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File Reference No: 1820-100
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RE: Proposed Accounting Standards Update—Revenue Recognition (Topic 605): Revenue from Contracts with Customers (Issued 06/24/10)

The Bauer Review, an organization at the University of Houston's C.T Bauer College of Business, is focused on researching and analyzing EITF topics for publication to the FASB, IASB and other regulatory boards.

We sincerely appreciate the FASB and IASB support for giving the Bauer Review an opportunity to provide a comment on the proposed standard change. The Bauer Review team would like to also express their excitement in being able to become active participants in the discussion for the profession. This will be the first publication to be issued from the Bauer Review. We will strive to strengthen our voice through such opportunities to assist and grow the value of the profession through subsequent comment considerations.

The Bauer Review would also like to complement the persons below for their contribution in reviewing the final copy of the response provided here-in.

Special Acknowledgments: Troy Hopkins, *J.D/Bauer MBA Special Relations*

Dr. George Gamble**,** *Ph.D./Robert Grinaker Professor/ Director of the Institute for Diversity and Cross-Cultural Management*

Sincerely,
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RE: Proposed Accounting Standards Update—Revenue Recognition (Topic 605): Revenue from Contracts with Customers (Issued 06/24/10), File Reference No: 1820-100

The objective of this report will focus on giving a response to the questions addressed by the FASB and IASB for revenue recognition from contracts with customers.

Question 1:

Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether to:

(a) Combine two or more contracts and account for them as a single contact

Response:

Contracts from their initial formation face a wide variation of dynamic economic considerations before two or more parties form a general consensus to become committed under the proposed transaction. There exist multiple factors which both the project owner and contractor hold while remaining bonded to the agreed upon terms of the contract. For example, such factors or risks include but are not limited to the performance satisfaction, delivery date guarantee, safety of goods delivered or services provided, design quality and probable scheduling changes which arise due to unforeseen conflicts (internally and/or externally) by each party in the contract. Although contracts are primarily performed for a singular purpose such as the construction of a bridge, the *intrinsic* means of performing the service vary in its execution due to a firm's need to have a competitive gain. The proposed standard seeks to combine two or more contracts into a single contract on the basis of a "price interdependence" model. While the model strives to provide consistency in the proposed application in the future, it should also be noted that industries offer multiple contracts exist for the purpose of a "single commercial objective". In this context, the contractor may reasonably be awarded or offer multiple contracts for services related to labor, material, and delivery to mitigate the various risks in meeting the agreement requirements. Similarly, when complex projects face a myriad of underlying risks with assumptions of what is reasoned to be sound estimates of reliability in completing the terms of the contract, the most significant risk both parties face is the incapacity to deliver and receive the final goods and services. The aforementioned risk is realized when an attempt is made to consolidate multiple performance obligations into a singular action or bond. For example, a performance variable can either be mutually exclusive or dependent on another variable; with each variable comprising of its own unique time implementation phase requirements. Consequently, the ability to recognize revenue maybe forfeited forthwith by the contractor from the inability to fully or partially satisfy the performance obligation(s). Correspondingly, firms who derive earnings primarily from contracting are likely to see multiple changes in their ability to strategically execute their objectives. The significant lost in value, both tangible and intangible, places not only the contractor in jeopardy but as importantly the ability of stockholders, suppliers, lenders and other stakeholders' capacity to derive their respective value. In such situations, the ability to segment contracts can provide the leverage needed from defaulting on the contract agreement or at best serve to mitigate augmenting time delays and costly expenditures. To this extent, fluctuations in measurement techniques arising from the principle variation in revenue uncertainty and its subsequent effects on cost of revenue can be theoretically controlled through mitigating project risks through the assignment of multiple contracts. It can also be inferred the principles of matching expenses and revenue recognition may become subjective as a result of a

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single contract that is too difficult to interpret or track. Consequently, leading to future infringements in which statements will need to be restated under *FAS 154: Accounting Changes and Error Corrections* (see also *ASC 250-10*) - possibly leading to a poor representation (perception) in earnings. Accordingly, a multiple contract could serve to sustain the underlining concept of applying "conservative accounting" while simultaneously assisting management in mitigating risks related to the project. Moreover, segmented contracts can provide firms and users with clarity in interpreting the underling risks cited in the disclosures within the financial statements. Clarity serves to accomplish in resonating the true representative risks, estimates, position and value of the firm. As well, the consolidation of multiple contracts based on a "price interdependence" model can strain the initial intent of the guidance by undermining the flexibility afforded to market participants. Flexibility is thwarted when manageable risks become magnified or progress toward a threshold of incapacity as result of regulatory action and not from open market participation. Thus, a subjective accounting item can lead the firms, users, and the market into an equivocal position as a result of multiple types of risk being consolidated.

In addition, paragraph 15 states:

> *"Conversely, an entity shall segment a single contract and account for it as two or more contracts if the price of some goods or services in the contract is independent of the price of other goods or services in the contract. Goods or services are priced independently of other goods or services in the same contract only if both of the following conditions are met:*
> *(a) the entity, or another entity, regularly sells identical or similar goods or services separately; and*
> *(b) the customer does not receive a significant discount for buying some goods or services together with other goods or services in the contract. "*

Response to paragraph 15:
A "price independence model" can inhibit industry specific pricing techniques of contracts. For example, the technology industry (i.e. application software, business software/services, scientific and technical instruments etc…) offer a wide ranging breadth of products and services which are uniquely tailored for a client. In such instances, the need of the contract is dependent on a client's demand for a particular product and/or service. Therefore, firms within the industry strive to differentiate their goods or services through intellectual property protection options and aim to safeguard employee capital. Consequently, goods or services are less likely to be "identical" with a competing firm. Equally important, a firm will provide products and services which cannot be regularly offered separately as demonstrated through following illustration:

> *Entity A builds a patented product for customer B; with B holding certain rights to the patent with A. B realizes the full merit of the patented product with the support of A. Another competing entity could support B, but would not be able to fully service the need of B.*

In such case, a competing entity would not be able to "sell [an] identical or similar good or services separately" as offered by A. B is more likely to opt in having A help in supporting their business need because of their demand is based on the long term *value* to be derived and not on the *pricing* of the goods or services. Subsequently, A may not provide the same or similar good or service to another future client. That is to say, technology companies offer a variation of project mixes in the future at which time it may be difficult to estimate the effect on pricing or relation to the amount of revenue to be recognized. Similarly, given the high evolutionary development in technology at any given time, products and services often become prehistoric and unmarketable. As a result, would a firm's ability to choose an option between segmenting a contract or consolidation become impaired in the future?

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Moreover, consistent with BC47 of page 92:

> *"In contrast, representatives from other industries (for example, the technology industry) preferred to account for an individual good or service as a separate performance obligation even if it is not sold separately. Those representatives thought that to do otherwise would result in an entity's financial statements not providing users with useful information about revenue and profit margins as the entity transfers goods or services to customers."*

Accordingly, the risk of limiting the option of segmenting the contract can significantly alter the ability of users to fully or clearly ascertain the value of a firm or the ability of a firm to mitigate potential losses of revenue.

Lastly, what consideration is given if the goods or services provided do not have a readably available market? What proposed standard or recommendations does the Boards seek to provide for industries in which rivaling competitors do not provide similar goods or services? For example, there often exists time when innovative entrepreneurs set to create a new niche in the market in which the timing of competitors remain uncertain. Such entrepreneurs benefit from the competitive advantage present in their service. The language of the paragraph implies that a contact will only be segmented if there is a good or service *regularly* made available in the market. Additionally, the same paragraph proposes:

> *"An entity shall segment a single contract and account for it as two or more contracts if the price of some goods or services in the contract is independent of the price of other goods or services in the contract*."

What interpretation can be extracted from the word "some" in the passage? Would it apply to at least one or more goods or services? Is "some" equitable to a percentage? If so, what qualities and attributes comprise to form a reliable percentage? Does it matter if the good or service is one in which gives the client the critical ability to exercise utility of the promised good or service?

Recommendation for Question 1:
Therefore, it is recommended firms should have the option to singularize or segment a contract. This would serve in the best interest of the firms, users, and the overall market.

Question 5:
Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

Response
The credit risk should not affect the transaction price and revenue an entity can recognize when it satisfies a performance obligation. Conceptually, it is foreseen when bids on a project is requested by a client (client or requestor), the bidding participants (entity or contractor) are more than likely to consider several economic risk variables such as the ability of the requestor to uphold its own performance obligation to provide full payment for goods or services received.

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Accordingly, paragraph 38(b) requires the transaction price can only be estimated if:

> "*The entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.*"

It is presumed then the entity previously considered a requestor's credit risk among other considerations in formulating the transaction price when a bid was presented. Similarly, a client is obligated to economically choose a bidder in its ability to deliver long term value as a result of making an offer on the goods or services requested and in return pay the full price under market value. Mutually, both parties are assuming a risk: the requestor relying on the contractor to deliver the promised goods or services and the bidding participant to be fully paid. Therefore, it might even be reasoned the client should have the option to reduce the risk due to the failure of not receiving the goods or services; however, such risk can be mitigated as highlighted in the response given to question 1 by segmenting a contract.

Furthermore, the reduction in the transaction price would result in an economic loss in value to be derived. Consequently, limiting the true quality of the revenue recognized resulting from a timing difference. As a result, an entity incurs an opportunity cost in which revenue could have been realized towards the utilization for other purposes such as making investments in other profitable projects, appropriately compensating management, developing firm value, reducing debt, and rewarding shareholders. Moreover, the reduction in transaction price could obscure the valuation of goods or services an entity provides. Users or the market may not clearly understand the full merit of value offered by an entity. Obscurity maybe created as a result of the pricing differences due to a customer's credit risk. The credit risk estimates are likely to differ among the type of project and the client involved from firm to firm within the industry. The valuation of such goods or services will not provide consistent comparability in judgment across similar firms in the industry. Plus, insurance companies charge higher premiums on high risk clients <u>if</u> a claim is to be filed. Similarly, the client in return makes the choice and obligation to pay the additional cost to leverage the risk of further augmenting the expenditures in the event he/she wishes to exercise the right to file a claim; none the less both the insurer and customer benefit. The insurer's higher premium interest rate is based on its unique estimates of a risk profile for a client but is also as importantly guided by open market conditions. Insurers only reduce the price offered by limiting coverage of the services requested. In this context, a contractor's ability to consider reducing the transaction price simply on estimating credit risk does not equate to creating full economic value. The aforementioned concept can be viewed from a contractor's profit formula at present time ($\mathbf{P_0}$):

$\mathbf{P_0}$ = *Quantity (TP – VC) – FC *Quantity relates to goods or services given

In order to compensate for the loss in value due to a reduction in the transaction price (TP), a contractor will need to offer fewer goods or services (Q). As a result, the contractor must then decide to choose a combination of:

(a) Further reducing the transaction price (TP),
(b) Reducing the variable costs (VC)
(c) Obtaining a liability from financing through suppliers and/or other lenders

Similarly, the reduction in price has the effect limiting the revenue to be recognized at the present time. Equally, reducing the variable cost will burden the contractor in providing services which are not competitive in the market. As well, incurring a liability may dissuade future confidence from users (assuming the return on the project is less than expected). Subsequently, the services given might discredit the reputation of firm or impede future relations with prospective clients. As a result, the client only benefits (assuming if needs are met); however, in the case of the insurance example both parties receive a benefit.

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Accordingly, the Boards provided the following illustration on page 70:

Example 20—Customer Credit Risk
"An entity enters into a contract with a customer to provide goods for $1,000. Payment is due one month after the goods are transferred to the customer. The entity assesses, on the basis of its experience with contracts with similar characteristics, that there is a 10 percent chance that the customer will not pay the consideration. Hence, the transaction price is $900 [(90% × $1,000) + (10% × $0)]. When the entity transfers the goods to the customer and satisfies its performance obligation, it recognizes a receivable and revenue of $900"

Applying the aforementioned example to the following illustration:

Transtec Gothard was awarded a $1.69 billion contract to build technology support systems for the railway of the Gotthard Base Tunnel project.[1] The tunnel will be the world's longest railway masterpiece.[2]

A 10% credit risk results in a loss of $169 million of revenue at P_0. The examples above only highlight a singular contract; however, there is a steady increase in the materiality when coupled with other contracts a firm is held to satisfy.

Recommendation for Question 2:

To reconcile the inconsistency in comparing a firm's value in the open market and the financial loss incurred to a contractor, it is recommended the transaction price should not be reduced on a credit risk estimation model. If a credit risk issue is present, the contract should provide an adequate stipulated clause that the client has acquired sufficient financing support from a third party lender. Thereby, transferring the burden of non-payment solely to the client while simultaneously mitigating the opportunity costs incurred to the contractor.

Respectfully Submitted,

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Sources Cited:

[1]"Transtec Gotthard wins CHF 1.69 billion contract for railway technology." *Alpiq*. Web. 15 Oct. 2010. <http://www.alpiq.com/news-stories/press-releases/press_releases.jsp?news=tcm:98-56986>.

[2]"Final Breakthrough of the Longest Railway Tunnel in the World." *AlpTransit Startseite*. Web. 15 Oct. 2010. <http://www.alptransit.ch/en/news/article/2010/10/15/hauptdurchschlag-im-laengsten-eisenbahntunnel-der-welt/>.

*All other references mentioned relate to the proposed standard:

"Proposed Accounting Standards Update: Revenue Recognition (Topic 605) – Revenue from Contracts with Customers." Financial Accounting Standards Board. (06/2010): PDF file. <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820852272&blobheader=application%2Fpdf>.