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Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Request for Comments on Proposed Project -
Issues Related to the Recognition of Revenues and Liabilities

Dear Mr. Lucas:

J.P. Morgan Chase & Co. is pleased to submit its response to the Financial Accounting Standards Board's request for comments on the proposed scope and importance of a potential project related to the recognition of revenues and liabilities. Our comments are provided in the attachment to this letter.

We would be pleased to address any questions you may have regarding our comments at your convenience. Please feel free to contact me at 212-270-7559 or David M. Morris at 212-701-7007.

Very truly yours,

J.P. MORGAN CHASE & CO.

**REQUEST FOR COMMENTS ON PROPOSED PROJECT -
ISSUES RELATED TO RECOGNITION OF REVENUES AND LIABILITIES**

MAJOR QUESTIONS

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?**
 - There is a need for the FASB rather than the public sector to comprehensively and expeditiously address issues associated with the recognition of revenues, subject to full due process.
 - The FASB should coordinate its efforts with that of the international standard setters (IASB and UK ASB) to promote convergence of accounting guidance on revenue recognition. The Accounting Standards Board in the UK issued a Discussion Paper on revenue recognition in July 2001 and since has undertaken a project on revenue recognition. The IASB plans to consider adding a project on liabilities and revenue recognition to its agenda.
 - The efforts of the EITF and AcSEC in developing accounting guidance have been hindered due to the lack of a general revenue recognition standard.
 - The proposed goals of the revenue recognition project, which are to develop a general standard on revenue recognition that applies to business entities generally and to eliminate, to the extent possible, inconsistencies that can arise from applying current guidance, are strongly supported.
 - Also refer to the response to question 2 in this section.

2. **Is the proposed scope of such a project as described in this proposal insufficient, appropriate, or too ambitious?**
 - The primary focus of the project should be revenue recognition.
 - If the FASB decides to undertake a separate but simultaneous project on liability recognition, then such effort should not hinder the scope and timing of the revenue recognition project.

3. **Should specific issues identified above or in the appendix be excluded from the scope of the proposed project? If yes, for each specific issue, please indicate whether it should be addressed as part of another FASB project, by others, or not at all and why.**
 - As noted in the response to question 2 above, the primary focus of the project should be revenue recognition. If the FASB decides to undertake a separate but simultaneous project on liability recognition, then such effort should not hinder the scope and timing of the revenue recognition project.
 - We have not identified any revenue issues identified in the appendix to be excluded from the scope of the revenue recognition project.

4. **Should specific issues *not* identified above or in the appendix be addressed as part of the proposed project? If yes, please describe the specific issue and indicate why it is sufficiently crucial that it should be addressed as part of the proposed project.**
 - We have not identified any additional issues to be addressed.

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?**
 - Refer to the response to question 2 above.

APPENDIX - EXAMPLES OF ISSUES TO BE ADDRESSED

Issues Related to Both Revenues and Liabilities**1. With regard to the fundamental recognition criteria in Concepts Statement 5 that apply to all elements of financial statements:**

- (a) **Is the criterion pertaining to *measurability* operational, and if not, should it be amplified or eliminated?**
- Under the *measurability* criterion, an item to be included in the financial statements must have a relevant attribute that can be quantified in monetary units with sufficient reliability.
 - The *measurability* criterion is an appropriate fundamental recognition criterion that should be readdressed in the FASB's proposed "top-down" and "bottom-up" approach discussed in 1(d) in this section.
- (b) **Is the criterion pertaining to *relevance* operational, and if not, should it be amplified or eliminated?**
- Under the *relevance* criterion, information to be included in the financial statements must be capable of making a difference in user decisions.
 - The *relevance* criterion is an appropriate fundamental recognition criterion that should be readdressed in the FASB's proposed "top-down" and "bottom-up" approach discussed in 1(d) in this section.
- (c) **Is the criterion pertaining to *reliability* operational, and if not, should it be amplified or eliminated?**
- Under the *reliability* criterion, information to be included in the financial statements must be representationally faithful, verifiable, and neutral; recognition may sometimes involve a trade-off between *relevance* and *reliability*.
 - The *reliability* criterion is an appropriate fundamental recognition criterion that should be readdressed in the FASB's proposed "top-down" and "bottom-up" approach discussed in 1(d) in this section.
- (d) **Should other criteria be added, and if so, what should those criteria be?**
- While we have not identified any other criteria to be added, we concur with the proposed simultaneous "top-down" and "bottom-up" approach for the revenue recognition project described in the next to the last paragraph on page 5 of the Proposal.
 - The "top-down" approach would focus on "the conceptual guidance in Concepts Statements 5 and 6."
 - The "bottom-up" approach would focus on "the detailed authoritative guidance and other accepted practices for revenue recognition and would include developing a comprehensive inventory of that guidance and those practices."
 - The tentative conclusions about the conceptual guidance (i.e., "top-down" phase), which includes the Concepts Statement 5 *measurability*, *relevance*, and *reliability* criteria set forth above, would be tested by applying them to the specific revenue recognition issues (i.e., "bottom-up" approach) addressed in current guidance, which might result in further refinement of the conceptual guidance.

2. Are conceptual criteria for recognition needed or would the definitions of the items to be recognized in financial statements be sufficient if those definitions were refined and clarified?

- Conceptual criteria for recognition are needed.
- It would not be possible to define all current and potential items that should be recognized in financial statements.

Issues Primarily Related to Revenues

1. With regard to the additional criteria in Concepts Statement 5 for recognizing revenues in "earnings":

(a) Should the *realized or realizable* criterion be eliminated, and if not, should it be modified (and how)?

- The *realized or realizable* criterion should not be eliminated.
- The FASB should readdress whether this criterion should be based on a concept of earnings as the definition of income rather than on a concept of income that is fundamentally based on measurements of assets, liabilities, and changes in them as set forth in Concepts Statement 5. This was part of the basis for dissent by a FASB member to Concepts Statement 5.
- Reference also should be made to the response to question 1(d) in the preceding section.

(b) Should the *earned* criterion be eliminated, and if not, should it be modified (and how)? Should the criterion instead focus on *performance* by the entity, and if so, how should performance be defined?

- The *earned* criterion should not be eliminated.
- Paragraph 83b of Concepts Statement 5 appears to adequately focus on *performance* by the entity by including the following language in the *earned* definition: "An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."

(c) Should the criteria explicitly refer to changes in assets and liabilities to eliminate any potential for conflict between the recognition of revenues and liabilities?

- As indicated in the response to question 1(a) in this section, the FASB should readdress whether this criterion should be based on a concept of earnings as the definition of income rather than on a concept of income that is fundamentally based on measurements of assets, liabilities, and changes in them as set forth in Concepts Statement 5.

2. Should the Board eliminate the notion of earnings and the related recognition criteria so that only one set of recognition criteria would apply to all components of comprehensive income? If not, should the Board develop a conceptual definition of earnings that differs from that for comprehensive income, and develop recognition criteria that are consistent with that definition for determining which items should be included in earnings as opposed to OCI? If so, how should earnings be defined?

- The FASB should not eliminate the notion of earnings and the related recognition criteria.
- The FASB should develop a conceptual definition of earnings that differs from that for comprehensive income, and develop recognition criteria that are consistent with that definition for determining which items should be included in earnings as opposed to other comprehensive income.
- The FASB should begin with the definition set forth in Concepts Statement 5.

3. **Should *gains* be defined separately from *revenues*? If so, should revenues continue to be defined in terms of 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?**
- The FASB should distinguish between *gains* and *revenues* and should provide guidance on each.
 - Revenues should continue to be defined in terms of an entity's main or central ongoing operations.
 - Gains should continue to be defined in terms of an entity's peripheral or incidental activities.
 - We have not identified any further elements to be defined.
4. **Should revenues continue to be defined in terms of asset inflows, asset enhancements, or liability reductions? If not how should they be defined? Should they be defined in terms of asset inflows or liability reductions stemming from the entity's fulfilling its obligation to its customers (as the ASB has proposed)? If so, how should asset enhancements that result from an entity's main or central ongoing operations be defined?**
- Revenues should not be defined in terms of asset inflows, asset enhancements, or liability reductions.
 - The FASB should readdress the definition of revenues based on the *realized/realizable* and *earned* criteria in paragraph 83 of Concepts Statement 5.
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?**
- Regarding those circumstances when the entity has partially but not fully performed, refer to the response to question 9 in this section.
 - In the case of revenue arrangements that consist of several distinct elements, refer to the response to question 8 in this section.
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?**
- Revenue recognition should not be prohibited if the customer retains the right to return.
 - Accounting for sales with the right of return is the subject of SFAS 48, "Revenue Recognition When Right of Return Exists," which sets forth the conditions, all of which must be met, if revenue from such sales transactions is to be recognized at the time of sale.
 - Often the critical condition is whether the amount of future returns can be reasonably estimated, especially when a company lacks sufficient experience with a new product to know what level of returns to expect or when a company markets a low-volume, high-dollar product.
 - Another critical condition is that the buyer must have paid the seller, or the buyer must be obligated to pay the seller and the obligation is not contingent on resale of the product (i.e., sales are not on consignment).
 - If sales revenue is recognized because all of the conditions in SFAS 48 are met, then any costs or losses that may be expected in connection with any returns must be accrued in accordance with SFAS 5, "Accounting for Contingencies."
 - Under SFAS 48, sales revenue and cost of sales reported in the income statement should be reduced to reflect returns, both actual and estimated future returns.
 - Among other things, SFAS 48 does not apply to sales transactions in which a customer may return defective goods, such as under warranty provisions.

- 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?**
- Estimation is appropriate for revenue recognition. For example, under APB Opinion 29, "Accounting for Nonmonetary Transactions," revenue is recognizable if it is determinable within reasonable limits (i.e., no major uncertainties exist about the realizability of the value that would be assigned to an asset received in the nonmonetary transaction accounted for at fair value).
 - Contingencies should affect the recognition and measurement of revenue. For example, if all of the SFAS 48 requirements for recognition of revenue when the customer retains the right of return are not met, then revenue cannot be recognized. Additionally if all such conditions are met, then any costs or losses that may be expected in connection with any returns must be accrued in accordance with SFAS 5, "Accounting for Contingencies."
- 8. Should revenue recognition guidance address how to determine the units of accounting in an arrangement that consists of more than one distinct arrangement? Should it address how to allocate consideration to those units?**
- Yes to both questions.
 - This issue is being addressed under EITF Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." While no consensus has yet been reached, the Task Force has agreed that providing guidance on this issue prior to the development of a comprehensive revenue recognition framework by the FASB would improve financial reporting.
- 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?**
- Such circumstances are covered by paragraph 84c of Concepts Statement 5, which states that "If a product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned – as production takes place – provided reasonable estimates of results at completion and reliable measures of progress are available."
 - The related footnote goes on to state that "If production is long in relation to reporting periods, such as for long-term, construction-type contracts, recognizing revenues as earned has often been deemed to result in information that is significantly more relevant and representationally faithful than information based on waiting for delivery, although at the sacrifice of some verifiability."
 - On the surface, the percentage-of-completion approach continues to make sense, but it should be readdressed in the revenue recognition project with the "bottom-up" approach discussed above being used to test this concept.
- 10. Is additional guidance needed on how to determine the fair value of assets and liabilities associated with revenues being recognized?**
- This issue should be handled in the separate FASB project on fair value.
- 11. In what circumstances should revenues be presented on a "net" rather than a "gross" basis?**
- The relevant guidance for this issue is the recently issued EITF Topic D-103, "Income Statement Characterization of Reimbursements Received for 'Out-of-Pocket' Expenses Incurred."
 - Given the level of dissent by constituents, this issue should be revisited by the FASB.

Issues Primarily Related to Liabilities**1. Should *probable* be eliminated from the liabilities definition?**

- No, *probable* should not be eliminated from the liabilities definition.
- The distinction drawn between the *probable* definitions in Concepts Statement 6 and SFAS 5 should be reevaluated. Footnote 21 of Concepts Statement 6 states that *probable* "refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." Paragraph 3 of SFAS 5 defines *probable* as "the future event or events are likely to occur."

2. Should the liabilities definition continue to focus on *future sacrifices of economic benefits*?

- Yes, the liabilities definition should continue to focus on future sacrifices of economic benefits arising from present obligations to transfer assets and/or provide services.

3. Should liabilities be defined as arising only from *legal obligations* (as opposed to also arising from *equitable* and *constructive obligations*)? Should the legal doctrine of *promissory estoppel* be incorporated in the definition either directly or indirectly?

- Liabilities should not be defined as arising only from *legal obligations*, but should also include obligations arising from *equitable* and *constructive obligations*.
- Footnote 22 in Concepts Statement 6 defines *obligations* as: "... broader than *legal obligations*. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth. It includes equitable and constructive obligations as well as legal obligations."
- Paragraph 40 of Concepts Statement 6 states:

An *equitable* obligation stems from ethical and moral constraints rather from rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right – to do what one ought to do rather than what one is legally required to do.

A *constructive* obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

- The legal doctrine of *promissory estoppel* should be incorporated in the definition of liabilities either directly or indirectly.
- As addressed in SFAS 143, "Accounting for Asset Retirement Obligations," the legal doctrine of *promissory estoppel* is a written or oral contract that serves to include obligations incurred through third-party reliance upon a promise, even in the absence of consideration in exchange for that promise.

4. Should the liabilities definition encompass conditional or contingent obligations?

- The liabilities definition should not specifically encompass conditional or contingent obligations.
- When conditional and contingent obligations meet the definition of a liability, they will be recorded on the balance sheet. Prior to that time, they should only be disclosed in the footnotes, if appropriate.
- Paragraph 35 of Concepts Statement 5 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." Additionally, SFAS 5, "Accounting for Contingencies," requires the accrual of an estimated loss from a loss contingency by a charge to income if it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

5. Should the liabilities definition encompass obligations of an entity to *stand ready*?

- The liabilities definition should encompass obligations of an entity to *stand ready* to provide services or to use assets.
- For example, if an entity has received a computer maintenance fee in advance for a three-year period, then the entity must carry a liability for the fee relating to the portion of the maintenance period that has not yet elapsed. A manufacturer must carry a liability to satisfy any potential warranty claims. An insurance company must carry a liability to cover estimated eventual claims.

6. Should the liabilities definition encompass obligations of an entity to *stand aside* (such as those arising from noncompete agreements)?

- The liabilities definition should not encompass obligations of an entity to *stand aside* (such as those arising from noncompete agreements).
- Obligations of an entity to *stand aside* do not represent a responsibility of an entity to settle a present duty or responsibility to another by the probable future transfer of assets or performance of services.