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The Accounting Principles Committee of the Illinois CPA Society (Committee) appreciates the opportunity to provide its perspective on the Discussion Paper "Preliminary Views on Revenue Recognition in Contracts with Customers." The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These recommendations and comments represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

As a preamble to our comments on the Boards' questions we offer the following specific observations:

We do not believe the complexities of revenue recognition in relation to non-profit organizations (including unconditional promises to give), rights of use for a period of time (including leasing arrangements and membership agreements), stand-ready obligations (including insurance and warranties) and financial instruments contracts (and similar arrangements) will readily lend themselves to a simplified model based on contracts (written, oral or implied). We do believe the Boards could make substantial progress towards simplification and convergence of many standards by focusing on products and services. We believe the Boards should undertake separate revenue recognition projects for unconditional promises to give, rights of use, stand-ready obligations, and financial instruments contracts.

Additionally, we are concerned with the ability of preparers, in practice, to disaggregate and separately account for the components of complex agreements comprising multiple contract types. As noted by the Boards in their recently issued discussion paper on lease accounting, complex contractual arrangements can be too complex or contain inter-related elements making disaggregation impracticable. For example, a contract for sale of a photocopier can include arrangements for sales of goods both present (the machine) and future (toner), sales of services (monthly inspection and servicing), warranties on parts, and, potentially, embedded derivatives if the seller and buyer function in different currencies. The complexities and inter-relationships among these provisions may be such that the contract should not be disaggregated just as the contract to lease that same copier (with the attendant supplies and services) might not need to be disaggregated leading to recognition of revenue at the end of the contract period.

The Preliminary Views document seems to assume that that the individual contract is the unit of account. The Boards should consider the appropriate units of account as the project continues. For example, it is not practical to think that warranties will be accounted for on an item-by-item basis. Warranties, product returns and other stand-ready obligations can only be assessed by knowledge of the broader class of



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transactions over longer periods of time. A requirement to allocate a portion of each individual contract to performance obligations that are not determined on an individual contract basis, may introduce a level of book-keeping complexity that is not necessary to generate useful information. The same overall results may be best achieved by refining the model to enable integration of processes that arise from different units of accounting. As noted in Appendix C, the Boards will consider units of account that may arise by combining contracts in customer arrangements. For example, some individual revenue arrangements may be part of a master agreement. Identification of the appropriate “contract” and unit of account for purposes of revenue recognition is important.

Among the topics yet to be considered as listed in Appendix C of the Preliminary Views document, the Boards have listed presentation of the rights and obligations as either “gross” or “net” as an open area. We believe this is one of the more fundamental questions in this project, particularly as it relates to stand-ready obligations such as warranties or product liability. We also note that the recently issued Preliminary Views document on leases has concluded that a gross presentation approach is appropriate. We recognize that lease accounting and revenue recognition are very different areas, but note that the Boards are taking a contractual approach to both and believe it could be conceptually inconsistent to conclude that one set of contracts be accounted for gross and the other net.

Finally, a project of this magnitude should be evaluated extensively through field testing. Such field testing should cut across industry lines not only to assure the Boards that the project is industry-neutral in its design, but ensure the Boards capture a wide variety of situations and types of contracts, and to identify potential difficulties in application. We believe this is imperative if the Boards are to avoid the future need for interpretations, exceptions and clarifications that lead to complex or overly detailed guidance.

Our comments related to the questions posed in the document are as follows:

Question 1

Do you agree with the Boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We agree. We commend the Boards’ efforts to reduce the volume and diversity of standards related to the recognition of revenue. We further agree with the Boards’ proposal to base recognition of revenue on the changes in rights and obligations arising from contractual arrangements with customers in so far as they relate to sales of products and services. As noted above, we believe the current phase of the project should be limited to revenue transactions related to sales of products and services. As discussed in our general comments above, we believe the Boards should develop separate projects for unconditional promises to give, rights of use, stand-ready obligations and financial instruments contracts. Accordingly, the examples in this Preliminary Views Documents related to those areas should be deferred and included in later proposals.



Question 2

Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

We do not believe the Boards have made a case for a single model to handle transactions other than those related to sales of products and provision of services. The Boards have previously stated that leases have been excluded from the project because of difficulties with the contractual model; we believe those same difficulties arise with respect to the other areas mentioned above. It is not clear in these situations as to the nature of the contracts, both formal and implied, or the nature of the attendant rights (which are yet to be considered in a Preliminary Views document).

We also do not believe the Boards' proposed model provides decision useful information for so-called onerous contracts. Issues related to such contracts are most likely measurement issues unrelated to decisions about recognition; rather they are measurement issues that arise post-recognition. It is not clear to us that an entity would enter into a contract that is deemed onerous at inception in the absence of some other obligation or transaction, not included in this contract, which is being settled as part of such contract negotiations.

Question 3

Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We do not agree and believe the restriction to outputs of "an entity's ordinary activities" is too broad. As specified now, for example, it includes financial instruments which are not included in the scope of this project. As noted above, we believe the Boards' approach in this document is a good one for goods and services. Accordingly, we believe the definition of contracts in this document should be limited to those related to selling goods and providing services.

Secondly, we believe the concepts underlying this document will necessarily be applied by analogy to transactions not part of an entity's "ordinary activities". For example, a real estate developer who sells a building to a customer in the ordinary course of business may also sell its headquarters building. This latter transaction does not generate revenue as it would not be considered a sale of goods or services in conjunction with the entity's ordinary activities, but it will likely generate a gain or loss. The concepts underlying the contractual model in this document can also be applied to that situation. We encourage the Boards to consider incorporating recognition of gains and losses from transactions of this nature into this project either as an appendix to a document on sales of goods and services, or in conjunction with later deliberations on those sales transactions that do not involve goods and services.

Finally, we note the Boards' focus on "enforceable rights" in the definition of a contract is consistent with terminology currently in place in their definitions of assets and liabilities in the continuing conceptual framework project. However, we caution the Boards on the potential for structuring of agreements in this vein. For example, a contract to purchase goods that is cancellable by the buyer prior to delivery is likely not one that creates an "enforceable obligation" but we believe it is no different in substance from a contract that allows the buyer an unconditional right of return post delivery. The proposed model allows



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the seller to estimate returns in the latter scenario; should it also allow the seller to estimate cancellations in the former? The seller's obligations are economically the same in both scenarios; providing for different accounting treatments in these two situations could lead to deal structuring to accelerate or delay recognition of a performance obligation and its related contract rights.

Question 4

Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

With respect to goods and services, we believe identifying performance obligations would help entities identify deliverables as it focuses analysis of the arrangement on the underlying economics and the business purpose attendant to the transactions. However, consistent with our recommendation above that "right of use" arrangements not be part of this project, we direct the Boards' attention to Example 7 "Nonrefundable upfront payment – no initial revenue recognition". In the example, all revenue is recognized in the first year of a one-year arrangement. However, if the up-front fee is so large relative to the monthly charge, it may be highly unlikely that the customer would not renew the contract not only for the next year, but for a number of years as well. Is that renewal feature a stand-ready obligation that must be recognized at inception of the contract? If not, how will a standard address transaction structuring designed to front-load revenues in contractual arrangements by means of "bargain renewals"?

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

We do not agree and believe this is a question of "unit of accounting". Multiple performance obligations may exist that are satisfied concurrently. Those obligations should be combined into a single performance obligation and recognized concurrently with the transfer of the related assets to the customer.

It is not clear to us how the Boards are reconciling their conclusions in this document with those set forth in paragraph 3.32 of discussion document on leases. The Boards indicate, for example, that preparers may find it difficult to separate the components of a lease contract and such components are often inter-related. We do not see why those considerations do not apply to revenue contracts as well. The Boards believe arrangements with multiple deliverables can be separated by management into components even when those components are not individually priced or sold. We do not understand why the Boards believe preparers can perform this task for revenue arrangements but not for leasing arrangements.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?



That is a stand-ready obligation that has long been considered in doing business, but not on a contract-by-contract basis in many cases. One doesn't track individual warranty obligations for example, but looks at that general obligation as a cost of doing business as opposed to one that attaches to each specific project at the time of sale. Accordingly, while the Boards' depiction of the warranty arrangement with respect to a single transaction is conceptually appealing, it is not consistent with the underlying economics of the entity's business. Again, this may be a matter of specifying the unit of accounting as the broader performance obligation, but as noted above, we believe the Boards' should separate stand-ready obligations from this phase of the project.

This question is also tied directly to question 8, below. It is not clear to this Committee that a stand-ready obligation to accept returned goods post delivery is economically different from a performance obligation to deliver those same goods pending customer acceptance or cancellation.

Question 7

Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

This situation is analogous to that addressed in Question 6, above. It is not clear whether discounts, free goods and services, or points are stand-ready obligations or simply costs of doing business. Consumer goods manufacturers are exposed to product liability and may be required to accrue the costs of that legal exposure as a stand-ready obligation; however there would be no scenario under which we would consider the resolution of that stand-ready obligation to be an adjustment of revenue. Similarly, it is counter-intuitive that an entity would earn "revenue" because it did not have to provide services under a warranty obligation; preparers and users have long considered those arrangements to be costs of doing business, not adjustments to revenue.

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

We do not agree because the concept of customer control is complex. For example, the issue of customer acceptance, discussed at length by the SEC in SAB 101/104, is a key element in its guidance for recognizing revenue and impacts customer control. It seems clear that customer control necessarily implies acceptance, otherwise the customer would not have the ability to dispose of the goods or even pledge it as collateral for a loan. However, assume a customer obtains control of goods but has an unconditional right of return. The seller has satisfied its performance obligation related to delivery; it has a continuing performance obligation related to the requirement that it stand ready to accept the return of those goods. While the seller may be in the same economic position pre- and post-acceptance, the financial statement depiction of the obligation as either a pending sale (performance obligation) or as a potential return (stand-ready obligation) may lead users to different conclusions as to the future prospects of the business and will lead to structuring of agreements to achieve a more favorable presentation.



As with so many other accounting problems we face the dilemma of whether to recognize a transfer based on the customer obtaining control or on the transfer of substantially all risks and rewards. This model points to the many difficulties associated with de-recognition of assets in SFAS No. 140. Does the customer have to be able to consume or re-sell the product without restriction to demonstrate control? Can the customer control the asset without possessing all the risks and rewards of ownership or might that merely give rise to other rights and obligations to be recorded by the seller at the time of transfer – and corresponding rights or stand-ready obligations on the part of the buyer – related to risks and rewards still outstanding? Complexities and inter-relationships here may call for the Boards to consider the practicality of not further breaking down these contractual arrangements but aggregating them and considering them as contingencies for possible disclosure. Arrangements that come to mind include conditional call options, rights of first refusal in the event of customer re-sale, and price protection arrangements (e.g., a rebate if the customer finds the identical product available from another seller at a lower price within some specified time-frame).

Question 9

The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

See our comments on Question 8, above. In paragraphs 4.20 et seq. the Boards state that an asset may not have been transferred to a customer, and the performance obligation may not have been satisfied, in situations where there is a contractual requirement for the customer to communicate its acceptance of the good or service. However, it may be possible for the customer to have control over the underlying economics of the asset in the period between the delivery of the asset and the time the customer communicates its acceptance. If the customer controls the underlying economics of the asset prior to communication of acceptance, this would appear to be a situation no different from a customer obtaining an asset and having an unconditional right of return. Accordingly, there appear to be levels of obligation involved in a contract requiring acceptance no different from those in a contract providing a right of return. If acceptance is viewed as a right of return, then there exists an obligation to stand ready to accept return of the assets that should be subject to the same principles of recognition as other stand-ready obligations. The Boards should consider whether there are substantive, economic differences between a right to cancel an order, the requirement that delivered goods be accepted and an unconditional right of return post delivery and acceptance. We believe that all three scenarios may result in identical obligations and question the usefulness (and potential for transactions structuring) of characterizing them as “performance obligations” or “stand-ready obligations”.

Question 10

In the Boards’ proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous. (a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

We agree that initial measurement should be at the transaction price.



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(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

We do not agree with respect to contracts for sales of goods that it should be necessary to adjust the performance obligation. We believe the current model that requires entities to adjust inventory to "lower of cost or market" already captures the economics related to performance obligations that would be deemed onerous. With respect to service contracts, the fact that a contract is onerous would likely be a result of increases in compensation costs for those providing such services. Recognizing losses in the current period for those performance obligations would appear to be little more than expensing currently the increases in compensation that has yet to be earned.

We believe that performance obligations should not be re-measured even for so-called "onerous contract" situations. It is no more relevant to re-measure an obligation that has become onerous than it is to re-measure one that has become excessively favorable. Furthermore, it singles out "loss contracts" for special treatment while leaving break-even or marginally profitable contracts to work their way through future reporting periods. We believe bad business decisions that impact future periods' transactions and financial performance should be allowed to do just that.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

See our comments above with respect to contracts for transactions involving arrangements for other than goods and services.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

See our comments above with respect to contracts involving arrangements other than goods and services. For example, measurement of performance and stand-ready obligations related to financial instrument contracts should likely be at market value (defined in SFAS No. 157). However, it is not clear to us that all performance obligations arising in connection with sales contracts should result in revenue. For example, we do not believe that satisfaction of the stand-ready obligation with respect to warranties should result in revenue. We recognize this will be addressed when the Boards consider gross vs. net reporting of contractual arrangements, but the outcomes of this and similar deliberations will necessarily impact the conclusions as to the appropriate approaches to measurement.

Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.



(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

We agree. The costs of obtaining a contract are costs of doing business however; to the extent such costs are identified with and charged to a customer, they should be included in the determination of revenue for that transaction. This is consistent with the current method of accounting for shipping and handling costs.

(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

This question implies the potential for deferring contract origination costs to some later time period. This historically has been the source of numerous problems for the profession as it has so often led to inappropriate deferrals to accomplish earnings management. Unless there is some short time-lag between the incurrence of these costs and entering into a contract as discussed in the immediately preceding question, we see no basis for deferral of contract origination costs.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

We agree as those underlying selling prices have likely been considered in the negotiations related to the larger contract of which they are a part. However, as noted in our comments to Question 5, above, the Boards must reconcile their conclusions with respect to this allocation with their conclusions expressed in the preliminary views document on leasing. The same considerations should apply to both situations.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

We agree with this approach as noted in our comment letter on EITF 08-1. We believe this is consistent with the Boards' move away from bright-line standards and rightly defers to the judgment of management which is the basis for the determination of the overall contract price of which these other goods and services are a part. An inability to estimate the standalone prices does not appear to be consistent with one's ability to negotiate a fair price for the larger transaction.

However, as noted above, the Boards seem reluctant to require this sort of allocation in leasing arrangements which are not necessarily any more complex than revenue arrangements having multiple deliverables or containing multiple types of contracts. The Boards should consider not requiring allocation in those situations where it is impracticable or where separate prices are not reasonably



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available. In such cases, revenue should be recognized when the performance obligation as a whole has been satisfied.

We appreciate the opportunity to offer our comments.

Sincerely,

Reva B. Steinberg, CPA
Chair, Accounting Principles Committee



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APPENDIX A
ILLINOIS CPA SOCIETY
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2009-2010

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times, includes a minority viewpoint.

Current members of the Committee and their business affiliations are as follows:

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