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27 August 2013

Mr H Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Mr Hoogervorst,

Draft Standard: 'Revenue from contracts with customers'

We are writing to express our concern regarding the latest developments in the new Revenue Recognition Standard related to the recognition of income from sales-based royalties.

The most recent Exposure Draft published in November 2011 included, at paragraph 85, specific wording that concluded that for licences of intellectual property, it was not appropriate to record royalty income based on the sales made by a third party licensee in advance of those sales being made. Subsequently, we understand that the Boards came to the view that the wording of this paragraph was too prescriptive and appeared to have the nature of a "rule", although they decided that the outcome from applying that rule remained appropriate.

At the Board meeting on 24 July, when this matter was discussed further, it appears that the Boards tentatively decided to move away from the previously agreed approach characterised by paragraph 85. We understand that the latest position is that it would be expected that a "minimum amount" of royalty income should be recorded in all cases where doing so would not result in a significant revenue reversal, and the situations in which that minimum amount could be zero would be very limited. This would be a fundamental change in the basis of revenue recognition for licences of intellectual property, and we do not believe that it would faithfully reflect the nature of such licensing transactions, or provide useful information for the users of financial statements.

Should this position remain, it is unclear how this "minimum amount" should be calculated since it bears no relationship to the two established measurement bases under IFRS of historical cost or fair value, nor the two ways in which revenue should be measured set out in the draft Standard. It appears that the amount recognised would be entirely judgemental, destroying any prospect of comparability between entities and leading to the prospect of fluctuations in revenue over time that have no bearing whatsoever on the activities of the entity in any given period. As such, it is difficult to see how including this minimum amount could provide any decision useful information for users of accounts. It is clear that the Boards recognise that the relevance to users of financial statements is an important concept, and in the recently published Discussion Paper on the Conceptual Framework, paragraph 4.10 states that "the IASB should not require the recognition of an asset or liability if the IASB concludes that recognising that asset or liability would result in information that is irrelevant, or not sufficiently relevant to justify the cost of preparing it."

It is also not clear what asset is created from recording the revenue. IAS 37 'Provisions, contingent liabilities and contingent assets' defines a contingent asset as "a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity." The asset created from recording the minimum amount of revenue fits this definition precisely; the past event is the transfer of the licence and the future events are the sales yet to be made by the licensee, which may never materialise. Contingent assets are, of course, not permitted to be recognised in financial statements. Equally, the licensee would not record a liability to pay the royalty in advance of any sales made, because he had the ability to avoid making those underlying sales. While it would always be possible to ensure that the Revenue Standard took precedence over IAS 37 for the income/asset side of the transaction, it would seem illogical to create such asymmetry deliberately.

In the Exposure Draft on Leases issued in May this year, the Boards decided not to require lessors to include future variable lease payments in the measurement of a lease asset. Accordingly, variable lease payments are included in profit or loss in the periods in which that income is earned (paragraph 77(c)). Paragraphs BC151 and 152 of the Basis for Conclusions to the Exposure Draft on Leases explain that while some Board Members believed that the variable payments should be included, but were persuaded that the benefits of doing so would not outweigh the costs, particularly given the questions raised over reliability of the amounts, other Board Members believed that the payments should not be included because they did not meet the definition as an asset for a lessor, as the lessee was able to take actions to avoid them.

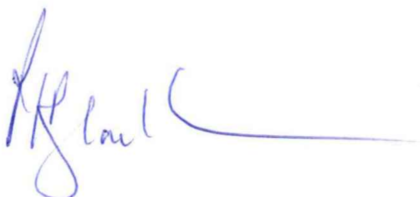
It is hard to understand how, in a principles-based standards regime, two virtually identical transactions could be required to be treated in entirely opposite ways, particularly when the two relevant Standards are being developed at the same time. As it stands at the moment, an amount of the variable income receivable in the future under a licence of intellectual property would have to be recorded in advance of the true amount being determined and becoming payable, if it ever were, but variable income receivable in the future under a lease of a different type of asset would not be recorded until when, or if, the amount actually becomes payable.

The first Revenue Exposure Draft required a virtually identical treatment as the latest proposal, for the recognition of income from sales-based royalties. There was significant feedback from both preparers and users that this approach would not provide meaningful financial information. The staff of both Boards have spent much time since the first Exposure Draft through the outreach process engaging with representatives of preparers and users in understanding and addressing these issues and concerns. The Boards also heard those concerns and addressed them in the second Exposure Draft in November 2011. We accept that the second Exposure Draft might need some refinement, but we see no evidence that respondents to it were pressing for any significant changes in this area.

The Staff Paper (item 7c) presented to the 24 July Board meeting set out two options for revised wording that were the culmination of all of the positive and collaborative outreach activity. It is therefore extremely disappointing that the Boards now appear to have ignored all of that work and with that, the views of many preparers and users. There was a suggestion at the Board meeting that if the accounting did not produce a result that was particularly useful, then users could be required to disclose the amount of potential future income recognised in this way. More disclosure is not a remedy for bad accounting. All that will happen is that preparers will create a "non-GAAP" measure that excludes these amounts from their performance reporting and users will similarly adjust out the amounts. It seems inconceivable that the Boards would require a particular basis of accounting in the full knowledge that both preparers and users would immediately adjust for it outside their full IFRS financial statements.

In our view, this proposed change of approach from the position set out very clearly in the second Exposure Draft is so significant that, if it is maintained, full re-exposure and re-consultation on this concept would be necessary in order to meet the Boards' requirements to ensure that due process has been followed. We therefore urge the Boards to reconsider this issue and to return to one of the two options set out in the Staff Paper for the 24 July meeting. While they may not be totally conceptually pure, they represent a much more sensible and pragmatic solution than the latest proposals and are much more likely to result in financial information that is relevant, reliable, representative, comparable, understandable, and above all useful.

Yours sincerely



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SVP, Corporate Controller

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