to Identifying Performance Obligations and Licensing not directly dealt with in ED.

You will find below our comments and remain at your disposal to discuss directly some of the issues that we have extensively analyzed.

Yours sincerely

Please provide any additional comments on the proposed Update:

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