March 29, 2002

Timothy S. Lucas, CPA
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Letter of Comment No: 17 File Reference: 1050-001 Date Received: 3/29/02

Re: FASB's Proposal for a new agenda project, Issues Related to the Recognition of Revenues and Liabilities

Dear Mr. Lucas:

One of the objectives that the Council of the American Institute of CPAs established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect positions of the American Institute of CPAs.

TIC has reviewed the aforementioned FASB proposal for a new agenda project and is pleased to provide the following comments:

General Comments

TIC believes that there is a critical need for a general standard on revenue recognition to close the gap between the broad conceptual guidance in the FASB's Concepts Statements and the detailed guidance in the authoritative literature. TIC also believes this project should be one of the FASB's highest priorities.

Phased Approach

TIC agrees with the FASB's approach of simultaneously addressing the revenue recognition issues from a "top-down" and a "bottom-up" approach. We believe the "bottom-up" approach of gathering and compiling a comprehensive inventory of all the authoritative guidance and accepted practices for revenue recognition will be useful in applying revenue recognition principles in practice and will be necessary to address revenue recognition issues at the concept level.

Compendium of Revenue Recognition Guidance

The proposal indicates that the FASB will be developing a "comprehensive inventory" of current authoritative guidance and accepted practices of revenue recognition during the "bottom-up" approach phase of the standard-setting process. TIC believes that this compendium of existing revenue recognition standards and guidance should be published on the FASB's web site or in some other form, prior to the issuance of an exposure draft

on the project, rather than waiting until the draft is complete. Ideally, this document should be a living document, so that when new guidance is issued, it could be updated and kept current. The document would have the dual benefit of facilitating the deliberation process for those who are planning to comment on the FASB's exposure draft and of codifying existing literature in the interim to promote compliance with existing standards and best practices.

TIC agrees that the issues that this project would address are not unique to the United States and encourages the board to explore the opportunity for a joint project with the IASB. Since the IASB has indicated that it is considering a similar project, it would seem that this project is an opportunity for the two boards to issue a joint standard.

Additionally, one standard versus two does not add to the standards overload problem and would seem to be in the best interest of both preparers and users of financial statements.

Specific Comments

Request for Comments Issue 1. Is there a need for the FASB or others to comprehensively address issues associated with the recognition of revenues and liabilities? If yes, should the FASB take on such an effort or defer to others? If so, to whom?

TIC believes the FASB should focus on developing a general principle-based standard on revenue recognition that applies to all business entities. Any industry specific or narrow issues relating to revenue recognition should be delegated to AcSEC or the EITF. TIC believes that industry specific guidance is necessary and beneficial to practitioners when applying standards; however, the guidance should be based on general principles set by the FASB.

Request for Comments Issue 5. Should the proposed project, in addition to developing a new, general accounting standard on revenue recognition and revising the related guidance on revenues and liabilities in Concepts Statements 5 and 6, develop a new, general accounting standard on liability recognition?

TIC believes the project's main focus should be revenue recognition. TIC believes the issues relating to revenue recognition are pervasive and more in need of immediate attention than issues concerning liability recognition.

APPENDIX

EXAMPLES OF ISSUES TO BE ADDRESSED

TIC has commented below on some of the issues identified in the appendix of the proposal to assist the FASB in focusing on the areas of most importance to smaller firms and their clients. The areas identified are those that have been troublesome in practice.

Issues Related to Both Revenues and Liabilities

Issue 1. With regard to the fundamental recognition criteria in Concepts Statement 5 that apply to all elements of financial statements:

(d) Should other criteria be added, and if so, what should those criteria be?

TIC believes that most practitioners do not understand the notion of representational faithfulness and instead follow the notion of "substance over form" in determining "reliability." TIC believes that any principles-based standard of revenue recognition should include the concept of substance over form. The concept of substance over form has previously been rejected by the FASB in Statement of Financial Accounting Concepts (SFAC) No. 2, Qualitative Characteristics of Accounting Information, paragraph 160, which states:

Substance over form is an idea that also has its proponents, but it is not included because it would be redundant. The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. Substance over form is, in any case, a rather vague idea that defies precise definition.

TIC believes SFAC No. 2 should be amended to restore the concept of substance over form. Although the phrase may be "vague" and "defies precise definition," it is commonly used in practice. Most recently, it appeared in the *Highlights of GAO's Corporate Governance, Transparency and Accountability Forum*, March 2002, Report no. GAO-02-494SP, page 4. The forum participants agreed that one of the issues to be addressed in designing an updated financial accounting and reporting model is that:

Accounting and reporting rules should be based on "economic substance" of the related transactions and should employ a "substance over form" doctrine in resolving related matters.

Additionally, the concept is mentioned in the "Broad versus Detailed Standards" section of the FASB's Codification and Simplification Projects paper (March 2002), page 3:

A shift to less-detailed standards would place the focus on accounting for the substance of the transaction rather than its form.

Issues Primarily Related to Revenues

Issue 3. Should gains be defined separately from revenues? If so, should revenues continue to be defined in terms on an entity's main or central ongoing operations and should gains continue to be defined in terms of an entity's peripheral or incidental activities? If not, how should they be defined? Should another element, in addition to revenues and gains be defined?

TIC has not identified any instances that would indicate a need to change practice for accounting or presenting gains. However, TIC believes that the more appropriate place

for the board to address this issue is in its project on Financial Performance Reporting by Business Enterprises.

Issue 5. In what circumstances, if any, should revenue recognition be required when the entity has partially but not fully performed? In the context of revenue arrangements that consist of several distinct elements, in what circumstances should recognition occur on the completion of individual elements?

TIC believes that the project should provide general guidance on multiple-element arrangements. Currently many practitioners will use the guidance in SOP 97-2, Software Revenue Recognition, and SAB 101, Revenue Recognition in Financial Statements, which may not be appropriate in all cases. Also, many small firm practitioners believe that the guidance in SAB 101 is well written in "plain english" with practical real world examples. In contrast, many small firm practitioners find the writing style in many of the EITF's, such as EITF 00-21, difficult to follow. TIC believes that any new standard on revenue recognition should use SAB 101's writing style as a model.

Issue 6. Should revenue recognition be prohibited if the customer retains the right to return or should both revenue and a related liability to accept returns be recognized?

TIC believes that the new standard should provide additional guidance on revenue recognition when the right of return or a right of forgiveness exists. Practitioners are facing arrangements involving the contingent forgiveness of a receivable if the buyer boosts the seller's sales by conducting an advertising campaign for the seller's benefit. In today's service economy, the impact of special service agreements on revenue recognition is as important to address as the actual return of inventory.

Issue 7. To what extent is estimation appropriate in revenue recognition? For example, should recognition be prohibited if consideration in an arrangement is subject to variability even though that variability is estimable? Should contingencies affect the recognition or measurement of revenue?

TIC believes that revenue recognition should be based on facts and circumstances when consideration in an arrangement is subject to variability, even though it is estimable. TIC believes any general standard on revenue recognition should provide guidance in the form of "a list of factors or indicators" that would address issues relating to variability, including how the quality and reasonableness of the estimate affects revenue recognition. Perhaps the guidance could be modeled after paragraph 8 in SFAS No. 48, Revenue Recognition When Right of Return Exists.

Certain industry specific guidance is helpful in estimating revenue. For example, in the healthcare industry, revenue is estimated net of a contractual allowance for every procedure performed based on the third party payer's fee schedule. To prohibit the recognition of revenue in this instance would not be prudent since the revenue can be estimated based on a recognized parameter (i.e., the fee schedule).

Issue 9. In what circumstances, if any, should the amount of revenue recognized be based in some way on the proportionate part of costs that it has already incurred?

TIC believes that any new standard on revenue recognition should provide additional guidance on when it is appropriate to recognize revenue based on the percentage of completion method. SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, paragraphs 12 –14, which discusses the kinds of contracts covered by the SOP, does not provide enough guidance to allow consistent application among companies. For example, it is extremely common for some entities outside of the construction industry (in particular manufacturers) to use percentage-of-completion accounting as an acceptable method of revenue recognition for large orders that require longer-than-usual production cycles.

Issue 11. In what circumstances should revenues be presented on a "net" rather than a "gross" basis?

TIC believes further guidance in this area is necessary but should be addressed as part of the FASB's project on Financial Performance Reporting by Business Enterprises. An example of a practice problem encountered concerns "net" v. "gross" treatment in related party transactions. The issue is whether inventory transfers between entities under common control should be recorded "gross" as a sale or "netted" as an adjustment to inventory and related purchases on the separate financial statements of each entity?

Another related party revenue recognition issue arises in situations with two related entities that enter into contracts with each other and separately with an unrelated third party. The issue is whether to show the revenues and expenses related to these transactions gross, as the form of the transactions would dictate, or net as the substance of the transactions indicates.

Other Revenue Recognition Issues

Contingent receivables

TIC believes that any revenue recognition standard should provide guidance concerning contingent receivables. For example, Company A provides nonrecourse, pre-settlement financing to personal injury plaintiffs. The Company provides cash advances to plaintiffs awaiting trial or settlement. Amounts advanced to plaintiffs are recorded as an asset, net of an allowance for uncollectible advances, which is based primarily on the historical loss experience of the Company. Guidance is lacking regarding when to recognize fee income. Some argue that it should not be recorded as income until it is received upon favorable settlement of the case; others say the fee was earned when the advance was made.

Recording Reimbursements for Out of Pocket Expenses

In EITF 00-10, Accounting for Shipping and Handling Fees and Costs, the EITF concluded that that all amounts billed to a customer in a sale transaction related to shipping and handling, if any, represent revenues earned for the goods provided and should be classified as revenue. TIC believes guidance should be provided for other out-of-pocket expenses, such as travel expenses. TIC believes most companies net these amounts against the related expense.

Accounting for Certain Sales Incentives /Rebates

TIC is aware that in recent years the EITF has or is in the process of addressing certain sales incentives /rebate issues. TIC believes many small firm practitioners do not have the time to keep up with, and therefore are not aware of, these EITFs and the guidance they provide. To assist small firm practitioners TIC believes all revenue recognition guidance including EITFs should be in one place such as the current text or the FASB website. See our comments above concerning compendium of existing revenue recognition standards and guidance.

Practical Guidance on Revenue Recognition

TIC believes that the new standard should provide practical guidance on how revenue recognition is affected by the timing of delivery of the product or service and when the risk of loss is transferred. Many practitioners currently use SAB 101, Revenue Recognition in Financial Statements, for guidance even for non-public entities.

Not For Profit Issues

TIC believes additional guidance is necessary to help practitioners differentiate between recording receipts as liabilities versus temporarily restricted contributions. The lines become blurred when the organization is primarily missioned based, like a church. For example, assume a church collects a special offering that will be used, in part, to support another religious organization—a mission for example. It is difficult to determine whether some of the offering collected for the mission should be recorded as the church's revenue or whether the church should record the entire offering as a liability.

We appreciate the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience or provide more details on the examples presented.

Sincerely,

Candace Wright, Chair PCPS Technical Issues Committee

cc: PCPS Technical Issues Committee and PCPS Executive Committee