ARTHUR ANDERSEN

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March 27, 2002

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

Dear Mr. Lucas:

Enclosed please find the Arthur Andersen LLP comments on the proposal for a new FASB agenda project, "Issues Related to the Recognition of Revenues and Liabilities."

If you have any questions about our comments or would like to further discuss them, please call me at 312-507-2335 or Teresa M. Dimattia at 312-507-4448.

Very truly yours,

John E. Stewart

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Enclosure

JES/mt

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Director of Research and Technical Activities
Financial Accounting Standards Board
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P.O. Box 5116
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Dear Mr. Lucas:

This letter contains our comments on the proposal for a new FASB agenda project, "Issues Related to the Recognition of Revenues and Liabilities" (the Proposal). Below, we first provide you with our overall comments on the scope of the project and then address the specific questions posed in the Proposal.

Overall Comments

We have long been proponents of the Board adding a project on revenue recognition to its agenda. Most recently, in the 2001 Annual FASAC Survey (the Survey) we scored the possible topic on revenue recognition with a "1" indicating that "the Board should add this topic to the agenda now." In addition, in ranking the Board's future agenda priorities (which included over 20 specific topics), we ranked revenue recognition as the number one priority. Our views are based on the fact that revenue recognition is, and will continue to be, a topic of major focus to investors, analysts, preparers, auditors and regulators. Revenue is often the largest single caption in the income statement and it often drives a number of key performance indicators used to explain results and trends. Our view is also based on the fact that there is an obvious need for better guidance in this area given the number of restatements involving revenue recognition. Despite the SEC staff and EITF's efforts, a considerable void in the accounting literature still exists related to revenue recognition. For these reasons, we wholeheartedly support the Board adding a project on revenue recognition to its agenda.

While we acknowledge that liability recognition deserves some attention by the Board (we ranked it eighth among the Board's future agenda priorities in the Survey), we do not believe the issues related to liability recognition are as pressing as those related to revenue recognition. We also acknowledge that there is some overlap between the concepts inherent to liability and revenue recognition. However, we do not believe that this overlap is so significant that the issues must be covered as part of the same project. We also do not believe that this overlap creates a conceptual conflict that must be resolved in order to provide comprehensive guidance on revenue recognition. On this issue, we point to paragraph 79 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, which explains why there are incremental considerations in dealing with revenue recognition: "Further guidance in applying the recognition criteria to components of earnings is necessary because of the widely acknowledged importance of information about earnings and its components as a primary measure of performance for a period. ... The widely acknowledged importance of earnings information leads to guidance intended in part to provide more stringent requirements for recognizing components of earnings than for recognizing other changes in assets or liabilities."

In the end, we fear that a project designed to comprehensively address both liability and revenue recognition would die under its own weight. Further, our current environment is demanding more timely resolution of accounting issues, and a combined revenue and liability recognition project would, based on past experience, be years in the making. This would leave us no better off than our current situation. Alternatively, we would suggest that the Board address liability recognition as a separate project after initiating or completing work on its higher priority projects, including a project on revenue recognition.

Specific Questions

1. Our overall comments indicate that there is a substantive need for the Board to address issues associated with revenue recognition. We believe the Board, rather than another standard-setter, should address these issues due to the fundamental nature of the issue and the broad spectrum of parties that would be affected by a standard on revenue recognition. While we believe the EITF has made good progress on the revenue issues it has undertaken, it is clear, particularly when reviewing the evolution of EITF Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables*, that the development of broad revenue recognition concepts requires the deliberate due process afforded Board projects. Also as discussed in our overall comments, we do not believe it is necessary for the Board to address both revenue and liability recognition as part of the same project. A revenue recognition project alone is an ambitious and daunting undertaking. Adding liability recognition to the same mix would make the project difficult, if not impossible, to manage and complete on a timely basis.

2. We believe that a single project encompassing both revenue and liability recognition issues is far too ambitious. As discussed earlier, we believe the Board should first focus on revenue recognition. The revenue recognition issues needing attention are much more pervasive and pressing than the liability recognition issues that need attention. And, while a revenue recognition project is, in-and-of-itself, an ambitious undertaking, we believe such a project is critically necessary.

   We also believe that the scope of a project focusing on revenue recognition should be broad – that is, it should provide a fundamental framework for determining if and when revenue should be recognized. The scope of such a project should not solely seek to replace or centrally codify the revenue recognition literature that currently exists. This approach will require the Board to consider the effects of the fundamental framework resulting from this project on the many fragmented pieces of authoritative literature that currently exist to deal with revenue recognition issues on a topic- or industry-specific basis.

   While the scope of a project focusing on revenue recognition should be broad, the standard resulting from such a project should be operational. That is, the guidance within the standard should not be so high-level that two independent parties could reach different conclusions when analyzing the same facts. However, we acknowledge that a Board project on revenue recognition should not be so detailed that it attempts to address every conceivable specialized industry issue. While this is a difficult line to draw, we believe it must be drawn and drawn closer to the detailed end of the spectrum for a resulting standard to be operational.

3. As discussed earlier, we do not believe that it is necessary for the Board to address liability and revenue recognition in the same project. Given that we believe revenue recognition issues are of a higher priority, we believe the Board should first focus on those issues and move on to liability recognition issues as higher priority projects are completed.

   In addition, in the Appendix to the Proposal, the Board poses a question related to eliminating "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." We do not believe it would be worthwhile for the Board to address this issue as part of a project on revenue recognition. This question, or certain aspects of it, would be better addressed as part of the Board's proposed project on "Reporting Information about the Financial Performance of Business Enterprises: Focusing on the Form and Content of Financial Statements."

4. Other objectives not specifically identified in the Proposal or its appendix that we believe should be addressed as part of a comprehensive project on revenue recognition include the following:

   <u>Bridge the gap between, and define the intersection of, the accounting frameworks and concepts related to financial instruments and revenue recognition</u>
   The link between these two areas stems from sales transactions generating both revenue and one or more financial instruments. The financial instrument(s) resulting from a sales transaction can take many forms. For example, an entity sells a product and receives a financial instrument with uncertain cash flows (e.g., a derivative indexed to gold). In this situation, does the uncertainty related to the cash flows affect the entity's ability to recognize revenue? For another example, an entity sells a product to its customer, the customer finances its purchase of the product with a third party, and the entity guarantees the customer's receivable with the third party. In this situation, how should the entity account for the sale of the product, the receivable, and the guarantee? Answering these questions requires an understanding of the literature pertaining to both revenue recognition and financial instruments. If the intersection of the related literature is not clear, then competing answers may result.

   <u>Reconcile the notions of profit deferral and revenue deferral</u>
   Under the current literature there are situations where profit deferral is the prescribed accounting and situations where revenue deferral is the prescribed accounting. The reasons why the profit deferral model is prescribed in some situations while the revenue deferral model is prescribed in other situations is not readily apparent. Still another approach prescribed in certain situations is the cost recovery method. A comprehensive revenue recognition project should determine whether these models should exist within the literature and, if so, provide clear conceptual reasoning for the situations where each should be used.

   <u>Emphasize the importance of constructive obligations in determining whether revenue has been earned</u>
   While understanding an entity's legal obligations under a sales arrangement is important in understanding when revenue should be recognized, so too are an entity's constructive obligations. In many cases, an entity's constructive obligations are more meaningful from a revenue recognition perspective than its legal obligations. We believe the issues that arise in revenue recognition related to constructive obligations can be addressed without also addressing liability recognition. The

position taken in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, equates liabilities with legal obligations. We do not believe that position should equate to deferred revenue only being representative of an entity's legal obligations. We believe deferred revenue should represent both an entity's legal and constructive obligations.

The issue of constructive obligations surfaces in many upfront nonrefundable fee situations. Even though an entity does not have any legal obligations that, if unfulfilled, would require refunding a portion of its fee, it does have constructive obligations to carry-out certain responsibilities. An example of this is an initiation fee charged by a health club to new members. Although the health club may have no obligation to remain open and no obligation to return the initiation fee should it cease operations, the constructive obligations to the new member are significant. A comprehensive revenue recognition project should give recognition to constructive obligations to appropriately reflect an entity's true standing with its customers. This notion seems to interact naturally with the pre-existing notion of an "earnings process."

<u>Provide guidance on the accounting for direct costs that relate to a specific revenue stream</u>
In our response to the Survey, we indicated that "A revenue recognition project should also consider related deferred cost accounting." Working through issues raised as a result of entities transitioning to the SEC staff's Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*, we learned that to the extent resolution of a revenue recognition issue requires revenue deferral, the next logical issue that gets raised relates to cost recognition. The best way to illustrate this point is through an example. An entity receives an upfront nonrefundable fee for performing certain services at the initiation of a long-term services arrangement. The entity concludes that the upfront services are not a separate element and therefore the related consideration for those services must be deferred initially and recognized as revenue over the term of the services arrangement. Since the entity has deferred the consideration related to the upfront services, may (or must) it also defer the costs incurred to provide those upfront services? If yes, then would there still be a basis for the company to defer the costs incurred to provide those upfront services if the entity did not receive nonrefundable upfront consideration from its customer? These are only a few of the questions that surface once an entity starts down the path of cost deferral. Given the interrelationship between the revenue recognition and cost recognition issues, a comprehensive revenue recognition project should address the accounting for direct costs that relate to a specific revenue stream.

<u>Supply guidance on the recognition of losses by a seller on firmly committed executory contracts</u>
The need for guidance in this area is evidenced by the fact that this issue is currently on the EITF's agenda as Issue No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts." Accounting for "loss contracts" is currently covered within certain existing authoritative literature dealing with revenue recognition. Instead of this issue being dealt with on a case-by-case basis, it should be dealt with on an overall basis. Bringing it under the umbrella of a comprehensive revenue recognition project accomplishes this objective.

<u>Prescribe revenue-related disclosures</u>
Clear guidance on the types of revenue-related disclosures an entity is required to include in its financial statements should result from a comprehensive project on revenue recognition. This information is critical in today's environment given the multitude of business models and transactions that exist and the rate at which these models and transactions are growing in complexity.

5. We do not believe that the proposed project should develop a new general accounting standard on liability recognition. See our comments above in support of this position.

Other Comments

As we have stated in previous comment letters to the Board, we agree that international harmonization is critical. However, given the need for revenue recognition guidance, we would sacrifice international harmonization if it is impracticable or if it would unduly delay completion of the project.

We would be pleased to discuss our comments further with the Board or staff.

Very truly yours,

Arthur Andersen LLP

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