June 19, 2009

Technical Director Financial Accounting Standards Board 401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

Subject: Discussion Paper - Preliminary Views on Revenue Recognition in Contracts with Customers

Dear Director,

I am writing to express my deep concerns about the direction of this project. I have spent my career studying revenue recognition both in public accounting and private industry and as a government official and private investor. I have a great appreciation for the complexities and inconsistencies posed by U.S. generally accepted accounting principles and the dangers of weak or vague guidance that does not tie the accounting to objectively observable facts. My first observation then is that this Discussion Paper is misnamed. It really should be titled "Preliminary Views on How to Encourage Fraudulent Revenue Recognition" or "What Happens when Two Standard Setters Go Native with the Registrant Community." I would highly recommend that the Board members and staff working on this project read and ponder the vast treasury of SEC enforcement releases that involve fraudulent or misleading revenue recognition and consider whether those circumstances would still be considered fraud, or fraud to the same extent, under the views set forth in this Discussion Paper.

More specifically, my responses to your most objectionable "Request for Comments" follow:

## Questions:

(1) Do you agree with the Board's proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? How would you address inconsistency in existing standards that arises from having different revenue recognition principles?

I believe the Board would be better served reducing the number of obvious inconsistencies in practice and encouraging the IASB to simply adopt SAB No. 104 and EITF 00-21. This could be accomplished more quickly than the revenue recognition utopia that the Board seeks through the Discussion Paper. For example, the Discussion Paper clearly indicates the Board's views that warranty accounting is problematic. Under U.S. GAAP, the simple fix is to simply rescind Technical Bulletin 90-1, remove warranties from the scope of SFAS No. 5 and make either EITF 00-21 or FIN 45 applicable to warranties. The world does not need an entirely new model fraught with horrific, unforeseeable unintended consequences to solve that problem.

(3) Do you agree with the Board's definition of a contract?

The requirement in SAB No. 104 and SOP 97-2 to have persuasive evidence of an arrangement has served the investing public well and should be retained. Creating wiggle room so that a CEO on the verge of being shot for missing a revenue forecast can foist a "the dog ate my contract" story on his finance team, auditors and unsuspecting investing public is not a better principle.

(4) Do you think the Board's proposed definition of a performance obligation would help entities identify consistently the deliverables in (or components of) a contract?

The Discussion Paper presumes that the determination of performance obligations and allocation of revenue based largely on management judgment will result in superior decision-useful information. As an investor in Microsoft, Cisco and Apple, I accept that the amount of revenue they have recognized is likely less than the "value" they have delivered to their customers due to the application of the stringent multiple element guidance in SOP No. 97-2. I take comfort, however, in the knowledge that the revenue they have recognized is based on objective criteria. This is a better world than one where management is permitted to judgmentally determine performance obligations and allocate revenue amongst those satisfied and to be satisfied, particularly after messianic CEO's get to provide input into such determination. Katy, bar the door!!!

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

This is a circumstance where the Board's proposal, while addressing some theoretical abuses and diversity in practice (e.g., warranty accounting), will likely have some unintended consequences as follows:

• The discussion of rights of return maligns the "failed sale model" and suggests that such a right is a performance obligation that should have revenue allocated to it. When exercised by the customer, the performance obligation would be satisfied and, voila, revenue would be recognized. Bizarre. There simply isn't an investor in the world that believes accepting a return is a revenue enhancing event. Why it is necessary to rescind SFAS No. 48, a standard that has worked well over many years, is unclear. It is especially disconcerting to think that the determination of the estimated selling price for this right will be largely in the hands of management. Certainly, management of a company desperate to make quarterly revenue estimates (of which there are many in today's world) would find such an accommodative principle comforting, like a warm glass of milk before bedtime on the last day of the quarter.

Further, the application of such a principle will actually eliminate certain decision-useful information for investors. In many industries, the application of SFAS No. 48 results in the application of the "sell-through method" where revenue for sales into retail or distribution channels are not recognized until a sale to an end customer occurs. The sell-through method aligns revenue recognition with actual end user demand for the company's goods or services – a highly desirable outcome of any revenue recognition standard from an investor's standpoint. How the approach set forth in the discussion paper with its substitution of subjective management judgment instead of actual objectively observable demand represents an improvement in accounting is a mystery.

The performance obligation approach will make the accounting in certain areas more complex than under existing standards. For example, SOP No. 97-2 identifies postcontract customer support, or PCS, as a typical deliverable in software arrangements. That standard requires that generally that revenue attributable to PCS be deferred based on vendor-specific evidence of fair value and recognized ratably over the period covered by the PCS arrangement. The Discussion Paper, however, if applied to the typical PCS arrangement would likely result in the bifurcation of what is a single element under SOP 97-2 into at least three performance obligations – an embedded warranty (bug fixes), telephone support, and enhancements or upgrades. Presumably management would be required to derive the estimated selling price for each of these and estimate the number of bug fixes and enhancements to be provided over potentially multiple years under the arrangement. Amounts deferred would then be recognized as the performance obligations were satisfied. All of this will require systems and processes that don't exist today. Moreover, these items typically are not sold separately and their satisfaction is largely within the control of management. Therefore, users of the financial statements will be left to the mercy of purportedly well-meaning management. And they say there is no Tooth Fairy.

EITF 00-21 has a more common sense approach by focusing on what has standalone value to the customer and collapsing elements when there is insufficient objective evidence of their value. Although this is a compromise of theoretical virtue, it's more valuable to investors because it can be verified.

(6) Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation?

To further elaborate on the views expressed in Question (5) the theoretical conclusion that a right of return represents a performance obligation in the Discussion Paper appears to be driven by the control of the asset triggering mechanism for revenue recognition. The Board has not made a persuasive argument that merely transferring control of the asset is sufficient basis to recognize revenue.

(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?

Although control of the asset or receipt of the service is certainly an indicator that revenue should be recognized, it should not be the sole determinant. For the reasons set forth under my response to Question (5), decision-useful information may be reduced in certain circumstances by applying such a standard. Further, permitting some revenue recognition because the standard requires, come hell or high water, that all performance obligations be allocated some revenue and recognized when they are satisfied is dangerous. As an investor, the notion that a company can recognize a subjectively determined amount of revenue by merely relinquishing control of an asset while retaining substantial risks and rewards of ownership is disquieting in the extreme. The Board should reconsider its commitment to the control of an asset concept in light of this and its experience with SFAS No. 140 and QSPE's.

(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?

This concept is acceptable so long as objective and reliable evidence of standalone selling prices exist. Investors can rely on that type of information. If such evidence does not exist, it is a strong indicator that the customer views the performance obligations as a bundle with value being delivered over time. To subjectively bifurcate and allocate revenue to performance obligations as management sees fit is a leap of faith in the innate goodness of man that as an investor I am not prepared to take. I would highly recommend focusing on how the customer sees the arrangement rather than management – these are not necessarily the same.

(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?

Yikes! Substituting significant management judgment for objective and reliable evidence of value in a pursuit of revenue recognition theoretical purity is fool's gold. I implore you to resist the temptation.

Sincerely,

Clarence Hodges

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