

13 March 2012

International Accounting Standards Board
30 Cannon Street
London EC4M 6
United Kingdom

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

Dear Sir / Madam,

SwissHoldings, the Swiss Federation of Industrial and Services Groups in Switzerland, represents 56 Swiss groups, including most of the country's major industrial and commercial enterprises. We very much welcome the opportunity to comment on the above-mentioned Exposure Draft issued in November 2011. Our response below has been prepared in conjunction with our member companies. We outline some general comments below and answer the specific questions of the ED in the annex.

GENERAL COMMENTS

In general, we welcome the changes made to the 2010 ED which in general reflect some of the proposals as stated in our 2010 comment letter as regards (amongst other things):

- Providing better guidance on accounting for contracts satisfied over a period of time;
- Providing some clarity on the control concept and its application, though we note that there is no definition of control; etc.
- Permitting the allocation of revenue using the residual method although only in limited circumstances;

We note that our concerns regarding the following points as highlighted in our 2010 comment letter have not been addressed to date:

- Conducting the onerous test at a performance obligation level and the disclosure requirements associated with this;
- Eliminating the need to present credit risk on the face of the financials, as a deduction from sales;
- The excessive disclosure requirements in general.

Whilst we found additional clarification guidance in the new ED helpful, our review of the latest proposals presented some difficulties re:

- Determining who a "customer" is where assets transferred are not necessarily goods and services, e.g. does the transfer of a license to a licensee for use in R & D or other make the licensee a customer?

- Need to clarify that in some circumstances there could be more than one counterparty to a contract – a “direct customer” who takes initial control and ownership of the goods but also an “indirect customer” whose contractual terms with the vendor finally determine the consideration to be received by the vendor (see also Other Comments below);
- Clearly articulating whether certain transactions, as illustrated later in this comment letter, should be accounted for at a point in time or over a period of time;
- Determining how total revenue from combined contracts should be allocated to performance obligations (PO’s) identified. This is also illustrated below by way of an example;
- Clarifying when variable consideration is different from contingent consideration;
- Clarification of the circumstances under which amounts payable to a customer are revenue deductions or operating expenses; we consider that this is especially important as the main text of the current ED is not consistent with the Basis of Conclusion, which implies that current US GAAP accounting guidance should be applied. In order to clarify this, we suggest to remove the reference to US GAAP and to include an example (e.g. one on slotting fees) in the new standard;
- Incremental costs of obtaining a contract and related impairment charge reversals;
- Permitting either retrospective or prospective adoption transition possibilities.

Our detailed responses to the specific questions raised in the ED and other comments are set out below in the annex.

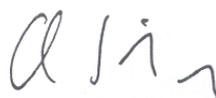
Yours sincerely

SwissHoldings

Federation of Industrial and Service Groups in Switzerland



David Frick
Chair, Nestlé SA



Christian Stiefel
Chair Executive Committee

cc SH Board

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ANNEXE

ANSWERS TO SPECIFIC QUESTIONS IN THE INVITATION TO COMMENT

QUESTIONS FOR RESPONDENTS – INVITATION TO COMMENT

Question 1

Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

We agree with the requirements as articulated in ED paragraphs 35 and 36. However, we believe they are currently written based on the discussion around long term construction contracts and that the application to contracts in other industries requires further clarification, e.g. with respect to the application of the output method. We illustrate this in example II below.

With reference to activities in the Pharmaceuticals industry, we note that the proposals may give rise to changes in the way some of our transactions are currently accounted for.

Example I

When a trademark or brand name has an indefinite useful life, but is transferred to a sales partner for a 10 year period (we are not clear whether a sales partner is customer in this context).

Questions

- i. Is the license transferred at a point in time? If so, revenue can be recognised in its entirety on transfer of the asset at contract inception or;
- ii. Is the license transferred over time since the sales partner obtains control of the license for a limited period of time (when compared to the useful life of the asset) and thus, does not obtain substantially all (or a majority of) the risks and benefits associated with the license? In this case, we believe revenue should be recognised over the term of the contract i.e. 10 years.

Our current accounting treatment would require that this transaction be accounted for as a transfer over time and thus revenue would be recognised evenly over the 10 year term.

Where the trademark or brand name has a useful life of 10 years and was being transferred to the sales partner for a 10 year period, then this would be accounted for as a “sale” and all the revenue would be recognised upfront on contract inception /execution, whichever is later.

With reference to the above example, it should be noted that in our view, the licensor has no other performance obligation to transfer to the sales partner other than to maintain the patents associated with the transferred asset and this does not constitute a performance obligation transferred to the sales partner.

Example II

As a second example, Company X enters into a license agreement with Company Y to transfer the rights to use a compound for a consideration of \$50m. In a separate supply agreement signed on the same date, X is required to supply Y quantities of the compound which Y cannot obtain from other suppliers on the market. The license would be useless to Y, if Y does not receive the compound from X. X supplies the compound to Y over a 3 year period at a price which gives rise to a loss on supply of \$10m in total. The fair value of the license is \$35m. Y will

continue to use the license even after the supply agreement is fully executed and completed as it will obtain capabilities from X (technological know-how transferred from X during the supply period) to enable production of the compound for its own use. X will continue to produce the compound for its own use and for other customers who require the compound.

Observations:

In the example above it has to be first assessed whether the license, the transfer of know-how and the supply agreement are distinct performance obligations. Based on the guidance in ED paragraph 28, it could be concluded that this is not the case as the customer cannot benefit from the license without the supply agreement until the know-how is transferred. Accordingly, the assessment on whether the license, the know-how transfer and the obligation under the supply agreement are transferred at a point in time or over time has to be made for all three components together. As the customer does only obtain control over the compound to be delivered under the supply agreement and the know-how to produce the compound over the term of the supply agreement, it can be concluded that the license is also transferred over the same time period. Therefore the question arises which method (output or input) is the best to be applied to determine how revenue should be recognized. In the current situation we believe an output method is most appropriate, as the "input" to transfer the license is negligible, but the license itself has a significant value. However, the basis for revenue recognition should not be the amount billed to the customer as the amount charged for the license covers losses, which will be made on the subsequent delivery of the compound. The following other approaches could be deemed acceptable applying an output method as described by the standard:

Approach 1:

Recognize the entire amount based on the quantity of the compound sold to company Y. This ignores the fact that the value of the license is not linked to the units sold/produced as Y still has control of the license after the supply contract is concluded.

Approach 2:

Recognize the fair value of the quantity of the compound sold to company Y when they are sold. Recognize the fair value of the license straight-line over the period of know-how transfer. The outcome of this treatment would be identical to a situation in which the supply contract was a separate performance obligation.

Approach 3:

Recognize the fair value of the quantity of the compound sold to company Y when they are sold, the value of the service to transfer the technological know-how over time and the value of the license at the inception of the deal. This treatment would result in the same accounting as if all three components of the contract would be a separate performance obligation.

We believe that approach 2 would reflect facts and circumstances best. We suggest that an example is provided which covers this type of situation.

In the construction industry, it is our view that the construction of a highly customized asset based on the specifications given by the customer would in principle suggest that control is transferred to the customer as the asset is being created as the customer can, at any time, modify asset specifications as the construction progresses. However, construction contracts usually include a reimbursement clause of all costs incurred in case of a contract termination. Due to the last sentence of paragraph 35 (b) (iii) which requests that the payment for the performance completed to approximate the selling price of the goods and services (including a profit margin), revenue for contracts which do not include reimbursement of costs with a profit margin could not be satisfied over time. Since it would be very difficult in many situations to agree with the customer on a profit margin to be paid for the completed performance in case of a

termination of the contract, we suggest to delete the last sentence of paragraph 35 (b) iii and to add in to paragraph 32 point "(g) the ability of the customer to direct the specifications of a highly customized product".

Question 2

Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9), or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

In our view, the event which gives rise to the generation of revenue is very different from the subsequent event which may give rise to credit losses on receivables and thus, this element – credit risk should be recognised and measured separately. Furthermore, it is normal business practice to sell goods and services to customers whose customer history suggests they will make payments for satisfied performance obligations. In our view, a company that has a non-triple A rating may still make 100% of the payments due from them as depicted by the customer history to date. Thus, we would not expect that any credit risk should be recognised in the books for such customers.

We are not in favour of the proposal to recognise credit risk in a line adjacent to revenue on the face of the income statement. Whilst we acknowledge that any diminution in the value of receivables should be recognised in the income statement, preferably as an operating expense, after separating any financing elements because in substance it is part of the cost of doing business, we are not clear on why the Boards would suggest that any credit risk be captured in the manner proposed, especially since allowances for bad debts are currently disclosed to investors in the IFRS 7 notes.

Although the impairment assessment of trade receivables is not supposed to be governed in the new revenue recognition standard we would like to point out that an expected loss model is considered to be inappropriate to assess trade receivables for impairment for many Corporate manufacturing and service entities. As mentioned above, an expected loss model may lead to an immediate recognition of an impairment in the line adjacent to revenue, which is not supported by historical evidence and also not by a specific event indicating that a loss will occur in future. Such an adjustment would have the nature of a lump sum allowance. Such an immediate reduction would be in most circumstances very judgmental and would not capture the economic reality and history of customer relationships for most Corporate manufacturing and service entities. Currently, these entities have systems in place which are quite robust in automatically ageing debtors at a customer level and local management familiar with various markets are better placed to judge when such receivables prove to be doubtful and as a result need to be provided for on a specific and not overall portfolio basis ONLY at the time that it is evident that the specific customer will not be able to pay.

Following outreach with IASB and FASB staff, we communicated the fact that we do not support the proposed "Three bucket" model under the still to be finalised IFRS 9 project on Amortised Cost and Impairment. Whilst the proposals contained therein may work well for the financial services sector whose business model includes loans to customers, this feature is not normal for Corporate manufacturing and service entities and where it exists, the amounts lent to customers are very immaterial.

Question 3

Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

We agree with the proposed requirements, especially the proposal to recognise revenue to the extent that the revenue is reasonably assured. Within the Pharmaceuticals Industry, there are often circumstances in which the consideration for licenses transferred to "customers" could be in the form of the successful achievement of milestones associated with the various phases in R & D. Such consideration cannot be deemed reasonably assured as each phase of R & D requires FDA or other regulatory authority approval before they can formally be deemed "complete". There is no guarantee that such approval would be obtained.

Given this, we would expect that no revenue should be recognised in the books of the licensor in respect of these milestone amounts as they are not "reasonable assured". We also note that the criteria stipulated in ED paragraph 85 could be extended in scope to include any other production based milestone outside the control of the seller / licensor / other supplier which give rise to the generation of revenue following contract inception / execution.

In our view, the text contained in ED 85 with reference to "...the customer promises to pay additional consideration" should be reworded to reflect the fact that contracts could be entered into in which the *total consideration* receivable on satisfaction of performance obligations is wholly dependent on subsequent sales.

We note that the definition of variable consideration in ED paragraph 53 which makes reference to discounts, rebates, etc. is very different from, for example, contingent consideration as per IFRS 3 which may be dependent on future events based on activities undertaken by the licensee e.g. success of R & D or sales and thus, suggest that the Board clarify its intention to ensure there is no diversity of application in practice. One way to do that would be to provide a definition of variable consideration in the appendix.

Question 4

For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

As stated in our 2010 comment letter, we do not support the requirement to conduct the onerous test at a performance obligation level unless management monitors profitability at a lower level.

We take the view that in line with IAS 37, the onerous test should be conducted at the contract level as is currently the case in practice.

IAS 37.66 makes reference to "onerous contracts" where a liability is only recognised and measured as a provision if the supplier has a present obligation under the contract.

Conducting the onerous test at a PO level when the overall contract is profitable in our view is an exercise which will require undue resources to execute, and the resulting information will not be decision useful to the users of financial statements. Also, in situations where PO's are combined

because the commercial objective of the transaction warrants this, we consider that no onerous test will be necessary when the overall contract from a commercial objective perspective is profitable.

IAS 37.10 defines a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefit.

The above text supports the view that the onerous test should be conducted at the contract level as no resources are expected to “flow” out of the entity if the test is conducted at the contract level.

We are not clear on why the ED proposes to limit the scope of the onerous test to performance obligations satisfied over time where this exceeds one year. As a principle, we believe that where a contract is onerous, the provisions of IAS 37 apply with no exceptions, and this will ensure consistency in application. We are also of the opinion that where the transaction price is allocated to different performance obligations, this process should ensure that individual performance obligations are not loss making, taking into account the specific facts and circumstances for each customer relationship.

Whilst we would not support any proposal to allocate the transaction price strictly based on margins associated with each performance obligation identified, we suggest that if it is determined that an outstanding performance obligation will give rise to a loss, then this loss should only be recognized if it cannot be absorbed by any margin to be made on other remaining performance obligations associated with the same contract. Only in these circumstances is there going to be a net cash outflow for the entity on completing all remaining elements of the contract requiring a net loss to be recorded.

With reference to the application of the time value of money concept generally and towards construction contracts in particular, it will also be helpful if guidance is provided on how the impact of the time value of money (TVM) should be allocated to performance obligations identified as well as how this concept affects retainers and advance payments. We note that advance payments made by the customer do not necessarily represent a financing component. In our view, it should clearly be stated that the TVM concept should only be applied to material amounts based on materiality thresholds established by management for the business as a whole. Given this the TVM concept should not be applied to sales transactions with values below the threshold established.

Question 5

The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports. The disclosures that would be required (if material) are:

- *The disaggregation of revenue (paragraphs 114 and 115);*
- *A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117);*
- *An analysis of the entity’s remaining performance obligations (paragraphs 119–121);*
- *Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123);*
- *A tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer (paragraph 128).*

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the cost to entities to prepare and audit that information. If you think that the proposed disclosures do

not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

Whilst we acknowledge that any disclosures on Revenue in the financial statements is of crucial importance to the users, we disagree with the proposals as in our view, they are unduly excessive and will result in disclosures which are out of proportion in relation to other important areas reported on in the interim financial report and will even potentially lead to a delay in producing the interim financial statements. Furthermore the cost of providing this information in the interim financial report, which is specifically allowed to be of a condensed nature, far exceeds any benefits to the users of these interim financial statements.

It would also be helpful if the Board could provide more detailed guidance of what should be included in contract assets and contract liabilities in the proposed disclosures for the annual financial statements as this is not entirely clear following discussions with our constituents. Furthermore, the Board needs to make it clear that such additional disclosure is only required where such related activities are material to the entity.

Question 6

For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

We generally agree that the concept of control should be applied consistently across all standards.

OTHER COMMENTS

Definition of a customer

We are concerned that the definition of a "customer" is too narrow and implies that only the immediate recipient of a good or service can influence the way in which revenue is recorded. By way of background, in the Pharmaceuticals and Medical Devices Industries, it is usual for companies to have several parties involved in a given transaction. A medication or a device is often sold to a wholesaler who takes full ownership and control but the final transaction price received by the vendor is sometimes not only defined by the price paid by the wholesaler. This is due to the fact that the medication or devices are eventually paid for by healthcare providers and discounts to the wholesale price are granted to these organizations (indirect customers). It is our opinion that the wording in ED paragraph 10 needs either clarification, or expansion in order to enable constituents to appropriately apply the definition of a customer; ED paragraph 10 only states that "a customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities" which is a very narrow definition.

Contract Modifications

Following review of the text contained in ED paragraph 22, it would be helpful if the wording contained therein can be made simpler to understand.

Zero margin for items externally procured but integrated "as is" into the final offering to the customer

We generally agree with and support the guidance on input methods to estimate the transfer of goods or services over time. However, where goods are purchased from external suppliers for use in large construction contracts, we disagree with allocating a “zero” profit margin to such goods which are used “as is” with no significant involvement by the seller in the design and manufacture of such goods in the satisfaction of performance obligations as we understand would be required by ED paragraph 46. In the case of large contracts where the entity is operating as a general contractor it is a core competence of the entity in offering a customer a “turn key” solution. As a result the general contractor should not be prohibited from allocating a profit margin to items acquired which are integrated “as is” into the final product or service sold to the customer.

Consideration Payable to Customer

There are a number of situations where vendors need to pay amounts to their customers. In certain industries these can be material.

Currently IFRS is silent on the income statement classification of many of these items which has led to considerable diversity in practice between entities applying IFRS and those following US GAAP.

We suggest that the opportunity is now taken to clarify the principles in this area. In this context with respect to consideration payable by the vendor to a customer we suggest that the board should delete the reference to the US GAAP guidance ASC 605-50-45-2 in BC160. The US GAAP guidance will be superseded by the upcoming revenue recognition standard, therefore the final standard would refer to something which is no longer in place. Just replacing the US GAAP reference by the wording of ASC 605-50-45-2 also is not an option because it implies that the full guidance in this section should be carried forward which is problematic as the principles underlying the US GAAP term “identifiable benefit” and the ED notion of a “distinct good or service” may not be the same.

In our opinion, the current US GAAP accounting in the area of considerations payable by a vendor to a customer does not fit into the principle based rules of IFRS and can lead in many cases to a different accounting treatment. Under current US GAAP for instance, penalties are always considered as revenue deductions, even if they are payable to a customer because the vendor is unable to supply (i.e. the vendor did not recognise any revenues). This is due to the fact that any payments to customers not providing the vendor with an identifiable benefit need to be classified as revenue deductions and may only be reclassified to costs, if they result in negative revenue on a cumulative basis (i.e. since inception of the relationship). However, paragraphs 65 to 67 of the ED on revenue recognition seem to imply that a revenue deduction is only applicable if there has been an underlying sale linked to the revenue deduction.

Furthermore, according to US GAAP 605-55-31, arrangements for services which cannot be entered with parties other than the customer of its products are not sufficiently separable from the sales transaction and are therefore treated as revenue deductions. The ED does not have such a requirement. According to the ED, services are distinct and have to be accounted for as separate performance obligations if they are regularly sold and if the customer can benefit from the service on its own or together with other resources that are readily available to the customer. For example, slotting fees for placing products in a prominent position in a shop could be considered as distinct services as they are regularly sold by the resellers to its vendors and provide a benefit to the customer (i.e. the vendor in this case). Under the principle based ED II these payments could be considered as costs while under US GAAP they would be considered as revenue deductions.

Incremental costs in obtaining a contract /amortisation and impairment

We note that with paragraphs 94 ff that it is explicitly stated that costs incurred with obtaining a contract (or indeed those connected with an anticipated contract) that are anticipated to be

recovered can be treated as assets. Paragraph 103 then mentions that impairment charges can be reversed if the impairment conditions cease to exist. We are not in favour of the principle of capitalisation of incremental costs of obtaining a contract and believe that it will lead to many challenges in interpretation and practice as the following example demonstrates.

Assuming that the final standard retains the concept of capitalisation of these types of costs we would like the Board to clarify exactly what would be permitted in the following situation.

In Q1, 20xx certain costs for a potential new contract are incurred however since the negotiations with the potential customer are at a very preliminary stage these costs are expensed as impaired. Costs related to the potential contract continue to be incurred during the year and are expensed as impaired.

In Q2, 20x1 the entity is awarded the contract.

Does application of paragraph 103 allow the entity to reverse the impairment charge on the contract acquisition costs?

Is it appropriate that there would be a difference in expense recognition if the entity only prepared annual IFRS financial statements and by December 31, 20xx there was an increasing likelihood that the contract would be successfully concluded?

Presentation of contract assets and liabilities

With reference to ED paragraph 106 as extracted below:

A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer, when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

In our opinion, the text underlined above could be clarified further as in its current form, its interpretation is restricted to circumstances that fit the context of illustrative example 18.

Where an entity has transferred goods and services, and consideration for such transfers is dependent on the future performance of the customer– contingent consideration (not royalties) – it would be helpful if guidance could be provided as to whether this circumstance gives rise to a contract asset or not especially if such amounts are reasonably assured.

In addition to this, we are not convinced about the proposal that remaining rights and obligations in a contract form a single unit of account and should be accounted for and presented on a **net** basis as either a contract asset or contract liability. Entities should be permitted to present information of this nature in a way and manner that best communicates the facts to its users.

Transition

It would be helpful if the Board permits as a practical expedient, the choice of applying either prospective or retrospective application. In our view full retrospective application would be unduly burdensome especially if more than one comparative period needs to be restated. Whilst we acknowledge that application of the ED proposals should be accompanied by relevant disclosures for the year of first application, limited disclosures should apply to comparative information.
