



## Via Email

November 3, 2010

Technical Director. Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk CT 06856-5116

Re: Exposure Draft – Topic 605 - Revenue Recognition – Revenue from Contracts with Customers – File Reference No. 1820-100

The Investors Technical Advisory Committee (ITAC) welcomes the opportunity to provide input on the Exposure Draft (ED) on Revenue Recognition – Revenue from Contracts with Customers. Our input is from our perceptions as users of financial statements with the goal of improving the financial reporting process.<sup>1</sup>

As we stated in our November 12, 2009 letter to both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (Boards), ITAC believes financial reporting for revenue is one of the most important standard setting area in terms of the potential effect on the income statement.<sup>2</sup> Revenue recognition continues to also be a source of continual challenges and problems as well as an area of possible fraud and manipulation of the financial statements.<sup>3</sup> Our prior letter encouraged the

 $<sup>^{1}</sup>$  This letter represents the views of Investors Technical Advisory Committee ("ITAC") and does not necessarily represent the views of its individual members, or the organizations by which they are employed. ITAC views are developed by the members of the Committee independent of the views of the Financial Accounting Standards Board and its staff. For more information about the ITAC, including a listing of the current members and the organizations in which they are employed, see http://www.fasb.org/investors\_technical\_advisory\_committee/itac\_members.shtml.

<sup>&</sup>lt;sup>2</sup> Letter from Rebecca McEnally, Member, ITAC to Mr. Robert Herz, Chairman, Fin. Accounting Standards Bd. & Sir David Tweedie, Chairman, Int'l Accounting Standards Bd. 1-2 (Nov. 12, 2009), http://www.fasb.org/cs/ContentServer?c=Document\_C&pagename=FASB%2FDocument\_C%2FDocument Page&cid=1176156547372 ("Financial reporting for revenues is not only the single most important standards setting are in terms of the potential effect on the statements of managers' revenue recognition and measurement decisions, but it has also been a source of continual challenges and problems, including fraud and manipulation of the statements")..

<sup>&</sup>lt;sup>3</sup> The potential effect on the single most commonly cited number in the financial statements, net income, of a small change in revenues is profound, and the major reason that revenue reporting has been subject to continuing instances of fraud and manipulation. For example, for the majority of companies that comprise the S&P 500 index, the long-term average of the ratio of reported earnings to revenues, sometimes referred to as the return on revenues, is in the range of 5 percent to 10 percent. Hence, an increase in revenues of 1

Boards to establish a comprehensive objective for revenue recognition and measurement and to clearly articulate this objective through a set of robust principles.<sup>4</sup> We believe, a robust set of principles and better disclosures, providing better transparency, may enable users to detect indications of fraud or manipulation and instances of overly aggressive revenue reporting.

We understand the FASB and IASB initiated this joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs that would:

- Remove inconsistencies and weaknesses in existing revenue recognition standards and practices;
- Provide a more robust framework for addressing revenue recognition issues:
- Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and
- Simplify the preparation of financial statements by reducing the number of requirements to which entities must refer.

We applaud the Board on its efforts in this project and believe some of these objectives were met in the ED. However, we continue to believe some of the differences outlined in the ED, such as differences in profit margin may continue to be contentious in the application of the proposed standard.

ITAC continues to believe the objective of revenue recognition is to recognize, measure and report the expected increase in the value of an entity's net assets resulting from a transaction between the entity and a customer that requires the transfer of goods and/or services to the customer.

To achieve this objective, as outlined in our previous letter, the entity should apply the following principles

#### A. At inception of the contract:

- (1) Recognize and record all assets associated with the contract by the nature of the asset (completeness);
- (2) Recognize and record all liabilities/obligations associated with the contract by the nature of the obligation and by the term of the transfer of the goods or services if more than one transfer is included in the contract (completeness);
- (3) Measure all assets and liabilities/obligations by either (i) the contract price **or** by the (ii) estimated fair values of the assets and liabilities/obligations if the fair

percent may well result in an increase in earnings of 20 percent, depending upon the nature of the cost structure of the company.

<sup>&</sup>lt;sup>4</sup> Letter from Rebecca McEnally at 2 ("The objective should be supported by a set of robust principles that can serve as benchmarks for determining whether the objective has been met").

values of the components differ from the amounts implied by the contract price (accuracy).<sup>5</sup>

- b. Following inception of the contract:
  - (1) Record any changes in assets and liabilities/obligations (including remeasurements that result from changes in estimates) when the changes occur, uncertainties are resolved, or improved information is available (accuracy, timeliness).
  - (2) Recognize revenues (losses) when transfers of goods or services to the customer or other changes have occurred and related contingencies and claims are resolved or terminated resulting in an increase (decrease) in the entity's net asset position in the contract (accuracy, timeliness).

We believe the ED makes some progress in capturing the principles we described above through five application steps to the core principle proposed:

- 1. Identify the contract(s) with the customer;
- 2. Identify the separate performance obligations;
- 3. Determine the transaction price;
- 4. Allocate the transaction price;
- 5. Recognize revenue when a performance obligation is satisfied.

However, we believe the model, and revenue reporting, could benefit from additional tightening consistent with our principles.

Our responses to individual questions and related comments will reflect these general principles and concepts.

### **Recognition of revenue**

- 1. Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether:
- to combine two or more contracts and account for them as a single contract:
- to segment a single contract and account for it as two or more contracts; and
- to account for a contract modification as a separate contract or as part of the original contract

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

Yes, ITAC agrees with the principle of interdependence and agrees that goods or services are priced independently of other goods or services in the same contract only if both the conditions outlined in paragraph 15 are met: (a) The entity, or another entity, regularly sells identical or similar goods or services separately; and

<sup>&</sup>lt;sup>5</sup> *Id*.

<sup>&</sup>lt;sup>6</sup> *Id*. at 3.

- (b) the customer does not receive a significant discount for buying some goods or services together with other goods or services in the contract.
- 2. The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

ITAC agrees with the proposed guidance for identifying separate performance obligations as outlined in paragraphs 21-24.

3. Do you think that the proposed guidance in paragraphs 25 – 31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

"Control" as a criterion in financial reporting has proven highly problematic in some areas and seems to invite game playing by sellers. If the goods are still in the physical possession of the seller, are incomplete and continuing to undergo production, and because of their incomplete state cannot currently be employed in the operations of the customer, even if the contract so specifies, we do not believe that the seller is entitled to recognize revenue. ITAC continues to believe that additional conditions of severability and usability should be placed in the definition of transfer in order to use control as a criterion for revenue recognition.<sup>7</sup>

We believe the definition can be enhanced by focusing on the full distribution of risks and returns associated with a revenue transaction. We believe a sale has not occurred unless all the risks and returns associated with the asset or services either have been transferred to the buyer or have been fully and completely recognized in the balance sheet and income statement of the seller. Delivery and legal transfer of title of the asset are not sufficient recognition criteria if risks and rewards are retained by the seller but not fully recognized as performance obligations. We recommend the FASB provide additional guidance on evaluating risks and benefits in determining separate performance obligations.

# **Measurement of revenue**

4. The boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

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<sup>&</sup>lt;sup>7</sup> *Id*. at 9.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

ITAC understands the rational put forward on recognizing revenue on the basis of an estimated transaction if it meets the conditions outlined in paragraph 38:

- (a) the entity has experience with similar types of contracts (or access to the experience of other entities if it has no experience of its own); and
- (b) the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances.

The proposal includes guidance which provides that, if the estimated price cannot be reasonably estimated, revenue will be limited to the amount that can be reasonably estimated. We are concerned that this approach will result in earlier revenue recognition than if revenue is not reported until a seller's prices are determinable. We believe that recognition should not take place if uncertainties remain that cannot yield to reasonable estimation.

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?

ITAC agrees that firms must take into account the credit status/ credit risks of their customers and report as revenue only what they expect to collect. We realize this would mean that allowances for doubtful accounts will reflect only changes in customer credit status that have occurred after a sale. Importantly, we would want to ensure that clear disclosures are required for any amount recognized as income or expense related to sales consideration that was not recorded in revenue. We believe this would provide a better projection of realizable income.

6. Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

ITAC agrees that if the contract includes a material financing component (whether explicit or implicit) that the entity should reflect the time value of money in the transaction price by discounting the amount of promised consideration using the rate that would be used in a separate financing transaction between the entity and its customer. The rate should reflect both the time value of money and credit risk. We agree that the entity shall present the effect of financing separately from the revenue from goods or services.

7. Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

ITAC agrees that the transaction price should be allocated to the performance obligations based upon the entity's standalone selling prices of the goods and services underlying those performance obligations. Of course, our position of support assumes that the reference standalone selling prices reflect the prices of the substantial proportion of the entity's actual sales transactions for the individual goods and services, and not, for example, stated, and possibly stale, list prices that are seldom realized by the entity in practice. It also assumes that a complete recognition and measurement of all such performance obligations occurs, i.e., those significant liabilities are not ignored in the initial recognition of the revenue transaction.

We believe that the measurement of the individual assets and performance obligations should reflect the most accurate estimate of the fair value, i.e., the present value of the expected future cash inflows and outflows under the contract.

#### **Contract costs**

8. Paragraphs 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognize an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

We agree that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition that an entity should recognize an asset only if those costs meet specified criteria. It is essential that the accounting and reporting for the transaction is complete, faithfully represents the actual economics of the transaction, and is accurate and timely in recognition and remeasurement. Any payments or other consideration expected to be received (or otherwise specified in the contract) as well as any payments expected to be made (or otherwise specified in the contract) should be completely and accurately recognized and measured.

Yes, from our perspective the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient.

9. Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

ITAC believes that costs specified can be considered as relating directly to a contract though there should be restrictions to costs that relate to the goods and services provided, so as to prevent unrelated costs being capitalized.

We agree with paragraph 59, that any costs incurred in obtaining the contract, whether direct sales commissions, indirect promotional costs, consideration awarded to their party agents, or other costs of any kind associated with obtaining the contract should be expensed immediately upon obtaining the contract.

# **Disclosure**

10. The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

Yes, ITAC strongly agrees that the proposed disclosure requirements will help users of financial statements. We believe that the requirements will assist users in understanding the amount, timing and uncertainty of revenue and cash flows from those contracts, including:

- (a) a disaggregation of revenue for the period,
- (b) a reconciliation from the opening to the closing aggregate balance of contract assets and contract liabilities, and
- (c) information about the entity's performance obligations, including additional information about its onerous performance obligations.
- 11. The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what if any, information do you think an entity should disclose about its remaining performance obligations?

ITAC agrees that an entity should disclose the amount of its remaining performance obligations and the expected time of satisfaction for these contracts as

outlined in paragraph 78 but should also include contracts with an original timing of less than one year but whose timing has now been extended.

We agree with the required description disclosures as outlined in paragraph 77.

12. Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

Yes, this would be helpful to investors. An entity should disclose its contracts both by type of service or good and geographically by region in a similar way to disclosure of segment information. As we have seen recently, economic drivers have profound differential effects on firms and it is important that investors be fully informed on potential outcomes. It would be useful to see more than one cut of business engaged in by the entity if it operates in different geographic regions and in lines of business.

13. Do you agree that an entity should apply the proposed requirements retrospectively (i.e. as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternate transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

Yes, applying the proposed requirements retrospectively allows for greater comparability both within entities and across entities. Given the potential significance of the change in the reported timing and amount of revenue recognition, it is critical that historical comparable information is required to be provided to allow investors to evaluate the performance of an entity.

## **Implementation guidance**

- 14. The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?
- 15. The boards propose that an entity should distinguish between the following types of product warranties:
- (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

ITAC agrees that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation, frequently one of such magnitude as to eliminate the profits realized from an activity. We have seen recent evidence of this with certain financial products issued in the financial markets. Where such rights of return or other guarantees and warranties exist, either explicitly or implicitly, they are necessary to induce a customer to purchase the good, and should be considered an essential condition of the sale. Entities should disclose the history of returns to investors based on the different types of warranties as well as use this information to determine whether the risk and returns were transferred to the customer.

- 16. The boards propose the following if a license is not considered to be a sale of intellectual property:
- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and (b) if an entity grants a customer a non-exclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license. Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive: Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

ITAC does not agree that the pattern of revenue recognition from the sale of a license should depend upon whether it has been granted exclusively. It seems the underlying commercial substance is similar to the right to use concept in a leasing agreement. The proposed standard should provide clarity on whether the rights granted in these types of agreements fall within the definition of leasing contracts.

# **Consequential amendments**

17. The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

Yes, we agree that in accounting for the gain or loss on the sale of some non-financial assets that an entity should apply the recognition and measurement principles of the proposed revenue model.

We encourage both Boards to continue their efforts in addressing the substantial and long-standing problems with standards for recognition and measurement of revenue by all entities. We believe that a single robust set of reporting principles, based upon complete and up-to-date recognition and measurement of all assets, liabilities, risk and rewards associated with the revenue contract, are an essential foundation for a standard. Should the Board wish additional information regarding our views, please contact either the undersigned or any member of the ITAC.

Sincerely,

Mary Hartman Morris

Mary Hartman Mario

Member, ITAC

Cc: Sir David Tweedie, Chairman, International Accounting Standards Board