June 10th, 2009

TO: FASB & IASB

FROM: (Prof.) Michael F. van Breda Ph.D.

RE: Revenue recognition proposal

I regret that I have come to this project late and only really awoke to it when I read the Discussion Proposal. Given all that has already been said over the past six years, there is probably nothing that I can add to the conversation. It is, nonetheless, an interesting opportunity and so I have attached my attempts at answering the questions that were asked. I have taken the opportunity to add a few general comments at the outset.

By way of background, I am the current author of *Accounting Theory* that originated with Eldon Hendriksen. It remains, in my view a masterpiece, which is why I agreed to try to carry it forward.

In Chapter 11 of that text, Professor Hendriksen and I argue that revenue is still largely undefined. What passes for a definition in the official literature is really a description of when it is *recognized*. It is not a definition of *revenue* per se. I would urge, therefore, the boards to consider stepping back conceptually, and in time, and making use of Paton & Littleton's definition of revenue as the *product* of the organization. This definition, or one like it, should precede any discussion of when revenue should be recognized and how it should be measured.

If we accept revenue as the product of the organization, then we have something that precedes the customer. In your terms, it is entity specific whereas the current definition of revenue is not only one of recognition recognition and not of revenue, but also has an inherent customer perspective built into it.

As Moonitz and Sprouse recognized many years ago, the product is created over time. Accountants merely recognize it at some point in time that is conventionally convenient for accountants. George May made this point almost a century ago. The issue at stake may be when to recognize "it" but it surely behooves us to get a better handle on what "it" is before we decide when we want to recognize "it."

There are several virtues to this notion of revenue as product. One is that it defines what one means by normal or ongoing operations when one comes to distinguish revenue from gains. For most companies, interest income for example is not part of the "product" of the company and should not be part of revenue.

Another is that the notion of revenue is independent of the customer. Using malt whiskey as an example, one begins with dirty water and ends with a very valuable product. There is more, though, to maturation processes than simply letting barrels sit idle. Tests are taken, temperatures are adjusted, rebarreling occurs. In other words, there is a process here that is part of the product of the distiller. One may still not want to measure this product at its current exit price, but measurement is a question independent of the definition of revenue.

Putting it another way, it seems to me that we muddy the question of maturation of whiskeys and the growth of timber, with changes in prices. Changes in price have nothing to do with the "product" while the processes have everything to do with the product. Creating a 12-year old Macallen is very much a creation of a product and part of revenue. A change in price is a gain, not revenue. In short, I think having the definition first, clarifies some of the issues that I see getting confused in the boards' discussions over the years.

Once one has a definition of revenue then it is time to turn to when one would recognize it. I would argue that there are two classes of revenue at this point. In the one class there is no identifiable customer, although, the assurance of finding a finding an identifiable customer would be a necessary ingredient if it were to be recognized. This class covers agricultural products and the malt whiskey example. In the other class one has the identifiable customer that is the subject of the discussion proposal.

I would add that if the fellow handing over a dollar bill to purchase a candy bar is considered to be in a contractual relationship with the far away company in a foreign land that owns the store, then it should not be hard to define the market for agricultural products where there is a guaranteed customer as an *incipient* contract with an *implicit* customer. This would exclude manufactured products on grounds that an implicit customer does not exist. The result of such a definition of customer – explicit and implicit – would mean that only one set of rules for revenue recognition would be needed. It would also mean that debatable claims such as "there is no revenue without a customer" could stand. But again, the key is that definition must precede recognition; and recognition must precede measurement.

I have no great problem in conceptualizing the revenue recognition in terms of contracts. I do believe though that if one is going to recognize revenue on the basis of changes in assets and liabilities that one should begin with the definition of those elements. If we are going to develop principles-based accounting, as I hope we are, then we need to go back to the basic principles at each point. What is the general rule for de-recognizing an asset and a liability? How does this general rule apply to this particular liability called a *performance obligation*? I missed that tight integration with the balance sheet in the proposal, although a reading of the minutes shows that it clearly came up in the boards' discussion.

Derecognition of a balance sheet element can only take place when an event has occurred. Changes in the balance sheet represented here by changes in the performance obligation are inherently a function of the income statement represented by revenue. I fail to see how it is possible to define revenue recognition, as opposed to revenue, in entirely balance sheet terms. The proposal says as much in the first chapter but then attempts to go its own way without mentioning earning, realizability and the like. I understand what the boards are trying to do, but I think it is somewhat of a fool's errand. One can only understand the change in the liability and its timing when one examines the causes and the timing of that change. There are two sides to every transaction: changes in performance obligation are defined by and motivated by the earnings process.

Put another way, I am content to accept that revenue should be recognized when there has been a change in the net contractual position. Likewise, I am content to measure the flow of water over the dam by the change in the water in the dam. But, to really understand revenue or, equivalently, to decide when the change in the level of the dam occurred and why, it is necessary to ask whether there was a transfer of assets to the customer that reduced the performance obligation. That is no more and no less than asking whether revenue was *earned*. In other words, the asset-liability approach must inevitably go hand-in-glove with the revenue-expense approach.

Question 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?

There is clearly a need for a coherent set of principles for revenue recognition and given the Board's asset-liability approach toward other issues it is wholly appropriate that this be the cornerstone of these principles. That said, it seems to me mildly quixotic to attempt to ignore decades of work based on the revenue-expense approach. The first thing that we teach our students in accounting is that there are two sides to every transaction. It is surely true that accounts receivable rises in a credit sale; but it is equally true that revenue rises as a result of that same sale. The Boards acknowledge as much in 1.19, but then seem to ignore their own words in the rest of the proposal. Ignoring the two sides of a transaction is somewhat akin to attempting to build a one-sided coin.

Using a different, but familiar analogy, one might attempt to measure the flow of water out of a dam by measuring the difference in water height in the dam at regular intervals. But if the height of the water in the dam is affected by rainfall, heat, leakage and other factors then the change in the water height alone cannot be a satisfactory measure of the *normal or so-called ordinary* flow over the wall.

I would propose that the Boards continue their contractual approach but extend and deepen it by integrating into it the insights from prior decades of work. The current proposal reads as though one were coming to the issue of revenue recognition completely *ab novo*. In particular, as noted in my introductory remarks, I would like to see a new definition of revenue.

Question 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 am not sure that one needs to answer this question because the Boards have done an excellent job of identifying its shortcomings already. Things that stand out include the following:

- The current proposal says nothing about realizability so unless the intent is to scrap all cash-flow accounting this proposal provides no help. (2.4)
- The current proposal ignores the possible recognition of revenue in the absence of customers. (2.5 & 2.10)
- The current proposal does not cover sales-type leases.
- The current proposal accepts the distinction between revenues and gains and provides no guidance on the distinction.

Question 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.

The definition of contract is relatively unexceptional except that it might be construed as so broad as to exclude nothing. The Board's assertion that a cash sale is the "simplest example of a contract" is debatable and seems to push the notion of a contract to the extreme. (2.15) There is not even a handshake when one walks up to the counter to purchase a candy bar. Is there any transaction, then, that is not a contract? The Board introduces the notion of a customer as a party "that has contracted" but suggesting that the person holding out a dollar for the candy bar has entered into a contract seems to extend the word contract far beyond its legal origins. However, as noted in my introductory remarks if one is going to use a contract this broad then including agricultural products is only a small stretch.

Question 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.

Once one accepts the very broad definition of a contract and the unsettled notion of a customer as party, then the definition of a performance obligation follows fairly automatically. In addition to these premises that one has to accept, there is also the matter of the "transfer of assets." As noted at the outset, the revenue-expense approach is the obverse of the asset-liability approach. It is difficult, if not impossible, to define an obligation without resorting to concepts long worked over by revenue-expense theorists; the first question being when are assets transferred. The second question is whether they have to be transferred in the ordinary course of business to be a performance obligation. The third question is what does one mean by the ordinary course of business. Accounting for securities is a classic example of where what in one case might be regular incomefrom the ordinary course of business might in another case be a gain. I can see that a contract approach might enable one might identify the deliverables; I fail to see how it would help to identify when control of those deliverables passed.

Question 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?
Paragraph 3.11 paints the nightmare that might follow if the notion of separating contracts into different performance obligations is to follow. The discussion

proposal provides no conceptual basis for deciding when to split and when not to split. At one moment there appears to be a suggestion that promises that are exchangeable should be recognized as assets (3.30). This is *NOT* a criterion for an asset and pops up here quite uncomfortably. The next moment there is a suggestion that "simultaneity" would preclude splitting. (3.23 & 3.24). Again, this appears nowhere in the definition of an asset.

Are the Boards suggesting that the deferred revenue taken in by a symphony, say, should be split up into separate performance obligations according to the concerts that will be given in the year that follows? Are they also suggesting that a travel agency that sells an airticket, ground transportation and hotel accomodation should not split these contracts into separate performance obligations because they are simultaneous? Should one follow paragraph 3.31 and separate out Beethoven concerts from Wagner concerts on grounds that they have "potentially different likelihoods of being redeemed"?

Paragraph 3.37 introduces yet another curious question. Would I pay extra for a key to my newly purchased car? Of course, I would. I would pay handsomely for that key in fact. Does that mean that we should report the keys to our cars separately from our cars? Merely to ask the question, suggests how inappropriate this criterion is for determining when to split a contract into a series of individual parts.

As a general comment at this point, I find myself unconvinced that the proposed approach will simplify matters if one has to reach for reasons outside of the accounting canon to justify the treatment of performance obligations. In my book, we will simplify only if we can build the notion of performance obligations on the existing foundation of what is an obligation and what is a right and not add new and extraneous criterion into the mix.

Question 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?

Question 7
Do you think that sales incentives (eg 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 take these two questions together partly because I have no firm opinion on either but two questions for the Boards. The first is why does it matter? The Board talks about the need to come up with a solution to revenue recognition that is decision-useful. The way these two questions are phrased avoids that criterion entirely. Instead, the Boards appear to be asking a more semantic question. A better question might have been, "Would reporting an obligation to return goods and report sales incentives separately be useful to readers?" I think that is an empirical question, which should be asked and which could be studied.

Question 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.

The criterion as it stands is unexceptional except that it raises the question ofwhen one has control. As far as I know, this continues to be a hot and unresolved topic in accounting that haunts the whole issue of off-balance sheet assets. If two customers take control of the asset with each of them having 50% of the asset, has control been transferred to "a" customer? If someone has an interest in an asset and transfers their interest in that asset to a third party, has there been a sale?

These are the sorts of questions that have haunted revenue recognition for decades. The proposed notion of a performance obligation being satisfied when control is transferred is hardly new and, by itself, will resolve few of the issues affecting accounting. One need go no further than the proposal itself to bump up against the problems and to realize that transferring control does not solve them.

Just to take one example that is based on the proposal, consider a builder, planning to build a staircase, who delivers the balusters, but not the balustrade. Does the homeowner, how certainly is enjoying no rewards from having the balusters lying in the yard, have control of the balusters? Does a partial payment really mean that control has passed? Is there no room here for reconsideration of the notion of substantial performance? In short, the basic notion of transferring control is fine, but it will have to hedged about with considerably more details before it becomes a useful criterion in deciding whether or not to recognize revenue.

Question 9
The boards propose that an entity should recognise 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 obvious answers are in the proposal and include the accretion of value in agricultural products. The decision might well be made to exclude these sorts of gains from the category of revenue, but that is simply to push the problem under another category without doing anything to solve it.

Question 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?
(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?
(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.
(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.

If I understand the premises of this chapter correctly then the Boards are essentially asking how one measures what we have traditionally called *deferred revenue*. Current practice, of course, is to measure deferred revenue by the cash paid in the transaction, which, in an arm's length transaction, is supposed to measure the value to the customer and be a reasonable estimate of the exit price – to the customer. I find it difficult to understand why one would then want to re-measure the deferred revenue to a non-existent, imaginary customer and in the process exclude the selling costs. The suggestion, which I understand comes from a desire to have all liabilities measured at a consistent exit price, raises questions about the applicability of the general principle. In the absence of empirical evidence, my priors are that the "full" exit price to a known customer is the more decision-useful measure of the performance obligation.

Question 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 (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise 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?
(b) In what cases would recognising 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.

Cost-benefit considerations would seem to suggest that the status quo is reasonably satisfactory in a decision-useful context.

Question 12
Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone 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?

As a general, theoretical principle, this approach follows the tradition of allocating costs in basket purchases and its familiarity should lead to its acceptance. That said, the cost of implementing this in practice promises to be horrendous and the Boards would be well-advised to permit many approximations.

The situation that came to my mind was the sale of season tickets. These usually come at a discount, often include the right to purchase extra tickets for friends, to have special privileges such as parking. Some concerts or games are more popular than others and would command a higher stand-alone selling price. Depending on how the season progresses, the cost of a stand-alone ticket can rise if the team proves successful. By proposing to split the performance obligation into its many different parts and then to measure each of these at (estimated) stand-alone prices, the Boards will generate a nightmare scenario for companies. It is not clear that the result will be any more decision-useful than simply splitting the season ticket price up equally over the season.

Question 13
Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone 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?

As noted in the previous answer, this sounds great in theory, but it will surely prove to be impractical. Estimates should be constrained by cost-benefit considerations in a decision-useful regime.