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File Reference No. 1660-100 Discussion Paper:  
Preliminary Views on Revenue Recognition in Contracts with Customers

Dear FASB:

Although the preliminary views document is focused on for-profit business entities, I am also commenting with an eye to the future of not-for-profit accounting standards. For clarity, I will first discuss the implications of “Preliminary Views on Revenue Recognition in Contracts with Customers” (PV-RRCC) for business enterprises. A separate section will provide my thoughts on how the changes in revenue recognition might ultimately impact accounting standards for not-for-profit (NFP) entities, particularly with respect to contributions. While I have been on the teaching side for many years, I do have industry experience (primarily small manufacturing firms) as well as both practical and academic experience with not-for-profit organizations. For both types of enterprises, I am commenting primarily from the perspective of a financial statement user (investor in business enterprises and donor to charitable entities).

Overall, I am very impressed with the discussion paper and I believe it provides a reasonable roadmap toward more consistent and logical revenue recognition practices. I am very happy to find that the performance obligation approach won out over the other method that was considered early on. I think the proposal is consistent with many current practices and will have little practical difference in areas like accounting for warranties or sales with right of return. I have principally spent my time (1) answering the 13 questions posed by the Boards and (2)

thinking about the implications for accounting for contributions. Within my responses to the questions posed, I have noted a number of areas where guidelines might be needed. However, these would be principles rather than rules. I did not have enough time to create a list of possible guidelines but they would include rebuttable presumptions, distinguishing between goods and services, distinguishing general rights of return from specific (measurable) rights of return, and the like.

This letter is organized as follows. First, I have my responses to the specific questions. Next, there are some comments on the examples in Chapter 6. Then I discuss the implications for not-for-profit accounting. As part of that discussion, I have included an appendix that illustrates the application of the PV-RRCC to unrestricted and restricted contributions.

## **My Responses to Questions Identified by the Boards in PV-RRCC**

- 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?**

I concur with the Boards' proposal to have a single revenue recognition principle that can be applied to most situations. The notion of contractual rights and obligations makes sense. I believe strongly that some notion of "customer satisfaction" is an important part of revenue recognition. The approach laid out in the discussion paper, taken as a whole, appear to be reasonably practical and logical.

- 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?**

I have given considerable thought to the implications of this discussion paper for accounting for contributions. This is discussed in a separate section at the end of this letter and the appendix includes examples laid out in diagrams similar to Para. 2.32. I have no other examples where the proposed principles would not provide useful information – but I'm sure there will be some, as with insurance contracts and other transactions with which I have limited experience.

- 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.**

While attorneys may not agree (I'm not a lawyer), I certainly see that the notion of contracts or at least enforceable rights might provide a useful way to reconsider the current accounting standards for contributions (FAS116). See discussion in separate section.

- 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.**

There will be a need for some general guidelines, some of which the Boards have already discussed. For example, goods and services delivered at different points in time or over different periods of time are a good indication that a contract embodies multiple performance obligations (see my other responses to #5, #7, #8, etc.).

- 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?**

For typical business transactions, I like the notion that we can determine the satisfaction of performance obligations (and the point in time when revenue is recognized) based on the point in time when the customer has control of the assets. This works best for products, of course. It certainly simplifies the accounting if we only have to worry about separate performance obligations if they are delivered to the customer at different points in time. I rather like the idea that services are assets that are immediately consumed by the customer – so they are an asset for an instant in time and become an expense almost immediately (as per examples in Para. 3.14 to 3.15). Realistically, the thought process for services is something of a tautology – it may not be as verifiable as the delivery of goods since the service provided may not be satisfactory to the customer but it cannot be returned. As a simple example, think about the street people who wash your windshield and expect payment for a service you didn't want or need. So it is important that there be a genuine contract – the service provided must be something the customer asked for! But this is a minor point and I think the approach delineated in Chapter 3 could work well.

- 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?**

I presume that one of the reasons we have detailed rules on this topic in US GAAP is abusive accounting and business practices. In some cases, companies have shipped unordered goods to customers to inflate year-end revenues, knowing that the goods would be returned in the next fiscal year. Accounting standards cannot be relied upon to prevent fraud – that's a separate matter. I'm not sure that it matters whether the right of return is considered a separate performance obligation or a sale that didn't happen since the net result would be essentially identical in its impact on the bottom line. I think I'd prefer the current practice of estimating returns and providing an allowance for those returns until the return period has ended – at least for any general right of return such as those offered by retailers like Wal-Mart and Costco. Estimating an allowance for returns would be simpler than dividing every sale into multiple performance obligations when only a small percentage of goods are returned. So I guess this means I have a preference for the “failed sale” approach discussed in Paragraph 3.39. Only in rare circumstances where there is an explicit price differential between goods sold with and without a right of return would it make sense to treat the right as a separate performance obligation (e.g., certain refundable versus nonrefundable airline tickets). However, if it is a

general right of return that applies to all products, the allowance for returns method makes more sense and would seem to be more practical. Under both approaches, it makes sense to NET the expected returns/refunds against the revenue rather than treat the performance obligation as a separate liability. If the returns must be made within a limited time period and it is impossible to estimate the returns, none of the revenue should be recognized until the expiration of the return period. This situation would presumably be rare if the right of return is a general business practice in the industry.

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?**

I believe that sales incentives may give rise to performance obligations. I just ordered a new laptop computer and was offered \$50 off on a docking station, if ordered at the same time. This incentive doesn't seem to require any special accounting since there was also a “special” price for the laptop. In short, the retailer accepted less revenue in order to make the sale now rather than later or never. So the issue is really whether incentives related to future sales or future delivery of additional goods give rise to performance obligations. Ignoring these performance obligations would have the impact of inflating current revenues and reducing future profits. In some cases, the measurement task would be easiest if all sales in the period are reduced by the estimated cost (and maybe profit) of future travel, free meal, or other benefits under frequent customer award programs. The potentially more important issues surround the free items promised, like a “free” phone, when it is given to the customer who signs up for a one-year service contract. In that case, the incentive is related to the service contract and would reduce the revenue over the entire contract. I don't think it is a separate performance obligation at all even though it is provided to the customer at a different point in time. So the trick will be deciding what part of the “multiple deliverables” is a sales incentive and which part constitutes the items the company was trying to sell. The world is complicated and it is surely impossible for any standard setting board to cover all possibilities. So there probably needs to be some general guidance (principles) and the use of judgment by accountants and auditors.

If something is identified as a “sales incentive” in a particular contract (or group of similar contracts), then the cost of the incentives should reduce the revenue recognized for the (other) performance obligations. In other words, the cost of minor and peripheral goods and services delivered concurrently or soon after date of sale might not be performance obligations of the basic contract with the customer. Instead, they could be considered current operating costs designed to increase current period sales. However, promises for future delivery of goods or services would have to be treated as a separate performance obligation. More substantial immediate sales incentives, e.g., a free iPod with the purchase of a computer, could be considered a separate performance obligation at the discretion of the seller although that would not be necessary in accordance with the discussion in Para. 3.24 – identification of separate

performance obligations is only necessary when the customer receives the promised assets at different times.

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.**

Control does seem to work better than just thinking about the transfer of “risks and rewards” which may not coincide completely with transfer of control. I’m just wondering how the change could impact lease accounting – especially for lessors. The lessor still legally owns the leased asset and can generally recover physical control if the terms of the lease are not met (failure to make payments). We’ve long been thinking about leasing as a transfer of the risk and rewards of ownership from lessor to lessee. In Para. 4.6, the Boards argue that control does not necessarily mean physical possession since the goods may be held for later delivery for the convenience of the customer. Will we need some clearer guidelines to make the distinction as to when physical possession (like a leased asset) means control and when physical possession does not indicate control (goods held for delivery at customer request)? I’m not sure the difference will always be clear. In the case of leases, the lessor would not be harmed by the destruction of the asset if the lessee were required by contract to continue to make payments – in other words, the lessee is responsible for taking out “insurance” on the asset. So possession would equal control by lessee in this instance. What if the lessee has no obligation to insure the asset against loss and the lessor were responsible for insuring the leased asset? If the lease agreement specified the payments would end if the asset were destroyed, would that mean the lessor has control the asset even though it is not in his physical possession? It would be less problematic to just go with the physical possession criterion but I’m sure that would cause other problems as with uniquely customized products – revenue could not be recognized until delivery.

In many cases, the Boards’ proposed recognition point for revenue (control of asset by customer) gets complicated. As I read on in Chapter 4, it becomes clear that control is not unambiguous as in the painting contract example and the customization of products examples. Materiality might be a consideration in making the judgment call – as in the case of paint. In addition, it became clear that differentiating between goods and services isn’t necessarily an easy task either. Since there are a variety of circumstances, the best bet is for the Boards to list things to consider when making the judgment call. I like the rebuttable presumption in Para. 4.56: assets used in completing another performance obligation (often a service) are not considered transferred to the customer until the service has been provided or the other assets are delivered. In most cases, supplies (assets) are consumed in the delivery of a service -- beauticians use up shampoo and other chemicals in providing hair salon services. And I’m pretty sure I own my own hair so these other assets improve my existing asset (at least hair spray adheres to the hair for a short period of time). This is a trivial example but my point is that the Boards should avoid standards that would have us worry over every little “asset” that is part of service delivery to meet a

performance obligation. Another example (which is a little dated) would be a wedding photographer's film. If the contract says the newlyweds are to receive the negatives, does this give them control over the film and mean that the photographer could recognize revenue related to the cost of the film before the wedding happens? I doubt anyone, including the photographer, would want to worry over it!

On the other hand, the land upon which a building is constructed is generally a significant portion of the total cost and who owns the land that is being improved is certainly one criterion to help decide whether the materials and services provided are being delivered to the customer during construction rather than when construction is complete.

Another issue is clearly the contractual schedule for payment – major up-front payments are an indication that services are being provided (customization of goods being delivered). However, this isn't a stand-alone criterion since the service provider might just be short on cash. So the ability to sell the finished or partially finished goods to other customers would also be an important issue in determining whether the degree of customization is sufficient to justify treating the transaction as a service rather than the delivery of goods.

Another indication is whether the contract involves changes to any asset that is not controlled by the entity with the performance obligations. Clearly, a painting contract is primarily a service since the contractor cannot remove the paint if the customer fails to pay. In other words, the ability to repossess something is a good indication that it is a product that is being provided rather than a service.

I also concur that the rule of law is an important factor. Particularly with respect to real estate contracts, specific laws may permit recoverability through liens on property and the like. Such laws would be important in determining the rights and obligations under contracts and the point at which performance obligations have been satisfied.

In summary, I'm sure that the Boards can come up with a short list of indicators to help folks decide whether a contract is for goods or services. Judgment will be required but that's better than trying to make a rule for all sorts of different types of transactions! The reason for providing the help in making the distinction between goods and services is obvious (I think): we need to be able to identify the point at which the customer controls the asset being delivered and thus the period over which or at which the contractor should recognize the revenue.

- 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.**

The most worrisome area would be the contracts that provide for both the immediate delivery of specific assets (including intangible rights) and continuing services (or intangible assets) over future periods. I've seen cases where a customer pays a large, nonrefundable fee for the right to produce a play, open a business in a particular geographic location, etc. Since the rights

provided to the customer are for a period of time, I tend to think of these transactions as the sale of services even though the customer may have no obligation to utilize the right. Sellers want to recognize the revenue immediately since the fee is nonrefundable. The seller can argue that it has nothing else to deliver AND that the customer has control of the (intangible) asset -- therefore revenue should be recognized immediately upon signing the contract. I'm not sure this is a reasonable interpretation since, presumably, the same right cannot be sold to other parties during the contractual period. I think the Boards should give some thought to providing implementation guidance for intangibles. Could forgone opportunities (opportunity costs) be considered a performance obligation? I think the most useful information would come from spreading the revenue over the time period for which the right was transferred to the buyer. Otherwise, companies would be puffing up current revenues at the expense of future periods (presuming exclusive rights were transferred). But what if the rights are non-exclusive? I don't know that this happens too often but it could.

**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?**

I am strongly in favor of measuring performance obligations at the initial transaction price. The arguments in favor that the Boards put forth in the PV-RRCC document are persuasive. In particular, the risk of error from using any sort of current exit price approach is very real and would cause unnecessary measurement problems and could well be perceived by users as unreliable. The Boards were wise to reject the current exit price approach. If time-value of money needs to be taken into consideration, it would presumably apply to contracts that call for payments in future periods (more than 9 or 12 months out) and this would a reduction in the contract right to receive the agreed upon transaction price. The approach in para. 5.43 which allocates the transaction cost to the performance obligations that will be satisfied over different time periods should work well. It is important that we don't have to break apart package sales (multiple deliverables) unless the components are to be delivered at different points in time. This should help keep the cost of recording and measuring transactions low.

**(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?**

I have a strong preference for the cost test trigger rather than the current price test trigger (para. 5.84). The current way we account for onerous construction contracts seems to work just fine. Projecting a profit margin would lead to measurement errors and be subject to bias (whether optimistic or pessimistic views of future events). I'm not particularly familiar with IAS 37 but FASB's other impairment tests on various assets seem to be similar in intent—a one way concern about overstating asset values. I don't have a particular problem with recoveries in asset

values (as permitted under IFRS but not US GAAP) but the cost trigger seems most consistent with existing practices and certainly does not prohibit the recognition of future profits if the projected losses are erroneous. Thus a cost trigger seems consistent with IASB existing standards as well as US GAAP. If it's not broken, let's not try a costly improvements that will require more estimates and allow greater opportunities to decide the period in which losses are to be recognized. ***On this point, please see separate discussion of warranty example #7 following my answer to question 13.***

In addition, I strongly agree with the statement in paragraph 5.39 which implies that routine remeasurement of all performance obligations would be unnecessarily complex. When contractors and manufacturers provide bids, it is based on cost estimates – and that's all they are - estimates. So the profit components as well as the cost component are uncertain for almost every contract for customized goods and services. Probably most “contracts” are settled by immediate transfer of goods or services so the issue won't even arise. The issue of onerous contracts becomes most important when the performance obligation is recognized in one period but not settled until a later period. After all, retailers often use “loss leaders” to get folks into the store – things they deliberately sell below cost. That is arguably an onerous contract but there is no need for complicated accounting because the loss is recognized immediately in the normal process of recording the transaction.

**(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.**

Allocating the transaction price to the individual performance obligations (if delivery periods differ) should work well. Estimating stand-alone selling prices if they don't exist is not a particular barrier given we are doing ever more estimates in this era of fair value measurement. The guidance to use observable inputs whenever available should be sufficient. The example in paragraph 5.53 is a familiar one to accountants.

With respect to usefulness: In my experience, students have never really understood why 100% of estimated warranty costs are currently expensed at the point of sale even though the warranty obligation continues through one or more future periods. Under the proposed approach, expenses would be recognized as incurred and the performance obligation would decrease over the warranty period. I think the proposed change will provide more useful information and will be more understandable to financial statement users. No information is really lost because the obligation will still appear among liabilities. However, revenues will be lower and expenses will be lower at the point of sale with essentially the same impact on bottom line that we have now. I'm trying to think through the deferred tax implications in the U.S. I presume IRS will want us to pay taxes on the full transaction price (like getting rent prepayments) but they have never let us recognize warranty expense until incurred. So it probably won't get rid of a temporary difference (too bad!) but it probably won't be any worse than the current computations since the



expenses will be deductible in the same period as warranty revenue is recognized on the income statement even though that revenue has already been taxed in a prior period.

**(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.**

With the possible exception of insurance and financial instruments, I can't think of any examples that would warrant a different approach. I could think of examples where companies would be reluctant to abandon current approaches that differ – but that is inertia rather than logic – or a concern over the potential adverse impact on earnings. Assuming a going concern, the impact should be mostly felt in the year of initial adoption. If everyone is making the change at the same time, the disruption for stockholders, financial analysts, creditors and other users should be minimal. And all users (and students) will benefit from having a single logical approach to revenue recognition that can be broadly applied. I am reluctant to have the “remeasure everything each period” approach used widely because it is too subjective. Warranties and long-term construction contracts should work just fine with a cost trigger to indicate the need for remeasurement. Stand ready contracts and take or pay contracts that cover long periods of time might benefit from remeasurement but the cost trigger approach should be sufficient most of the time. If the Boards are serious about getting rid of exceptions to the general rule and too many special rules for various industries, the rationale for permitted alternatives should be sound and based on genuinely unique characteristics that would make the ordinary approach misleading.

**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?**

Selling costs are logically associated with securing the original transaction and the Boards' proposed expensing of such costs is logical although I'm sure that there are some weird arrangements where companies would prefer to spread the costs over subsequent periods. In fact, I believe that certain start-up costs have been spread over presumed contract periods that go beyond the original contract. The argument is “matching” but there is a good bit of uncertainty once periods beyond those contracted are included in the recovery period. I prefer the immediate recognition approach. It really shouldn't make too much difference over the long-term if new contracts are being negotiated (say for cell phones or opening other types of service or insurance contracts).

**(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.**

I can't think of any but I anticipate that there will be opposition to changing current practices because of the hit to earnings.

- 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?**

Standalone selling prices appear to be the most reasonable approach to the allocation of the transaction price to the various performance obligations. We won't even have to make this type of allocation for the vast majority of contracts because the goods and services are delivered at the same point in time.

- 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?**

Yes, I agree that estimates will probably be necessary in some cases. I don't see any particular problems that would arise from allocating the original transaction price among the estimated values of the performance obligations. However, I agree that standalone prices and other observable inputs should be preferred over estimates whenever they are available. I believe this will be a better approach than the current US guidance on multiple deliverables which favors certain "values" over others which leaves some deliverables priced at "what it takes to balance" (as I recall).

#### **Comment on Appendix B – example on warranty costs.**

It seems to me that the differences between the illustrated methods are not particularly significant. However, it took me a couple of hours to get a spreadsheet working that would generate the numbers in B20 because I found the explanations very obscure. I'm sure it made perfect sense to the person who developed it but I was thinking how I could teach it and I didn't really understand the example until I did journal entries and t-accounts. Then it became obvious that it was the change in the revised "deferred revenue" account that gave rise to the contract remeasurement gains and losses. In addition, my first thought with respect to an appropriate allocation method for the example was to recognize revenue consistent with the expected product returns, 5%, 5% and 10% returns for an allocation of revenue 25%, 25% and 50%. The actual figures are more complex because the purpose was to get a constant gross profit margin on both fixed and variable costs. The process seems unnecessarily complicated to me. I doubt it is any harder to estimate warranty repairs than it is to estimate costs on long-term construction contracts. In the case of warranties, there is presumably a series of replacement contracts that are very similar. So the effect after the 3<sup>rd</sup> year would be essentially identical under any allocation

method. So it would be a lot simpler to NOT REMEASURE unless the contract becomes onerous (using a cost trigger like we do for construction accounting). In the examples in Appendix B, the contract was always profitable although the “fancy” allocation methods gave losses in the second year to preserve a nice profit in the final year. Note that all the gains and losses cancel out, and (assuming accurate cost estimates) the total profit on the contract is identical over time. So, why make things more complicated than they need to be?

Here is my comparison. The simplistic method just allocates based on the probability of expected “returns for repair” without remeasurement. The result is very similar to the constant profit margin method without remeasurement, but would be much simpler to teach! I can imagine the groans from my students if I tried to get across the remeasurement methods because they don’t actually preserve the gross profit margin any more than the simpler method. Estimates are just part of accounting and they are hardly ever perfectly accurate. So that raises the issue of why use a very complex process that is also subject to inaccuracies? Of course, companies should be paying attention to the actual costs so that they can arrive at better future estimates and, hopefully, charge customers a sufficient fee to assure a reasonable profit will be earned on future contracts. The contract revenue does not and cannot change for already signed contracts and no amount of fancy accounting will change that fact. I say, “let it ride” unless there is a genuine impairment (on onerous contract) to recognize.

	Impact on net income			
	Year 1	Year 2	Year 3	Total
Simplistic method, no remeasurement	1,000	950	1,350	3,300
Constant profit margin method, no remeasurement	1,227	1,177	896	3,300
B20 example with remeasurement	954	(641)	2,987	3,300
B22 example with remeasurement	1,045	(197)	2,452	3,300

### **Not-for-profit implications of the PV-RRCC – Accounting for Contributions**

As I read the discussion paper, I soon realized that there are many parallels between accounting for revenue from customer contracts and accounting for revenue from donors. It seems to me that the definition of a contract (para. 2.11) might be extended to (at least) donor-restricted contributions to charitable organizations. Note that contracts do not need to be in writing and the performance obligations can be implicit as well as explicit. They can also be based on law or regulations. The discussion in Para. 3.5 is also useful since there are statutory requirements like UPMIFA that call for prudent management of endowment assets and the various laws that permit not-for-profit organizational forms also come with statutory requirements related to the entity’s ability to use resources for private inurement rather than mission-related purposes. On the other hand, one could think of “ordinary business practices” as per Para. 3.6 that might make it more reasonable to not recognize revenue from pledges because the organization rarely seeks to collect on promises made, particularly for small pledges from

multiple donors. But I like the idea that both explicit and implicit terms impact the fulfillment of the performance obligation.

Where the analogy between donations and contracts with customers falls apart is in the discussion in Chapter 3 where transfer of CONTROL to the customer is used as a way to determine whether the performance obligation has been satisfied. Obviously, this doesn't map to contributions since the donor is not necessarily the recipient of the services or at least not the only recipient in the case of public goods like public broadcasting. Accordingly, some additional or special guidance is warranted for contributions. The donor wants the goods and services delivered to other parties and therefore the transfer of control to the donor would not be an appropriate criterion. It might be possible to create an alternate concept for "transfer of control of asset to beneficiaries" of the entity. Since charitable goods and services are often intangibles that are provided through general operations that support the entity's charitable mission, there may be no clear point or single point of delivery to the charity's beneficiaries (which might be society as a whole, the environment, or other broad goals related to the provision of public goods. However, gifts with time restrictions could imply recognition over multiple periods and it would make sense to recognize the contribution in the period on which the donor intended the charity have use of the resources, even if this is just general operations in accordance with charitable mission.

In Para. 5.20, the Boards say that they are "uncomfortable with an approach that allows an entity to recognize revenue before the entity transfers to the customer any of the goods and services that are promised in the contract." That's how I feel about recognizing donor restricted gifts before the entity has made any strides toward the satisfaction of the performance obligation embodied in the donor's restrictions. For regular transaction (program services fees and the like), I also agree that it is not appropriate for a nonprofit to recognize revenue before the performance obligation has been fulfilled.

Here is my proposed re-wording of definitions that would cover charitable contributions. Instead of the Boards' definition of customer in para. 2.21:

**A donor is a party that has contracted with an entity to obtain an asset (goods or services to be provided to the entity's beneficiaries) that represent an output of the entity's current or future operations.**

Likewise, here is a slight modification of the definition of performance obligation in Para. 3.2 -- the guidance for contributions would be:

**An entity's performance obligation is a promise in a contract with a donor to transfer goods or services to the organization's charitable beneficiaries.**

As discussed in Para. 2.30, payment by the donor (customer) does not trigger revenue recognition if the recipient charity has remaining obligations to fulfill. For unrestricted gifts, the

obligation is immediately satisfied through the existence of a going-concern with a mission acceptable to the donor – the acceptability of the charity’s operation is implied by the fact that the contribution was given. This situation is analogous to typical sales at a retail store where contract rights and obligations are simultaneously satisfied.

### **Do Donor Restrictions Create Performance Obligations?**

While donor intent is not always followed by the recipient, donors have the expectation that the restrictions they place on a gift will be honored (an implicit contract). Although rare, donor restrictions have been enforced under law. While I’m not an attorney, I was easily able to find a number of court cases based on concerns as to the intent of the donor – with various outcomes. For example, *Robertson v. Princeton* (settled 2008), *University of South Dakota Foundation v. Larry Long and Lucy Buhler* (2007), *Howard v. Tulane University* (2006), *Jane Fonda and Harvard University* (2003), *L. B. Research and Education Foundation v. UCLA Foundation* (2005). In some cases, gifts were returned to donors and in others, the recipient agreed to other forms of redress. In the case of St. Olaf College, the recipient filed a petition in court for guidance as to what to do with endowment-like funds that had originally been given in support of a radio station that was subsequently sold. Donors have also sued over nonfinancial assets contributed with strings attached as when Fisk University wanted to sell a couple of paintings or when the Barnes Foundation of Merion, Pa. sought to relocate the multibillion art collection to Philadelphia. Currently, we define contributions as nonreciprocal transactions and argue that the revenue should be recognized immediately because the donor (rarely?) has any right to repayment and little control over the use of the gift. This seems to be based more on the “realized” criterion than the “earned” criterion of revenue recognition.

With the new focus on the fulfillment of performance obligations, receiving cash does not necessarily trigger revenue recognition (Para. 2.30). Revenue is recognized when a performance obligation has been fulfilled. Fulfillment is generally based on the transfer of goods or services to the customer. I’ll come back to that in a moment. In the case of donations, the gift is normally made before the goods and services are delivered which means that the recipient has an obligation (liability) under the implied contract since the donor has fulfilled his or her contractual obligation. In the case of a pledge to give in the future, neither party to the contract has delivered and the remaining rights equal the remaining obligations. In this context, a promise to give at a future date would give rise to an asset (receivable) on the recipient’s books only if the recipient charity has acted in good faith and delivered the goods and services prior to the receipt of the donation.

So, how do NFPOs deliver charitable goods and services? NFPOs more commonly provide services rather than goods. The PV-RRCC contrasts goods and services as follows (para. 4.38): “Typically a good is an asset that is delivered to a customer at a point in time, whereas a service is typically a continuous transfer of assets to a customer over a period of time.” The service provided with the use of unrestricted contributions is operations in accordance with the

NPFO's mission during the current period. Charities also provide "goods" -- soup kitchens and food banks provide tangible assets to beneficiaries on the behalf of the entity's customers/donors. More commonly, financial resources are provided to beneficiaries: scholarship to attend college; grant to conduct research; payment of utilities, etc. Services range from health and social services like counseling, job training, or day care to performances and exhibitions of art, history, music, etc. Implicit or explicit contracts with multiple deliverables are probably less common for not-for-profit entities since the goods and services are generally provided at the discretion of the charity to beneficiaries it deems worthy. The donor might conceivably place tight restrictions on the utilization of his or her gift but charities may choose to decline gifts with too many strings attached.

Logically, charitable performance obligations are satisfied by the on-going operations of the entity in the current period (unrestricted gifts) or by future operations (time-restricted gifts) or delivery of designated goods or services in accordance with donor intent (purpose-restricted gifts). Timing of a gift could imply time restrictions. However, it would probably be hard to decide if gifts received at year end were intended for use the following year. Personal experience is that I often make a year-end gift to a charity and the next month I receive a notice that I need to renew my support for the coming year (renew my membership). My intent for making a year-end gift was to support future operations but that is obviously not what the charity is thinking. Of course the mailings may just be a fundraising ploy. However, solicitation documents could be examined as a basis for determining donor intent. If the solicitation is for earthquake victims, quick use is to be assumed and the recipients should be earthquake victims. If the solicitation is "help us continue providing valuable services," future use is implied but probably not worth worrying over. The solicitation would need to be more specific than that to trigger recognition of a time restriction.

The performance obligation for endowment gifts is satisfied by appropriate investment of assets received and use of investment return for general operating purposes (if there is no donor imposed purpose restriction) or for designated program activities. In other words, there are multiple contract obligations. This could also be the case with purpose-restricted gifts. For example, the donor could specify that 60% be used for scholarships and 40% for faculty travel. In the case of the scholarship deliverable, it would be revenue in the period when students receive the support. For faculty travel, the amount could be small enough (in proportion to total annual expenditures for that purpose) that current period revenue recognition might be justified without detailed designation of particular travel funding for specific faculty members. The college's intent might cloud the issue of "delivery" if the funding is requested/needed for future period rather than the current period. On the other hand, the real purpose of that portion of the gift is support for the mission of education and that makes it relatively "unrestricted" since, presumably, any faculty travel would satisfy the donor's intent. Since money is fungible, the college could consider the restriction met by any current period faculty travel and thereby free up resources for other uses. This is not a new issue with respect to purpose restricted donations.

General restrictions, say for use by the College of Science, are currently considered to be satisfied by recording the revenue to the accounts designated for use by that program. More specific restrictions, e.g., to provide a 4-year scholarship for a female student from a certain county in the state, are only considered lifted as the resources are provided to an appropriately identified student as she attends the university. The gift in this example has both time and purpose restrictions. In some cases, restrictions are so specific that the institution might not be able to award the scholarship for several years until a student with the necessary characteristics enrolls.

This right of return rarely exists with respect to contributions. The closest analogy would be conditional gifts which are currently recognized as revenue only once the conditions have been met. In fact, for contributions, a right of return implies a conditional promise and none of the revenue should be recognized until the conditions are met.

Please see attached Appendix for examples related to unrestricted (A), temporarily restricted (B and C) and permanently restricted (D) contributions in diagrams similar to Para. 2.32.

I am available to discuss or clarify any of these points if the FASB board or staff members feel that would be helpful. I know that the FASB will be interested mostly with comments on contracts with customers. Nevertheless, I hope my efforts to think about the implications for not-for-profit accounting will be useful too. I appreciate the Boards' effort to bring logic and coherence to the issue of revenue recognition. Eliminating special industry rules, when possible, is certainly a desirable goal.

Sincerely,

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## APPENDIX – APPLICATION OF PROPOSED REVENUE RECOGNITION CONCEPTS TO CONTRIBUTIONS

### Contents

Example A – unrestricted contributions

Example B – contributions with time restrictions

Example C – contributions with purpose restrictions

Example D – contributions to endowment (permanent restrictions)

### Example A: Unrestricted Contribution

	Net Contract Position	Contract Asset	Contract Liability
A. Donor makes unrestricted gift in cash  Charity continues to operate and provides charitable goods or services	Nil  (All contract rights and obligations are simultaneously fulfilled)	Donor’s desire to be charitable is satisfied and donor’s wealth decreases  Charity’s cash increases, revenue is recognized	Charity’s contract liability increases but is immediately decreased to zero by ongoing operations  There may be a moral and ethical obligation to use resources wisely

In Example A (unrestricted gift with immediate payment), the transaction is equivalent to a traditional retail sale of merchandise. The charity’s right to receive cash is instantaneously satisfied by its ongoing provision of charitable activities. The net contract position before and after the transaction is nil.

This is consistent with current accounting for unrestricted gifts received. However, pledges to give could be interpreted as executor contracts with the contract obligation perfectly offset by the contractual asset (pledges receivable) as illustrated in Example B.



### Example B1: Contribution with Implicit or Explicit Time Restrictions

	Net Contract Position	Contract Asset	Contract Liability
Donor promises to make an unrestricted gift in a future period	<p>Nil</p> <p>Contractual rights and obligations are offsetting for both parties</p>	<p>Charity has the right to receive a gift</p> <p>Donor has the right to expect efficient delivery of charitable goods and services in the future period</p>	<p>Donor has obligation to make a contribution</p> <p>Charity has obligation to efficiently deliver charitable goods and services in the future period</p>
a. Charity acts upon promise made and delivers charitable goods and services in the future period.	<p>Charity recognizes revenue from contribution because the obligation has been reduced.</p> <p>Donor position is a net obligation under legal doctrine of promissory estoppels as well as moral obligation</p>	<p>Charity has the right to expect the promised contribution</p> <p>Donor's asset has been delivered to beneficiary so value is zero</p>	<p>Charity's obligation has been satisfied (reduced to zero)</p> <p>Donor's obligation has not changed</p>
b. Donor makes the promised unrestricted gift	<p>Nil</p> <p>Donor is entitled to recognize expense or tax deduction for charitable contribution</p>	<p>Charity's asset is reduced to zero</p>	<p>Donor's obligation is reduced to zero</p>

In Example B (designated gift for use in future period), there are two possibilities.

In B1, the charity acts on the promise thereby fulfilling its obligation (decrease in liability) and therefore recognizes revenue.

In B2, the donor provides the gift prior to the period in which services are to be delivered. This reduces the asset (right to receive the gift) to zero but the obligation to perform has not been delivered. Presumably the revenue would not be recognized until the designated future time period because the donor's right to have services provided to future beneficiaries has not been satisfied until that point in time.

### Example B2: Contribution with Implicit or Explicit Time Restrictions

	Net Contract Position	Contract Asset	Contract Liability
Donor promises to make an unrestricted gift in a future period  (Same as B1)	Nil	Charity has the right to receive a gift  Donor has the right to expect efficient delivery of charitable goods and services in the future period	Donor has obligation to make a contribution  Charity has obligation to efficiently deliver charitable goods and services in the future period
a. Donor makes the promised unrestricted gift during the current period for the delivery of goods/services in a following period	Increase in net liability position for charity but no revenue is recognized	Charity's asset is reduced to zero (i.e., credit receivable, debit cash)  Donor still has right to expect the provision of charitable goods or services in the future period	Charity's obligation does not change  Donor's obligation is reduced to zero
b. Charity delivers charitable goods and services in the future period.	Charity recognizes revenue from contribution because the obligation has been reduced.  Net contract position of both parties is now nil	Charity's asset remains zero since the gift was received in prior period.  Donor's asset has now been delivered to beneficiary so value is zero	Charity's obligation has been satisfied (reduced to zero)  Donor's obligation is still zero

In both versions of Example B, current recognition practice would be slightly different since gifts would generally not be recognized until either received or until the charity has performed the implicit or explicit obligations to provide goods or services to its beneficiaries.

### Example C: Contribution with Purpose Restriction

	Net Contract Position	Contract Asset	Contract Liability
Donor promises to make restricted gift in a future period. It is restricted for support of a needy student.  Charity accepts the purpose restriction and promises to act to achieve donor's intent	Nil  Contractual rights and obligations are offsetting for both parties	Charity has the right to receive a gift  Donor has the right to expect that a needy student will receive the scholarship	Donor has obligation to make a contribution  Charity has obligation to deliver the scholarship to a student that meets donor's specification
a. Charity acts upon promise made and provides the scholarship	Charity recognizes revenue from contribution because the obligation has been reduced.  Donor position is a net obligation under legal doctrine of promissory estoppels as well as moral obligation	Charity has the right to expect the promised contribution  Donor's asset has been delivered to beneficiary so value is zero	Charity's obligation has been satisfied (reduced to zero)  Donor's obligation has not changed
b. Donor makes the promised payment	Nil  Donor is entitled to recognize expense or tax deduction for charitable contribution	Charity's asset is reduced to zero  The donor's asset is still zero	Donor's obligation is reduced to zero  The charity's obligation is still zero

In Example C (gift with purpose restriction), there are two possibilities.

In C1, the charity acts on the promise thereby fulfilling its obligation (decrease in liability) and therefore recognizes revenue before the gift is received.

In C2, the donor provides the gift prior before the purpose is satisfied (scholarship has not been provided). This reduces the charity's asset (right to receive the gift) to zero but the obligation to perform has not been delivered. The revenue would not be recognized until the scholarship has been delivered to an appropriately identified recipient. *The sequence of events would be equivalent to B2 so I haven't illustrated the second sequence of events.*

In both version of Example C, revenue recognition would differ from what we currently have under FAS116 (immediate recognition upon receipt of promise to give). As with Example B, a promise to give, of and by itself, would not trigger revenue recognition since the charity has not acted to provide the explicit goods or services. However, action that meets the donor's explicit restrictions in reliance on the promise to give could trigger revenue recognition even though the gift has not yet been received.

**Example D: Contribution to Endowment (permanent restriction) – one possible interpretation**

	Net Contract Position	Contract Asset	Contract Liability
<p>Donor promises to make a large gift to be held by the charity in perpetuity with the return used to support scholarships for needy students.</p> <p>Charity accepts the restrictions and promises to act in accordance with donor’s intent</p>	<p>Nil</p> <p>Contractual rights and obligations are offsetting for both parties</p>	<p>Charity has the right to receive a gift</p> <p>Donor has the right to expect that his or her future gift will be prudently invested and the returns used for scholarships</p>	<p>Donor has obligation to make a contribution</p> <p>Charity has an obligation to invest and prudently manage the endowment gift (but it can’t do it yet because it has not received anything) and use future returns to support needy students</p>
<p>a. Donor makes the promised gift</p>	<p>Increase in net liability position for charity but no revenue is recognized</p> <p>Donor can take charitable deduction (subject to law)</p>	<p>Charity’s asset is reduced to zero (i.e., credit receivable, debit cash)</p> <p>Donor still has right to expect perpetual investment with returns being used for scholarships</p>	<p>Charity’s obligation does not change since it has not yet invested the assets received</p> <p>Donor’s obligation is reduced to zero</p>
<p>b. Charity invests the assets received in accordance with prudent management practices and SPMIFA</p>	<p>Charity recognizes revenue from contribution first performance obligation has been satisfied</p>	<p>Charity’s contractual asset remains at zero</p> <p>Donor still has right to expect that investment returns will be used for scholarships</p>	<p>The first performance obligation has been satisfied (investment of gift) so this obligation has been satisfied (reduced to zero)</p> <p>Donor’s obligation has not changed (zero)</p>
<p>c. At the end of future periods, the charity allocates the investment returns between the portion deemed prudent for spending and the portion to be retained to maintain long-term purchasing power.</p>	<p>Charity recognizes investment returns used to pay scholarships as operating revenue and the rest of the return as nonoperating restricted revenue.</p> <p>Donor is entitled to recognize expense or tax deduction for charitable contribution</p>	<p>Charity’s contractual asset remains at zero</p> <p>The endowment asset remains on its books and increases (at least in good economic times).</p> <p>Donor still has right to expect that investment returns will be used for scholarships</p>	<p>The second performance obligation has been (partially) met and operating revenue is recognized (assuming scholarships have been awarded to students that meet donor’s criteria)</p> <p>The third performance obligation is met by appropriate reinvestment of returns to preserve value of original gift</p>

In Example D (endowment gift), there are multiple deliverables or multiple performance obligations.

The first performance obligation is the investment of the gift in perpetuity which cannot be satisfied until the gift has been received. Currently, endowment gifts are recognized when pledged so this would be a change in practice but it is consistent with GASB standards. Under the proposed revenue recognition guidelines, the endowment gift would be recognized as revenue only when the assets are received by the charity and invested.

The second performance obligation is use of investment returns in accordance with donor's restrictions. This cannot take place until time has passed and the investments have increased in value through receipt of dividends, interest, or realized and unrealized gains.

There are also legal restrictions (UMIFA, UPMIFA) which require prudent management practices to preserve the value of the gift in the long-term. This third implicit restriction means that only part of the actual return would be used for scholarships so that the amount of scholarships delivered many years in the future would have roughly equivalent purchasing power.

Thus revenue would be recognized in future periods as returns are recorded (receipt of dividends or interest and change in fair value). This recognition is consistent with current practice for the second and third performance obligations.

An alternate possibility exists: the charity's performance obligation is NEVER fully met because mere investment does not accomplish any purpose intended by the donor. With this alternate interpretation, the endowment corpus and any retained return would be an increase in net assets analogous to contributed capital in a for-profit corporation. In this case, an endowment gift, when received and invested, would increase permanently restricted net assets. No revenue would be recognized until returns are allocated to operations or other special purposes in accordance with donor intent and prudent management laws. After thinking through the implications of the PV-RRCC, I'm leaning toward this alternate "nonrecognition" approach to endowment gifts. Performance obligations are only satisfied over time as support is provided through the investment of the donated assets. Mere receipt and investment of the original gift does not accomplish the donor's purpose. The donor could have, instead, retained management of his or her assets and made gifts from those returns. Note that neither treatment is symmetrical between donor and recipient. In the illustration, the charity has performance obligations for which the donor receives no future tax deduction. In the alternate, the donor would receive tax benefits immediately while the charity's revenue would be recognized over many future periods (essentially for ever).