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Comment Letter No. 571
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International Accounting Standards Board
30 Cannon Street
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October 22, 2010

EXPOSURE DRAFT “REVENUE FROM CONTRACTS WITH CUSTOMERS”

Dear Sir / Madam,

In response to your invitation to comment, and as a preparer of accounts under International Financial Reporting Standards, I am pleased to attach our comments on the above mentioned Exposure Draft (ED). We agree that IFRS revenue recognition requirements need to be reviewed and support the objective of convergence in this area. From this viewpoint, we welcome the publication of this ED. Our detailed replies to the questions in the ED are given below. In these replies, we have not considered the specific accounting issues posed by long term contracts because we have no relevant experience in that industry sector. We believe the boards should consult carefully through their Outreach programme on the application of the ED proposals to that sector.

Yours Faithfully,

James Halliwell
Group Financial Controller

Recognition of Revenue

Question 1: *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 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 our view, revenue recognition timing and amount should be affected by the substance of contracts and not by their form. Whether an agreement consists of one or more contracts is in itself purely a formal matter, as the content of the contracts determines economic substance. The ED should have a principle-based approach to this issue. We agree that pricing is important in determining whether to bundle goods or services together into a single unit of account, but it may not be the sole issue and all economically relevant contract terms may need to be reviewed. We agree with proposed indicator (b) in paragraph 13 – negotiation as a package. Indicators (a) and (c) describe features – timing of entering into and performing contracts - which could be coincidental, especially for a large multinational group which is continuously transacting a high volume of contracts with its larger customers. Those indicators would capture too many unrelated contracts and reviewing all of these would not be an efficient way of identifying contracts which should be combined. We would recommend those two indicators are replaced by the following:

- the contracts contain explicit references to each other; and
- it is either not possible or economically rational for either party for either or both of the parties to perform one contract without also performing the other contract(s).

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. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?*

We agree that the definition of 'distinct' in paragraph 23 will in most cases result in accounting for the promises in the contract in accordance with its substance.

However, we have reservations about the way paragraph B42, example 10, describes the application of this principle to a combined technology licence and research and development services contract. In our view both the licence and the services would usually have distinct functions from the viewpoint of the licensee (the customer). The exclusive licence not only enables the licensee to exploit the technology but prevents other parties from doing so, whereas the services enable the licensee to develop the technology. The licensor will know the cost of the employees dedicated to the service and will have built recovery of those costs into the contract pricing. In many cases the stand-alone selling price of similar but non-identical research services will be observable and the required knowledge base to provide the services will not be completely unique to specific individuals whose contracts commit them to remain in the licensor's employment. The services are also subject to a distinct risk – retention of skilled employees – whereas the technology is also subject to IP risks such as commercial, technological or patent failure. In our opinion the licensor would often be able to identify the licence and the services as separate performance obligations and recognize the services as its employees provide them. The penultimate paragraph of the example refers parenthetically to this possibility, which could be read as implying that it is less likely. We think the boards should reword this example so that the scenario in which the licence and services are distinct performance obligations receives the same emphasis as the scenario in which they are not.

Also, further guidance is needed to distinguish between contract promises which are non-cash marketing incentives and in substance consideration payable to the customer, and promises which are performance obligations. This guidance could be provided by further definition of an entity's "ordinary activities" as this is part of the Appendix A definition of revenue. Incentive products or services which are incidental to the entity's ordinary activities – in the sense that the entity could substitute a cash discount of equivalent value to the incentive without affecting its ongoing customer relationships and its business model - should be considered as consideration payable to the customer rather than as a performance obligation. This would affect whether revenue is presented gross or net of that component of the contract in the financial statements.

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 the proposed guidance is sufficient but we recommend that transfer of risks and rewards of ownership (IAS 18.14(a)) should be added to the indicators of transfer of control in paragraph 30. Please see also our response to Q16 below in relation to licences.

Measurement of revenue

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 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 revenue should be recognized only when the transaction price can be reasonably estimated. The probability-weighted approach proposed in paragraph 35 may be appropriate for a large population of contract promises where the likely outcomes of variable consideration are normally distributed, such as where an entity sells a high volume of similar products to a large number of customers. In this context, it would be helpful if the boards could include guidance saying that it will often be sufficient in the estimation process to consider the relative probabilities of a small number of scenarios which are representative of the range of outcomes. In our view the probability-weighted approach is not appropriate for promises with unique attributes. Licences of patented intellectual property (IP) might fall into either of the above categories, depending on the industry, the number of licensees and the degree of customization or standardization of the licence terms. Uncertain milestone payments under licence contracts with unique or highly customized attributes should be recognized only when the uncertainty is resolved.

We agree with applying the principle in paragraph 38 in situations where entity or industry experience would potentially be relevant to predicting the uncertain outcomes. We also agree with Appendix B example 18 (management fees based on an index). We recommend further guidance is included to cover observable forward index values, for example in an active commodity trading market, which could potentially be used to measure the outcome of the uncertainty at a contractually specified future date. It would be helpful to clarify whether the initial amount of revenue linked to such an index would be measured in accordance with the IFRS 9 chapter 4.8 embedded derivative accounting requirements, and whether subsequent changes in the estimated consideration would be presented as revenue, or as gains or losses elsewhere in the income statement.

The paragraph 36 and 48(a) proposals on variable consideration as a reduction in revenue should apply to any party to whom the entity pays consideration and who has purchased the entity's products or services, whether they did so directly from the entity or indirectly via one or more intermediaries or distributors of the entity's products. The final IFRS Appendix A definition of 'customer' should be "a party that has contracted to obtain the entity's products or services and who directly pays the entity or receives consideration from the entity for those products or services". Without this change, an identical cash incentive could be accounted for differently depending on whether the customer bought the entity's products directly or via an intermediary. That would impair comparability.

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 recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?*

We agree that customer credit risk should not affect whether the entity recognizes revenue if the entity has an unconditional and legally enforceable receivable due from the customer, which is one of the indicators of transfer of control in paragraph 30(a).

We acknowledge that there are arguments in favour of reflecting customer credit risk in the transaction price in the same way as variable consideration, both on conceptual grounds and because the level of discounts granted and refunds made for returned products affects the collectibility of the remaining receivable balance.

However, we think that to make a further adjustment to the observable transaction price of products or services to reflect the customer's credit risk would be a step too far, for practical reasons and because it would make financial statements less understandable and comparable. The amount of reported revenue would be less understandable because other economic data available to users, such as total market size for an industry sector, will not usually incorporate a credit risk adjustment. It would be less comparable because different preparers selling the same products for the same prices to the same customers in the same market may make different estimates of initially expected credit losses. A revenue reduction for credit risk would, in our view, also be inconsistent with ED/2009/5 "Fair value measurement" paragraph 36 which proposes that the transaction price is the best evidence of fair value at initial recognition except in four specified cases. To adjust the stated transaction price for the effect of variable consideration and the time value of money is a reasonable requirement because both the calculation of variable consideration and the payment terms will be specified in the contract separately from any stated fixed price. In contrast, full payment performance is inherent in the other stated terms of the contract. A transaction price net of customer credit risk is easily observable only in certain contracts where the promised product is itself the provision of credit, such as the issuance of financial debt in an active market where the proceeds received by issuers vary according to their respective credit standing. We accept that if the entity factors its receivable without recourse immediately after making a sale, the factor will reduce the consideration it pays the entity to take account of the customer credit risk. In our opinion that is an entirely separate transaction in which the entity is explicitly paying for credit risk protection, and the entity should account for it separately from its sales contract with the customer for its goods or services.

For the above reasons, estimated bad debt provisions should be presented as an expense and not as a revenue reduction. If the boards wish to insist on the latter requirement, its application should be explicitly limited to discounting those contracts where the time value of money is material using the paragraph B82 guidance on including customer credit risk in the discount rate, since credit risk increases with the length of the credit period.

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?

If the entity is providing the customer with a credit period and the time value of money is material, we agree that revenue should be measured at a discounted amount and the discount unwind recorded as financial income over the credit term. In our opinion Appendix B example 21 gives sufficient guidance to apply this proposal.

However, we do not agree that reverse discounting as illustrated in the following example, no. 22, should be applied to all advance payments. Allowing customers a credit period is an integral part of most sales transactions and business models and is clearly a financial component of the transaction. This conceptually supports discounting. Treating advance payments by customers as a mirror image of this implies that the entity is borrowing from its customers. There may be evidence that some entities do this as part of their business model. In those cases we would agree that the financing component of the contract should be accounted for separately from the goods or services, in accordance with paragraph 15. This would support reverse discounting. However, receipt of advance payment is not sufficient evidence that the sales agreement has a financing component. The entity may agree to give a discount for advance payment to suit the customer, for example so that the customer can obtain a tax deduction in an earlier period by paying the entity in that period. Reverse discounting would obscure the economic substance of that arrangement, which results in a financing benefit to the entity which should be reflected by presenting a lower amount in the financial statements as a financial expense.

Question 7: Paragraph 50 proposed that an 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 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 believe that prescribing the exclusive use of one allocation method, albeit with the legitimate aim of promoting comparability between the financial statements of preparers, will lead to less decision-useful information in the financial statements. Some scope should be allowed for management judgement in selecting the allocation method which is most appropriate for a particular contract. Given the paragraph 54-56 proposals to account for onerous performance obligations within a contract and not for onerous contracts as under existing IFRS, a single contract with products and services of varying margins which contains an overall discount may have to be accounted for by recording a loss at contract inception for low margin products which are deemed onerous even though the contract is expected to be profitable overall. As the proposed criterion for combining multiple products and services for accounting purposes is price interdependence, recognizing an up front expense for onerous obligations calculated in this way, followed by recognizing higher profits on fulfillment of the contract, will not always reflect its economic substance. We suggest the final IFRS includes a rebuttable presumption that allocation should be based on stand-alone selling prices unless it can be demonstrated that another method would represent the contract more faithfully. This would also be useful in situations where it is difficult to estimate stand-alone selling prices because of a lack of observable data.

Contract costs

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, IAS 16 and IAS 38), an entity should recognize an asset only if those costs meet specified criteria. Do you think the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

As we have no relevant experience with long term contracts, we make no comment on the above questions.

Disclosure

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 agree.

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?

As we have no relevant experience with long term contracts, we make no comment.

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 agree.

Effective date and transition

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.

Retrospective application is preferable in order to avoid potential problems with revenue which would be recognized in a different period under the proposed requirements compared to existing IFRS. We believe retrospective application would be possible if enough time is allowed between publication of the final IFRS and its mandatory effective date for preparers to make the necessary changes to their systems. The time needed will vary by preparer and we urge the IASB to consult as widely as possible on this point through its Outreach programme.

Application guidance

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?*

The guidance on sale and repurchase of an asset (paragraphs B47-B53, and specifically B49(b)) is incomplete because it omits discussion of contract manufacturing arrangements which are common in many industries. An entity may sell a raw or intermediate material to a contract manufacturer for processing into a later stage or finished product which the entity has the right or obligation to repurchase. The repurchase price of the processed product would be higher than the sale price of the original product, not because this is a financing arrangement as suggested by B49(b), but because the increase in price compensates the contract manufacturer for the additional costs it has incurred and provides it with a return on the capital employed in fulfilling the contract. In our view, the entity should not recognize any independent revenue for the original sale to the extent that it repurchases the processed product. It should account for the profit or loss on that original sale by adjusting the repurchase cost of the reprocessed product.

On other issues in the application guidance, please see the comments in our responses to questions 2, 3, 4 and 6 above and question 16 below.

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 agree 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 obligation 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 or why not?

We accept the need for a principle to determine whether non-refundable lump sum licence income should be recognized on receipt or deferred. However, we are not convinced that this should be based on the exclusive or non-exclusive nature of the licence. We agree that in an exclusive licence the licensor has an obligation to continue to permit the use of its IP, but in itself that fact is equally true of a non-exclusive licence, and it does not necessarily prevent a licensor from having satisfied its performance obligation as soon as the licensee is able to use and benefit from the licence. If the licensor has granted access to the IP and has provided everything the licensee requires in order to continue to exploit that IP throughout the licence term without ongoing or continuous support from the licensor, and the licensor does not have any other related obligations to supply products or services to the licensee, the licensor should recognize a non-refundable lump sum on receipt, even if the licence is exclusive. The accounting should assume as a given that the licensor will respect the contract and refrain from intentional actions which would interfere with the licensee's rights. We note that paragraph BC162 uses this very argument in support of the proposals for net presentation of contract assets and liabilities. It seems to us to be equally valid in the context of recognition timing.

As an analogy, under the boards' proposed lessor derecognition accounting model, the lessor has fulfilled its performance obligation when it has transferred the underlying asset to the lessee, for example when it hands over the keys to a property at the start of a long term lease agreement. The lessor would not delay recognition of the appropriate amount of revenue beyond that point, even though it could theoretically have the locks on the entrances to the property changed so as to prevent the lessee entering. If it did that without cause, it would be in breach of the lease agreement. Likewise, if a licensor does not respect the exclusive nature of a licence, it should account for its liability for breach of the agreement, in accordance with IAS 37, only when that breach has occurred.

We agree that the licensor should spread non-refundable lump sum licence income over the licence term if the licensee will continue to need the licensor's technical assistance and/or ongoing supply of the licensor's other products or services in order to derive economic benefit from its use of the IP.

Consequential amendments

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 agree.