April 6, 2016

Technical Director
Financial Accounting Standards Board
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Sent via email to director@fasp.org

Re: Proposed Accounting Standards Update (Topic 606) — Identifying Performance Obligations and Licensing (File Reference No. 2015-250)

Engaged Capital appreciates the opportunity to comment on the Proposed Accounting Standards Update (Topic 606) — Identifying Performance Obligations and licensing (the “proposed accounting standard update”). Engaged Capital was established in 2012 and formed to create long-term shareholder value by bringing an owner’s perspective to the management and boards of undervalued public companies. Engaged Capital’s efforts and resources are dedicated to a single investment style, “Constructive Activism” with a focus on delivering superior, long-term, risk-adjusted returns for investors. Engaged Capital is a large, long-term shareholder in Rovi Corporation (“Rovi”), a company that would be affected by this proposed change, and is based in Newport Beach, California.

Below are our views on the proposed accounting standards update, with respect to the provisions around Intellectual Property (“IP”) licensing. As investors in public companies that license IP, such as Rovi, among others, we find the proposed accounting standard update critical to using financial information presented by these companies. I will discuss our views on the impact of the proposed accounting standard in the context of Rovi’s business and financial reporting.

Background

Fixed fee licensing deals are a critical source of revenue and cash flow for Rovi, and other public companies that license their valuable IP to others to use. For example, total IP licensing revenues comprised over 50 percent of Rovi revenues for the year ended December 31, 2015. Rovi earns this revenue by licensing its patents (as well as new patents granted or acquired during the contract term) as a single IP portfolio. Rovi’s licensees generally pay (and Rovi receives cash) for these licenses over the term of the agreement.

It is our understanding that there are multiple reasons why Rovi and its licensees would elect to structure a contract as a fixed fee license. For example, a fixed fee license structure is more easily accommodated if the licensee wishes to record the contract as a corporate expense, rather than at a business segment level. A fixed fee contract also allows for more efficient contracting between the licensor and licensee, who may have different views on expected trends in the share of the market (in Rovi’s case, predominantly cable subscribers) covered by its IP portfolio. In this case, a fixed fee deal facilitates reaching a consensus by removing the consideration of subscriber trends and instead the negotiating parties agree upon a fixed monetary value that satisfies their individual projections of the market. Finally, a fixed fee structure also gives the licensee more visibility into its contracted payments and allows the licensor to recognize the revenues according to the economics of the contract.
Current Revenue Recognition

Rovi currently records the consideration received under fixed fee licenses on a straight-line basis over the term of the agreements. As a result, revenues from fixed fee licenses are recognized over the same period as similar licenses with variable fees. This revenue recognition method is intuitive from a shareholder perspective, as both types of licenses provide similar economics to Rovi over the term of a contract (and for the licensee as well).

Proposed Revenue Recognition and Potential Consequences

As a publicly traded company with the majority of its revenues coming from IP licensing, transparency into the financial reporting, economics, and cash flow of licensing agreements is critical for investors to properly assess the company’s financial performance.

Unlike the current revenue recognition rules, the proposed accounting standard update would cause the revenue recognized to significantly diverge from both the economics and cash payments of the license agreement. For example, Rovi’s recent seven year fixed fee license with AT&T includes annual payments. Under the current revenue rules, revenue from this contract is recognized on a straight-line basis over the license term. Under the proposed accounting standard update, Rovi would recognize all revenue expected to be received over the next seven years in a single quarter, despite the fact that Rovi will be receiving regular cash flows on an annual basis over the life of the contract. This could lead to extremely “lumpy” results that are not truly representative of Rovi’s underlying business. Further, it would make financial analysis next to impossible for a business like ROVI since the revenue recognition and the actual receipts of the cash would diverge materially. The proposed rules would mean ROVI recognizes a one-time sale but in actuality, ROVI would receive cash each year for, in the AT&T example, 7 years. As an investor, we follow the cash, as that is what the market values and that is how analysts and investors evaluate companies. The proposed rule obfuscates the true economics of the contract and makes valuation opaque as opposed to clear and transparent, which we believe should be the goals.

Over the past two years, expectations surrounding the success of a few large IP renewal deals, including the AT&T deal referenced above, have been a large factor driving Rovi’s stock price movements. Investors forecast if and on what terms these contracts will be renewed and what impact they will have on earnings. As a result, we believe investors, in addition to following the cash, assess the company’s equity market valuation based off of a price to earnings (“P/E”) ratio. A change to revenue (and earnings) recognition from fixed fee license agreements, a material portion of Rovi’s revenue and profitability, would distort the value of a P/E ratio, just like it does by divorcing the actual cash flow from the revenue recognition. If the proposed accounting standard update was implemented, we would prefer management update Rovi’s financial results in a way that was not in accordance with generally accepted accounting principles (non-GAAP) such that IP license revenue is spread over the appropriate period for which Rovi is paid. Given the importance of fixed fee IP deals to Rovi, the non-GAAP adjustments could be sizable. Often, companies that provide non-GAAP reporting that is significantly different from GAAP accounting receive lower valuations in the public markets, all else equal. New investors would find it incrementally more time consuming to understand the company’s true earnings power and arrive at a valuation.

I appreciate the opportunity to comment on the proposed accounting standard update, as it pertains to IP licensing. As shareholders of a publicly traded company with significant IP licensing revenues, we believe the proposed changes ultimately make the relevant financial information less useful to its users - we would presume that the goal of any changes would not be that but be the opposite.

Sincerely yours,

Glenn W. Welling