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Technical Director – File Reference No.1660-100
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The accounting standards team of the American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to offer the industry-specific feedback we have obtained on the joint FASB/IASB (Boards) Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, (preliminary views document). This information was obtained outside of the official AICPA Accounting Standards Executive Committee (AcSEC) process, and was not approved or reviewed by the members of AcSEC. AcSEC has submitted a separate comment letter on the preliminary views document.

Appreciating that the preliminary views document has the potential to affect revenue recognition for perhaps all of the Boards' constituents, the staff of the AICPA have worked with various AICPA members to obtain feedback as to how the proposed principles in the preliminary views document could affect revenue recognition in certain industries. We conducted informal focus groups with some AICPA Expert Panels (Health Care, Insurance, and Not-for-Profit Entities), and formed two additional groups to address the construction and software industries.

We asked the groups to compare and contrast the accounting for common industry contracts under current GAAP and the proposed revenue recognition principles in the preliminary views document. We also asked the groups to provide comments on the following questions:

- Would application of the preliminary views document represent a significant change in accounting for the most common transactions in their industry?
- Would any of the proposed revenue recognition principles represent operational issues?
- Would application of the proposed revenue recognition principles require significant revisions to their accounting systems?
- Would the proposed revenue recognition principles provide management with useful and understandable information?
- Would the proposed revenue recognition principles result in a better economic representation of transactions?
- Would application of the proposed revenue recognition principles result in restructuring of common contracts to alter revenue recognition?

Attached are appendices with summarized information by industry:

Appendix A – Construction
Appendix B – Health Care
Appendix C – Insurance
Appendix D – Not for Profit

Appendix E – Software

Although we attempted to provide some structure to the comments received, the comments are unfiltered and do not necessarily reflect opinions of the AICPA staff. We would be happy to discuss any aspect of this letter with the Boards' members or staff.

Yours truly,

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Appendix A

Preliminary Views on Revenue Recognition in Contracts with Customers:

Construction Contracts

The following responses are a summary of information received from the construction industry group on how the Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers*, may affect accounting for construction contracts.

This information was not approved or reviewed by the AICPA's Accounting Standards Executive Committee.

1. *Will the proposal in the FASB/IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (preliminary views document), to base a single revenue principle on changes in an entity's contract asset or contract liability change Day 1 and continuing revenue measurement for common transactions in your industry? If so, how?*

Members of the construction industry group (industry group) believe that the revenue recognition principles in the preliminary views document would change Day 1 and continuing revenue measurement for construction contracts, but the extent of the change depends on the specifics of the contract and contractor.

Under current GAAP, the common methods of revenue recognition for construction contracts are percentage of completion and completed contract (both under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*). The proposed revenue recognition principle would eliminate the recognition of estimated revenues during the contract term (unless specific criteria are met for continuous transfer of assets) and instead recognize revenue when goods and services are transferred to the customer and expense costs are incurred (unless eligible for capitalization under other standards).

Common contracts under current GAAP and interpretation of the revenue recognition principles in the preliminary views document:

Transaction #1 – Contract to build a support beam for use on a bridge.

- Contract is to manufacture a support beam with a contract value of \$1,250 and cost of \$1,000 that will take 18 months to complete.
- During the manufacturing process, the customer does not have control over the beams as these are housed at the contractor site.
- The customer pays the full value of the contract upon completion, but is billed for half of the price at the end of the first 12 months.
- The manufacturer incurs costs of \$800 for materials and labor through 12/31/01, and \$200 during the next six months
- At 12/31/01 50 percent of the beam is completed

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- At 6/30/02 project is complete and customer has control over the beam

Current GAAP: Contract would be accounted for on a percentage of completion basis (Alternative A under SOP 81-1).

Interpretation of preliminary views document: The contractor’s performance obligation is the promise to deliver a support beam to the customer in 18 months. Because the customer does not receive any assets until the support beam is transferred at completion, revenue is recognized by the contractor only when the support beam is transferred to the customer.

Below is a comparison of the accounting for this transaction under current GAAP and our interpretation of the preliminary views document:

		Assets	Liabilities	Revenue	Expenses
31 Dec XI	Current GAAP	Accounts Receivable = 625 debit Construction in progress = 800 debit Materials = 800 credit Construction in progress = 500 credit	Billed in excess of earned = 625 credit Billed in excess of earned = 625 debit		
	Revenue Recognition PV model	Accounts Receivable = 625 debit Inventory = 800 debit Cash = 800 credit	P.O. = 625 credit	625 credit none	500 debit

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30 Jun X2	Current GAAP	Accounts Receivable = 625 debit Construction in progress = 200 debit Materials = 200 credit Cash = 1,250 debit Account Receivable = 1250 credit (zero balance) Construction in progress = 500 credit (zero balance)	Billing in excess of earned = 625 credit Billed in excess of earned = 625 debit (zero balance)	625 credit	500 debit
	Revenue Recognition PV model	Accounts Receivable = 625 credit (zero balance) Cash = 1,250 debit Inventory = 800 credit Cash = 200 credit	P.O. = 625 debit (zero balance)	1,250 credit	1,000 debit

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Comparison:

Revenue: Under the preliminary views document, no revenue is recognized until the support beam is transferred to the customer vs. current GAAP which recognizes revenue based on percentage of completion.

Expenses: Current GAAP applies a percentage of completion to total expected expenses while we are assuming the costs incurred are eligible to be capitalized as inventory, and under the preliminary views document will be expensed when the project is complete.

Balance Sheet: Under the preliminary views document a contract liability is established as the contract is in a net liability position, as the contract asset has decreased since the customer has been partially billed.

Transaction #2 – Contract to provide stone masonry on a 26 story building

- Initial contract is to do stone masonry on the exterior facade of a 26 story building that is under the customer's control. The contract value is \$1,500,000 and estimated costs to complete at inception are \$1,250,000. The contract is estimated to take 18 months to complete.
- Change orders added during year 1: Stone masonry on interior floors with a contract value of \$120,000 and initial estimated costs to complete of \$100,000
- Change orders added during year 2: Site Paving work with a contract value of \$110,000 and initial estimated costs to complete of \$100,000
- Due to delays in the project and cost increases, estimated costs at completion have risen to \$1,570,000 at the end of year 1.
- End of year 1:

Exterior Facade: actual labor \$210,000 (estimated remaining \$290,000) + actual materials \$465,000 (estimated remaining \$480,000) = total estimated cost to complete \$1,445,000 and 42 percent complete based on actual labor expended

Actual costs to date = \$675,000

Interior Floors: actual labor \$10,000 (estimated remaining \$10,000) + actual materials \$50,000 (estimated remaining \$55,000) = total estimated cost to complete \$125,000 and 50 percent complete based on actual labor expended

Actual costs to date = \$60,000

Site Paving: No work done on site paving during year 1.

Exterior façade + interior floors = 42.3 percent complete based on total actual labor expended

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Total billed and collected: \$1,000,000 (\$950,000 for exterior facade, and \$50,000 for interior floors)

- End of year 2:

No outstanding labor or material costs on the exterior façade or interior floors

Exterior Facade: total incurred actual labor \$448,000 + actual materials \$921,000

Total actual costs = \$1,369,000, of which \$694,000 incurred in year 2

Interior Floors: actual labor \$22,000 + actual materials \$99,000

Total actual costs = \$121,000, of which \$61,000 incurred in year 2

Site Paving: actual labor \$0 (estimated remaining \$35,000) + actual materials \$65,000 (estimated remaining \$25,000) = total estimated cost to complete \$125,000 and 0 percent complete since no labor expended

Additional billed and collected: \$700,000 (\$540,000 for exterior façade, \$68,000 for interior floors, and \$92,000 for site paving)

Assume all expenses are paid in cash.

Current GAAP: Contract would be accounted for on a percentage-of-completion basis (Alternative B under SOP 81-1, percentage of completion determined by labor costs expended to total estimated labor costs). Contract is accounted for in total and not segmented.

Year 1: Revenue earned = 756,154 = {735,000 (actual costs) + 21,154 (42.3% x expected profit margin (1,620,000 – 1,570,000))}

Year 2: Revenue earned = 905,876 = {1,555,000 (total actual cost incurred) + 107,030(93.1% x expected profit margin (1,730,000 – 1,615,000))} – 756,154(revenue earned in year 1)

Interpretation of preliminary views document: The contractor has 3 performance obligations that should be accounted for separately:

1. PO A = complete the exterior facade
2. PO B = complete the interior floors: Due to rise in costs, PO B becomes onerous at the end of year 1 and is remeasured
3. PO C = site paving: Due to rise in cost, PO C becomes onerous in year 2 and is remeasured

Year 1:

PO A Revenue earned = 630,000 = (42% complete x initial performance obligation)

PO B Revenue earned = 60,000 = (50% complete x initial performance obligation)

Year 2:

PO A Revenue earned = 870,000 = {(100% complete x initial performance obligation) – revenue earned in year 1}

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PO B Revenue earned = 60,000 = {(100% complete x initial performance obligation) – revenue earned in year 1 }

PO C Revenue earned = 0 = (no work started on site paving)
 (revenue to be earned in year 3 when job is complete)

Below is the accounting for this transaction under current GAAP:

	Assets	Liabilities	Revenue	Expenses
31 Dec X1	Cash 1,000,000 debit Cash 735,000 credit	Over billing 243,846 credit	756,154 credit	735,000 debit
31 Dec X2	Cash 700,000 debit Cash 820,000 credit	Overbilling 205,876 debit Balance = 37,970 credit	905,876 credit	820,000 debit

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Below is our interpretation of accounting for this transaction under the preliminary views document:

	Assets	Performance Obligation A	Performance Obligation B	Performance Obligation C	Revenue	Expenses
31 December X1	Cash 950,000 debit	320,000 credit			630,000 credit	
	Cash 675,000 credit					675,000 debit
	Cash 50,000 debit		10,000 debit		60,000 credit	
	Cash 60,000 credit		5,000 credit loss liability			5,000 debit (remeasurement) 60,000 debit

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31 December X2	Cash 540,000 debit	320,000 debit 10,000 debit Balance = 10,000 debit			870,000 credit	
	Cash 694,000 credit					694,000 debit
	Cash 68,000 debit		10,000 credit 2,000 debit Balance = 2,000 debit		60,000 credit	
			5,000 debit Loss liability Balance = 0			5,000 credit
	Cash 61,000 credit					61,000 debit
	Cash 92,000 debit			92,000 credit		
	Cash 65,000 credit			15,000 credit loss liability		15,000 debit (remeasurement) 65,000 debit

Comparison:

Revenue: Revenue is recognized under the preliminary views document based on the estimate of when goods and services have been transferred to the customer (recognizing a portion of the total contract value allocated to each performance obligation based on the amount transferred). Under current GAAP revenue is determined as a specified profit margin added to costs incurred.

Expenses: Expenses are the same under current GAAP and the preliminary views document since under both methods costs are expensed as incurred. Under current GAAP some companies do apply a percentage of completion to expected expenses to determine expenses incurred.

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Balance Sheet: Under the preliminary views document a contract liability or asset is established as the contract position changes, due to changes in the contract asset (from customer payment) and satisfaction of contract obligations.

2. *Do any components of the proposed revenue principle in the preliminary views document present operational issues for your specific industry, such as separation of performance obligations, or determining standalone selling prices of an individual good or service? If so, please explain.*

Yes, members of the industry group raised several areas that could present operational issues for the construction industry:

- Determining the approximate percentage of work that has been completed to date (in determining how much of the asset has transferred to the customer), could pose significant issues. Under current practice, contractors have multiple ways to estimate percent complete with the most commonly used being cost-to-cost. Contractors can estimate what their remaining costs are going to be and compare that with actual costs incurred to determine the percentage of revenue to recognize. Under the proposed revenue principle, contractors will need to determine how far along the project actually is which may involve additional judgment and could leave more room for finessing of financial reporting.
- Separation of and accounting for multiple performance obligations would require significant extra effort by the company (as opposed to only having one percentage of completion calculation), as it would be necessary to have separate complete accounting on each performance obligation within a contract.

Many of the common costs of a construction project (supervision, engineering and drafting, unloading and stocking operations, equipment rental and operator costs, miscellaneous materials, tools and supplies, safety expenses, etc.) would need to be allocated to each separate performance obligation in order to arrive at the expected costs for each performance obligation, and the industry group does not believe the additional time and cost involved in performing these calculations would provide any additional benefit to the company or financial statement users.

- The proposed principle for remeasurement of onerous performance obligations could provide misleading results. Some performance obligations within a single contract could be deemed “onerous”, causing remeasurement while other performance obligations compute to a savings with no remeasurement allowed. If accounted for under current GAAP, the contract would reflect an overall profit, whereas under the proposed revenue recognition principle the separation of a single contract into multiple performance obligations could result in mixed results within a single contract.
- The industry group is also concerned about determining standalone selling prices for use in allocating the values of performance obligations. Some members of the industry group are concerned that the use of standalone selling prices are irrelevant, as it does not take into

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consideration the long term relationships that companies may have with customers. The industry group believes the estimation of standalone pricing is not beneficial to the company or users of financial statements.

3. *Would implementing the proposed revenue principles require significant revisions to your accounting system? If so, please explain.*

Members of the industry group believe that depending on the type of contractor, implementing the proposed revenue recognition principles would require significant revisions to their accounting systems to account for and track separate performance obligations, and might hinder the company's ability to publish monthly financial statements in a timely manner. This was a concern for smaller companies that did not have advanced accounting systems.

4. *Would the revenue principle proposed in the preliminary views document provide information that is understandable by management and useful in making business decisions (as compared with current GAAP)? Please explain.*

Members of the industry group have differing opinions as to whether the proposed revenue principles would provide information that is understandable to management and useful in making business decisions:

- Some members of the industry group believe that the proposed revenue principles would not provide information that is more understandable and useful to management, as compared to current GAAP, in making business decisions, as management is interested in understanding if a contract is making or losing money throughout the contract.

Current accounting and the related software already provide methods for tracking detail cost vs. estimate data to determine where a job went right and where it went wrong. To break up the contract into multiple performance obligations and to report revenues on a micro-detail level would not provide any meaningful input that is not already known from comparing estimated costs to actual costs under current GAAP accounting as set forth in SOP 81-1.

- Other members believe that the proposed revenue principles would provide more understandable information for management use in some cases. In the case of the support beam manufacturer above, management would argue that the proposed standard does not provide them with useful information as they do not recognize revenue ratably over the project. However, in most percentage of completion cases, I can certainly see the argument that this will provide more useful information.

Also there would be a real benefit in simplifying the rules of recognition. Some believe that management has trouble understanding some of the more complex nuances within SOP 81-1 such as the rules related to owner purchases, job segmentation, claims, charge backs, leaving materials in inventory even though they are on the job site when installation is not imminent, etc.

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5. *Does the proposed revenue principle in the preliminary views document result in a better economic representation of transactions in your industry as compared with current GAAP? Is it an improvement over current GAAP? Please explain.*

Some members of the industry group believe that the proposed revenue principle is not an improvement over existing GAAP, as the current required disclosures provide useful information that is updated as the contract changes, and the resulting revenue recognized reflects those contract changes.

Other members of the industry group believe that application of the proposed revenue principle would cause the mechanics to change, but would not expect it to result in a material change in the financial results. A small amount of both costs and revenues would be recognized later (costs and revenues related to warranties and fabrication not done on the customer's property.) Therefore, either percentage of completion accounting, or the continuous transfer of assets method result in a reasonable accurate economic representation of the earnings resulting from the construction process.

6. *Would application of the proposed revenue principle in the preliminary views document result in restructuring of common contracts to alter the revenue recognition outcome? Please explain.*

Yes, some members of the industry group believe that the proposed revenue principle could result in several contracts being created that are currently included in one contract, so revenue could be recognized upon the completion of certain milestones.

7. *Do you have any other thoughts about the proposed revenue principle in the preliminary views document that might be helpful for the Boards' to consider in deliberating this project?*

Members of the industry group raised several issues for the Boards to consider:

- SOP 81-1 already provides well established adequate guidance for revenue recognition on long-term construction contracts. GAAP should continue to follow SOP 81-1 and not the new proposed revenue recognition method.
- Some members of the industry group like the idea of having a single revenue recognition standard in order to simplify financial information for users of financial statements and that is allows companies to use more professional judgment, but believe that additional industry specific information may still be needed for certain industries, including the construction industry
- The IRS currently requires percentage of completion for AMT purposes. Any change in revenue recognition would probably result in two methods of accounting for contracts during construction, similar to two methods of depreciation for fixed assets, resulting in an increase in administrative costs.

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- The construction industry is a very specialized industry and the accounting for “earned revenues” and “cost of earned revenues” is dissimilar to any other industry and should maintain its distinction so as not to confuse the users of a contractor’s financial statements. This proposed revenue principle would add significantly to the cost of a contract for contractors and could lead to confusion of its financial statement users.
- The statement in paragraph 5.56 of the preliminary views document that “In most contracts, those changes are not significant,” referring to not only changes in an entity’s performance but also as to price changes or quantities of goods and services that an entity expects to transfer to a customer is not an accurate statement as it relates to long-term contracts. Every contract bid is based upon estimates. Very few of these estimates match their actual costs incurred. Many of the individual cost items do indeed come close but there are so many variables that come into play in a construction contract that a contractor must perform a monthly cost to complete review process and adjust the cost to complete based on the most current information as opposed to the original estimates performed as much as a year to two years earlier. The methods of construction used to figure the original estimate may not be possible due to unforeseen site conditions, suppliers may have gone out of business or can no longer supply the promised goods at bid time, wages and benefits, insurance costs and modifiers may have changed since bid time. There are simply too many significant variables to list that affect a contract after its inception.
- The concept that after contract inception, the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous and recognizes a contract loss, is seriously flawed. The contract may not reflect a loss at all. Since every cost item within a contract is based upon estimates, one could argue that every separate cost item is a potential performance obligation. Therefore taking this example to an extreme, cost items reflecting overruns from budget would be deemed onerous and items known to be under budget would be projected at their original estimated cost, reflecting a false interim loss equal to the savings not recognized until completion. This would result in understating a contract’s profit during the construction process and any savings from the non-onerous performance obligations would not fall out until the completion of that particular obligation. Under most contracts, this fulfillment does not occur until the customer has accepted the overall contract and then paid the retention.
- The preliminary views document implies that companies should estimate costs using “probability-weighted expected amount of direct and indirect costs required to satisfy the performance obligation” (paragraph B14). Some members of the industry group believe that the concept of “probability-weighted” measurements in estimating costs is unrealistic. The vast majority of contractors do not have the expertise or the manpower or the data that would be required to make such calculations, nor could they afford the time or money to have outside consultants do the calculations for them. Some industry group members do not think using probabilities in estimating costs to complete would result in more reliable measurements than measurements currently being adhered to.

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Preliminary Views on Revenue Recognition in Contracts with Customers:

Health Care Contracts

The following responses are a summary of information received from members of the AICPA HealthCare Expert Panel on how the Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers*, may affect accounting for healthcare contracts.

This information was not approved or reviewed by the AICPA's Accounting Standards Executive Committee.

1. *Will the proposal in the FASB/IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (preliminary views document), to base a single revenue principle on changes in an entity's contract asset or contract liability change Day 1 and continuing revenue measurement for common transactions in your industry? If so, how?*

Some members of the AICPA Health Care Expert Panel (expert panel) believe that the revenue recognition principles in the preliminary views document would change Day 1 and continuing revenue measurement for health care contracts.

2. *Do any components of the proposed revenue principle in the preliminary views document present operational issues for your specific industry, such as separation of performance obligations, or determining standalone selling prices of an individual good or service? If so, please explain.*

Yes, members of the expert panel raised several areas that could present operational issues for the health care industry:

- In the health care industry, it is common to have multiple contracts that might apply to a single transaction. For example: Patient is admitted to a hospital for a surgery, agrees to pay the hospital for services rendered (price is not specific), and assigns her rights under any agreement with third-party payors. At the same time, the hospital might be contracted with the third party payor to for patients with insurance/benefits under the third-party payor's plan for specific contracted rates. If the third-party payor is not contracted, hospital's expectation of payment will be charged. A single patient could have multiple "third-party payor" coverage. The ultimate benefit of the third party payor arrangement varies based on relative benefit designs and varies patient to patient even under the same third-party payor agreement. Each patient situation is different, two patients may both have Blue Cross coverage, but there could be Medicare, motor vehicle accident, or other carrier secondary coverage (such as United). Typically, even after all third party payor payments there is still an amount due from the patient.

Application of the preliminary views document could result in operational challenges, such as determining the value at the onset of the agreement, when the volume, services, benefit design, and patients are unknown? Then how to modify the contract values based on subsequent changes? Even if a hospital is contracted with a third party payor, they may modify their practices to incentive patients to seek care at other hospitals. So, the fact that a contract exists does not necessary mean services will be provided.

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- In the health care industry, the determination of price for services rendered is very difficult. Who is paying for the services and at what rate? Trying to determine the future service mix at the onset of an agreement even though the actual services and patient circumstances are unknown would be a challenge and likely not lead to credible information.
- The definition of customer is also a challenge in the health care industry, when you have an individual receiving services that another pays for.
- Hospitals provide other services such as gift shops, cafeterias, parking, and so forth, which are typically cash sales, which do not seem to be affected based on this proposal.
- It is unclear how donations would be handled under the preliminary views document. Today, at the time of the pledge a receivable is recorded but the earnings aspect is driven more by the release of restriction (e.g. date the pledge is paid and meeting donor obligation). They don't see much change in this proposed view from current practice.
- Research/grants. Many hospitals receive grants to perform research. Currently, revenue is recognized as organization meets the requirements of the grant. The preliminary view document may not have much in terms of revenue recognition differences, although unclear if an asset/liability is recorded at the time of the grant.

3. *Would implementing the proposed revenue principles require significant revisions to your accounting system? If so, please explain.*

Yes, implementing the proposed revenue principles would require significant modifications to the billing systems in the health care industry. The billing systems currently utilized in the health care industry are focused on maximizing collections from any payor that might have an obligation for payment. This happens at the time of services as well months after the services have been provided. Incorporating an effort to value contracts (after you decide which ones) at the time the contract is executed is not consistent with the underlying billing systems.

4. *Would the revenue principle proposed in the preliminary views document provide information that is understandable by management and useful in making business decisions (as compared with current GAAP)? Please explain.*

Members of the expert panel believe that recognizing a contract obligation for services that have not yet been determined is not useful. In addition, recognizing a contract asset at the onset of an agreement is not reflective of cash expected to be collected. Currently, receivable balances represent services rendered but not yet paid. Recording an asset for services not rendered with a contract obligation would gross up the balance sheet with little useful information. There is no guarantee that those services will ever be required.

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It would be beneficial for the Boards' to confirm whether the preliminary views document is referring to off balance sheet assets and liabilities only or if the intent is to gross up the balance sheet.

5. *Does the proposed revenue principle in the preliminary views document result in a better economic representation of transactions in your industry as compared with current GAAP? Is it an improvement over current GAAP? Please explain.*

Members of the expert panel believe that a real improvement in the health care industry would be to clarify GAAP such that revenue is not recognized when collectability is not assured. Currently, significant revenue is recognized with a substantial bad debt provision for uncollectible amounts. The proposed guidance in the preliminary views document only obscures the economics further. Concerns about valuation of the contracts seem to add a layer of complexity that doesn't appear to mean much. Why add one more valuation exercise to determine something that is irrelevant.

6. *Would application of the proposed revenue principle in the preliminary views document result in restructuring of common contracts to alter the revenue recognition outcome? Please explain.*

No. Currently, the health care industry provides services and then determines how to get paid. There is minimal ability to modify agreements directly with patients.

7. *Do you have any other thoughts about the proposed revenue principle in the preliminary views document that might be helpful for the Boards' to consider in deliberating this project?*

Members of the expert panel raised several issues for the Boards to consider:

- The expert panel has submitted an issue for consideration to the FASB Emerging Issues Task Force regarding when revenue should be recognized by a health care organizations for services performed for which the ultimate collection of all or a certain portion of the amount billed or billable is either not expected at all, is doubtful, or cannot be determined at the time the services are rendered. This issue highlights the complexity surrounding revenue recognition for health care contracts that may require additional guidance by the Boards.
- We think the preliminary views document makes accounting for revenue more confusing than it already is. The health care industry's revenue cycle is one of the most complex, given that the individual receiving the service may be responsible for all or very little of the total bill. In addition, the actual contractual price is difficult to determine when, using multiple agreements, and benefit designs. Trying to determine all of this at the time contracts are entered into would seem to make the accounting process more complex with little benefit. I did not see a compelling reason for this modification in revenue recognition.
- This preliminary views document focuses on establishing values on the balance sheet for contracts rather than focusing on when services are earned. Focusing on the balance sheet rather than on the earning process seems to be missing the point. It doesn't matter that you

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entered into an agreement but rather the fulfillment of the provisions to earn revenue is more important. The contract can be terminated, modified, etc.

Appendix C

Preliminary Views on Revenue Recognition in Contracts with Customers: Insurance Contracts

The following responses are a summary of information received from members of the AICPA Insurance Expert Panel on how the Discussion Paper: *Preliminary Views On Revenue Recognition in Contracts with Customers*, may affect accounting for insurance contracts.

This information was not approved or reviewed by the AICPA's Accounting Standards Executive Committee.

1. *Will the proposal in the FASB/IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (preliminary views document), to base a single revenue principle on changes in an entity's contract asset or contract liability change Day 1 and continuing revenue measurement for common transactions in your industry? If so, how?*

Members of the AICPA Insurance Expert Panel believe that the revenue recognition principles in the preliminary views document would significantly change Day 1 and continuing revenue measurement for insurance contracts. Under current GAAP, for long duration contracts revenue is recognized when premiums are due with a related expense for future policyholder benefits (FASB Statement 60), or when deducted from account balances (FASB Statement 97). For short duration contracts, premiums are recognized over the coverage period and claims expensed as incurred. It is unclear for short duration contracts how significant the differences would be depending on clarification of the standard as discussed below.

We believe that the accounting for insurance contracts, including revenue recognition, should continue to be addressed by the joint Boards' project on insurance accounting. However, the Boards should ensure that the principles of revenue recognition for insurance contracts be broadly consistent with the principles in this proposed revenue recognition model to the extent the accounting reflects the economics of the transactions. If the Boards include insurance contracts in the scope of the revenue recognition standard, we believe the following issues, that have been identified to date, need to be addressed within the revenue recognition standard in order to provide for consistent application:

- **Performance Obligations:** The preliminary views document does not provide adequate and clear guidance on how to determine performance obligations in insurance contracts. There are several areas of conflicting views.
 - 1) It is unclear whether one or multiple performance obligations exist for short duration and long duration insurance contracts. For example, for short duration contracts, are there two separate performance obligations: a) one for the stand ready obligation during period of coverage and b) another for the claims handling obligation that includes the duty to defend, or is the stand ready obligation the only performance obligation? Others may believe that there are additional performance obligations beyond those noted above, including some that are delivered immediately. For example, some policyholders purchase insurance in order to comply with legal requirements requiring insurance to do business. Often a certificate of

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Insurance Contracts

insurance is required for employers to demonstrate workers compensation coverage, or for individuals to drive an automobile. An insurance company may enter into a contract with a reinsurer for the primary purpose of providing increased capacity to write additional business. These benefits of the contract might be considered delivered immediately.

Also, we are uncertain if there should be a performance obligation associated with the obligation to provide future discounts in upcoming years (i.e., promise to provide future coverage at a specified premium rate without re-underwriting the policy). If the policyholder is provided an option to pay a discounted premium, should the insurers' promise to provide the discount be a performance obligation? If yes, it is unclear how this obligation would be released under the proposed revenue recognition model. For example, it could be recognized at the end of each year and a new obligation would be set up when the policyholder renews the contract in the subsequent year or it could be recognized ratably over each year of the option period, which should be the same as the total coverage period. With regard to the latter, the majority of the revenue relating to the contract would be recognized at the beginning of the last year of the option period when the final option is exercised. Recognizing the majority at the beginning of the last year of the option period would be a significant change in the pattern of revenue under the current US GAAP model.

2) Is the incurral of a claim covered by an insurance contract recognized as a separate transaction outside the scope of the revenue recognition standard or is it part of the subsequent measurement of the performance obligation under the revenue recognition guidance? For example, for a short duration property/casualty contract, the Boards should clarify whether the performance obligation would include any liability for claims payable to the policyholder under the contract in addition to the stand-ready obligation and any claim handling performance obligation.

We believe that current users find the distinction between claims activity and premium recognition in short duration contracts useful for understanding the cash flows of the company.

3) How does one determine when the performance obligations are satisfied? Some believe the stand ready performance obligation might be released over the coverage period, inferring that the stand ready component of the performance obligation ends when the coverage period ends. However, others question whether this is the appropriate period, noting that additional claims will likely arise and reported claims will be settled after the coverage periods ends (e.g., adverse development covers and loss portfolios transfers of existing blocks of insurance business for which the incurral period of the underlying claims has passed) and still expose the insurer/reinsurer to insurance risk, and thus the insurer/reinsurer stands ready to pay claims that might emerge beyond amounts expected at the end of the coverage period. Similarly, it is unclear as to when any claims handling performance obligation component of a performance obligation should be released. Is the component released as claims are settled or not until the last claim is settled, and how is it determined when the last claim is settled?

Appendix C

Preliminary Views on Revenue Recognition in Contracts with Customers:

Insurance Contracts

- **Grouping:** The preliminary views document discusses accounting on a contract by contract basis which would be difficult in measuring whether there is an onerous contract. Current accounting allows for the determination of an onerous contract (referred to as premium deficiency in FASB Statement No. 60) by line of business instead of contract by contract. Due to the large number of small homogenous contracts and the lack of available updated information, applying the onerous contract method on a contract by contract basis would not be practicable.
- **Acquisition Costs:** We believe that the accounting for acquisition expenses, including its definition, should be handled separately outside of the revenue recognition project in the joint FASB IASB insurance project. The accounting should reflect the economics of the transaction that includes pricing that reimburses the insurance company for the costs incurred to obtain the contract (such as commissions).
- **Rights:** As noted in the preliminary views document, the Boards have not yet deliberated the recognition and measurement of rights, which could affect the interpretation of the accounting for insurance contracts under the revenue recognition model. It is unclear to us whether future annual premiums (e.g., premiums for years two through ten in a ten-year term policy), that are not contractually required, would be considered a “right” in the original insurance contract or whether the insurance contract would be considered a series of one-year contracts. The IASB considered this concept in its May 2009 meeting through discussion of Staff Paper 6A on “contract boundaries.” The accounting would be significantly different for the revenue and liability based on the outcome of the accounting for these rights.

Members of the Expert Panel would be happy to meet with the Boards’ members and staff to discuss examples illustrating the various ways the revenue recognition principles in the preliminary views document could be interpreted and applied to insurance contracts.

2. *Do any components of the proposed revenue principle in the preliminary views document present operational issues for your specific industry, such as separation of performance obligations, or determining standalone selling prices of an individual good or service? If so, please explain.*

We believe that separation of performance obligations will present significant operational issues within the insurance industry. As noted previously, it is unclear whether there is one or multiple performance obligations under an insurance contract. If multiple performance obligations are identified for an insurance contract, then determining standalone selling prices would rely heavily on estimates since these obligations are not normally sold separately. Current systems either recognize premiums when due (FASB Statement 60 long duration), when deducted from account balances (FASB Statement 97) or ratably over the coverage period (FASB Statement 60 short duration).

Appendix C

Preliminary Views on Revenue Recognition in Contracts with Customers:

Insurance Contracts

3. *Would implementing the proposed revenue principles require significant revisions to your accounting system? If so, please explain.*

Yes, see response to question 2.

4. *Would the revenue principle proposed in the preliminary views document provide information that is understandable by management and useful in making business decisions (as compared with current GAAP)? Please explain.*

We cannot determine whether the proposed revenue principles would provide understandable and decision-useful information as there are currently too many unanswered questions surrounding its application for insurance contracts.

5. *Does the proposed revenue principle in the preliminary views document result in a better economic representation of transactions in your industry as compared with current GAAP? Is it an improvement over current GAAP? Please explain.*

We cannot determine whether the proposed revenue principle in the preliminary views document would result in a better economic representation of insurance contract transactions as compared with U.S. GAAP since there are currently too many unanswered questions surrounding its application for insurance contracts.

6. *Would application of the proposed revenue principle in the preliminary views document result in restructuring of common contracts to alter the revenue recognition outcome? Please explain.*

There are currently too many questions surrounding application of the proposed revenue recognition principle to insurance contracts to sufficiently answer this question.

7. *Do you have any other thoughts about the proposed revenue principle in the preliminary views document that might be helpful for the Boards' to consider in deliberating this project?*

Due to the many open questions related to applying this proposed revenue recognition model to insurance contracts and the active project for insurance contracts that has already issued IFRS 4, Insurance Contracts, and the IASB Discussion Paper, *Preliminary Views on Insurance Contracts*, we believe that insurance contract accounting should continue to be handled separately by the joint FASB IASB insurance project but the Boards should ensure that the principles of revenue recognition for insurance contract be broadly consistent with the principles in this proposed model.

Appendix D

Preliminary Views on Revenue Recognition in Contracts with Customers:

NPO Contracts

The following responses are a summary of information received from the Not-For-Profit (NPO) Expert Panel on how the Discussion Paper: *Preliminary Views On Revenue Recognition in Contracts with Customers*, may affect accounting for NPO contracts.

This information was not approved or reviewed by the AICPA's Accounting Standards Executive Committee.

1. *Will the proposal in the FASB/IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (preliminary views document), to base a single revenue principle on changes in an entity's contract asset or contract liability change Day 1 and continuing revenue measurement for common transactions in your industry? If so, how?*

Members of the AICPA Not-For-Profit Organizations Expert Panel believe that the revenue recognition principles in the preliminary views document would change Day 1 and continuing revenue measurement for certain not-for-profit contracts, but the extent of the change depends on the specifics of the contract.

Common contracts under current GAAP and interpretation of the revenue recognition principles in the preliminary views document:

Transaction #1: R & D cost-reimbursement contract with multiple deliverables. (could also apply broadly to other contracts with cost-reimbursement and a deliverable at the end of the contract.)

- NPO X enters into a two-year R & D arrangement with Pharmaceutical X (PX).
- PX will pay NPO X \$2,100,000 under a cost-reimbursement contract to perform clinical trials on a potential drug and provide proprietary research for PX.
- As part of the arrangement, NPO X will need specialized PP&E, costing \$100,000. (Assume PP&E purchased Day 1.) PX will retain title to the PP&E during the contract's term, and it is probable that title will transfer to NPO X at the end of the contract term.
- Payments are made based on monthly cost reports, with qualified expenses reimbursed as they are incurred, including an indirect cost rate with a recovery of 16 percent.
- 60 percent of the contract costs are incurred in year 1 and 40 percent in year 2 (excluding PP&E).
- 70 percent of the trial effort/product will be completed in year 1 and 30 percent completed in year 2.
- NPO X is obligated to deliver two reports, one at the one year mark (interim progress report) and one at completion (at the 2-year mark).

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Preliminary Views on Revenue Recognition in Contracts with Customers:

NPO Contracts

- The clinical trials involve providing the potential drug (and a placebo) to patients enrolled in the study and tracking their progress.
- PX owns the rights to and has access to all information pertaining to the clinical trial as the trial is conducted.
- The trial may be discontinued at any time by PX or government bodies, with NPO X entitled to reimbursement of qualified expenses to date. (If the contract is terminated early, NPO X will not receive the full \$2,100,000.)
- The performance obligations and their pricing as standalone selling prices (excluding the \$100,000 of PP&E), as well as their allocated transaction prices, are as follows:

	Stand alone selling price	Allocated transaction price
Clinical trial (PO A)	2,250,000	1,800,000
Final report (PO B)	250,000	200,000
	<u>2,500,000</u>	<u>2,000,000</u>

- The clinical trial is the most significant component of the contract.
- In addition, NPO X must provide an interim progress report after one year. Because the interim progress report is used in satisfying another performance obligation (the final report), the interim progress report is not considered transferred to the customer until used to develop the final report.

Accordingly, per par 4.56 of the PV, the interim progress report is not considered a separate performance obligation for purposes of revenue recognition. The clinical trial, however, is considered a separate performance obligation, and assets are considered simultaneously transferred to the customer as NPO X performs the trial, as discussed in paragraphs 4.7, 4.8, and 4.62 of the preliminary views document. (Satisfaction of the performance obligation pertaining to the trial is based on efforts/results, as opposed to costs incurred.)

	Assets	Liabilities	Revenue	Expenses	Equity
Day 1 Current GAAP	100,000 PP&E [PP&E per par 9.04 of the NPO Guide]	0	100,000 [contribution revenue] [PP&E per par 9.04 of the NPO Guide]	0	100,000 [contribution revenue]

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

	Assets	Liabilities	Revenue	Expenses	Equity
Day 1: Preliminary Views Document	100,000 PP&E		100,000 [contribution revenue] [PP&E per par 9.04 of the NPO Guide]	0	100,000 [contribution revenue] [PPE per par 9.04 of the NPO Guide]
Year 1: Current GAAP	100,000 PP&E 1,200,000 cash recd [2,000,000*.6] (1,008,000) cash spent [2,000,000*.6*.84] Total assets = 292,000	0	1,200,000 [.6*2,000,000] Computed based on costs incurred. Cumulative revenue of 1,200,000 is lower than under the PV in this fact pattern, because, proportionately, the performance obligations met to date exceed the costs incurred to date.	1,008,000 [.6*2,000,000*.84] Expense as incurred	292,000 [100,000 opening + 1,200,000 - 1,008,000] Includes 100,000 contribution revenue PP&E per par 9.04 of the NPO Guide
Year 1: Preliminary Views Document	100,000 PP&E 1,200,000 Cash rec'd [.6*2,000,000] (1,008,000) Cash spent [6*2,000,000*.84] 60,000 contract asset – PO A Total assets = 352,000		1,260,000 – PO A [.7*1,800,000] Portion of trial conducted— computed on effort/product rather than cost. Cumulative revenue of 1,260,000 is higher than	1,008,000 [.6*2,000,000*.84] Expense as incurred]	352,000 [100,000 opening + 1,260,000 - 1,008,000] Includes 100,000 contribution revenue PP&E per par 9.04 of the NPO Guide

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

	Assets	Liabilities	Revenue	Expenses	Equity
			under current GAAP in this fact pattern, because, proportionately, the performance obligations met to date exceed the costs incurred to date.		
Year 2: Current GAAP	100,000 PP&E 2,000,000 cash recd (1,680,000) cash spent [2,000,000*.84 cash spent] Total assets = 420,000	0	800,000 [.4*2,000,000] Computed based on costs incurred.	672,000 [.4*2,000,000*.84]	420,000 [292,000 opening + 800,000- 672,000]
Year 2: Preliminary Views Document	100,000 PP&E 2,000,000 cash received (1,680,000) cash spent [2,000,000*.84] Total assets = 420,000	0	540,000 – PO A [.3*1,800,000] 200,000 – PO B Computed based on effort/product rather than costs incurred.	672,000 [.4*2,000,000*.84]	420,000 [352,000 opening + 740,000 – 672,000]

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

To help understand NPO A's reporting under the PV, the JE's are as follows:

Day 1

PP&E (not covered by the PV)	100,000	
Contribution revenue (not covered by the PV)		100,000
To report contributed PP&E		

End of year 1

Cash – PO A	1,200,000	
Contract asset – PO A	60,000	
Revenue – PO A		1,260,000
To report activity on PO A: Cash received (2,000,000*.6), revenue earned (1,800,000*.7), and net contract asset position as of the end of year 1. (Assume for purposes of JE's that cash is assigned to PO A until PO A fully paid and then to PO B.)		
There is no entry for PO B as the performance obligation is in net nil position as no amounts have been billed or money received, and none of the obligation has been satisfied.		
Expense	1,008,000	
Cash		1,008,000
To report expenses incurred (2,000,000*.6*.84)		

End of year 2

Cash – PO A	600,000	
Contract asset – PO A		60,000
Revenue – PO A		540,000
To report the balance of activity on PO A: cash received (1,800,000 total -1,200,000 received in year 1), revenue earned (1,800,000*.3), and affect on net contract asset position, to bring it to a zero balance as of the end of year 1.		
Cash – PO B	200,000	
Revenue – POB		200,000
To report the balance of activity on PO B: Cash received (2,000,000 total -1,800,000 already assigned to PO A) and revenue earned (200,000). Entire revenue pertaining to PO B is earned in year 2.		

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

Expense	672,000	
Cash		672,000
To report expenses incurred on PO A and B: $(2,000,000 * .4 * .84)$		

Comparison:

Revenue: In this example, there is a difference in revenue recognition, as current GAAP recognizes revenue based on costs incurred while the preliminary views document recognizes revenue as the performance obligations are satisfied. In circumstances in which contract costs are incurred prior to satisfying performance obligations, the proposal will defer revenue recognition. Conversely, in circumstances in which performance obligations are satisfied prior to incurring contract costs, the proposal will accelerate revenue recognition.

Expenses: There is no difference as contract costs are expensed as incurred under both models.

**Transaction #2: College tuition
 (could also apply broadly to membership dues that are exchange transactions.)**

- Assume a June 30 YE.
- November 1, year 1, student applies to college, including \$500 nonrefundable application fee.
- March 1, year 2, college notifies student of acceptance. (Assume it costs the college \$400 to complete the application transaction.)
- May 1 student commits to attend college and pay \$10,000 tuition for semester Sep 1 to Dec 31. (Assume college incurs \$8,000 of costs per student per semester.)
- July 1 student registers and college bills the student for tuition.
- August 1 student pays \$10,000 for term September 1 through December 31.
- Refunds for withdraws are paid as follows: withdraw by Sep 30 = 95 percent refund; withdraw by Oct 30 = 75 percent refund. Withdraw Nov 1 and after = no refund.

[Note: These are actually two separate transactions: The application transaction and then the tuition transaction.]

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

	Assets	Liabilities	Revenue	Expenses	Equity
Nov 1 – Day 1: Current GAAP	500 cash recd	500	0	0	0
Nov 1 – Day 1: Preliminary Views	500 cash recd	500	0	0	0
Mar 1: Current GAAP	500 cash recd (400) cash spent Total assets = 100	0	500	400	100
Mar 1: Preliminary Views	500 cash recd (400) cash spent Total assets = 100	0	500	400	100
May 1: Current GAAP	500 cash recd (400) cash spent Total assets = 100	0	0	0	100 Opening
May 1: Preliminary Views	100 500 cash recd (400) cash spent Total	0	0	0	100 Opening

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

	assets = 100				
July 1: Current GAAP	500 cash recd (400) cash spent Total assets = 100	0	0	0	100 Opening
July 1: Preliminary Views	500 cash recd (400) cash spent 10,000 receivable for billed tuition Total assets = 10,100	10,000 contract liability	0	0	100 Opening
Aug 1: Current GAAP	500 cash recd (400) cash spent 10,000 cash recd for billed tuition Total assets = 10,100	10,000	0	0	100 Opening
Aug 1: Preliminary Views	500 cash recd (400) cash spent 10,000	10,000 contract liability	0	0	100 Opening

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Preliminary Views on Revenue Recognition in Contracts with Customers:

NPO Contracts

	cash recd for billed tuition Total assets = 10,100				
Sept 1: Current GAAP	500 cash recd (400) cash spent 10,000 cash recd for billed tuition Total assets = 10,100	9,500 [10,000*(1-.05)]	500 (10,000*.05) Revenue recognition based on potential refund due. Typically cumulative revenue would be higher as compared with the performance obligation model.	0	600 (100 opening + 500)
Sept 1: Preliminary Views	500 cash recd (400) cash spent 10,000 cash recd for billed tuition Total assets = 10,100	10,000 contract liability	0 Revenue recognition based on obligation performed, which is zero in this case. Typically cumulative revenue would be lower as compared with a potential refund due model.	0	100 Opening
Sept 30: Current GAAP	500 cash recd (400) cash spent 10,000 cash recd	7,500 (10,000*1-.25)	2,000 [10,000 * (.25- .05)] Revenue recognition based on	2000 (8,000*.25)	600 (600 opening + 2,000- 2,000)

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Preliminary Views on Revenue Recognition in Contracts with Customers:

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	for billed tuition (2000) cash spent semester costs Total assets = 8,100		potential refund due. Cumulative revenue to date is 2,500. Typically cumulative revenue would be higher as compared with the performance obligation model.		
Sept 30: Preliminary Views	500 cash recd (400) cash spent 10,000 cash recd for billed tuition (2000) cash spent semester costs Total assets = 8,100	7,500 [(10,000 * (1-.25)) 1 month out of 4 is performed	2,500 (10,000*.25) Revenue recognition based on obligation performed for 1 month out of 4. Cumulative revenue to date is 2,500. Typically cumulative revenue would be lower as compared with a potential refund due model.	2000 (8,000*.25)	600 (100 opening + 2,500 - 2,000)
Oct 31: Current GAAP	500 cash recd (400) cash spent 10,000 cash recd for billed tuition (4000) cash spent semester costs Total	0	7,500 [10,000* (1-.25)] Revenue recognition based on potential refund due. Cumulative revenue to date is the full 10,000. Typically cumulative revenue would	2000 (8,000*.25)	6,100 (600 opening + 7,500 - 2,000)

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

	assets = 6,100		be higher as compared with the performance obligation model.		
Oct 31: Preliminary Views	500 cash recd (400) cash spent 10,000 cash recd for billed tuition (4000) cash spent semester costs Total assets = 6,100	5,000 [(10,000- *(1-.5)] 2 months out of 4 are performed	2,500 (10,000*25) Revenue recognition based on obligation performed for 1 month out of 4. Cumulative revenue to date is 5,000. Typically cumulative revenue would be lower as compared with a potential refund due model.	2000 (8,000*.25)	1,100 (600 opening + 2,500 - 2,000)
2 Months ended Dec 31 – Current GAAP	500 cash recd (400) cash spent 10,000 cash recd for billed tuition (8000) cash spent semester costs Total assets = 2,100	0	0 Revenue recognition based on potential refund due. Cumulative revenue to date is 10,000. Typically cumulative revenue would be higher during the life of the contract, as compared to a performance obligation model.	4,000 (8,000*.5) (Expenses for 2 months)	2,100 (6100 opening – 4000) Note: Under current GAAP and practice, college actually has more equity at Oct 30 than Dec 31, because costs get reported as period costs each month, and revenue is front loaded

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**Preliminary Views on Revenue Recognition in Contracts with Customers:
 NPO Contracts**

					to some extent.
2 Months ended Dec 31 – Preliminary Views	500 cash recd (400) cash spent 10,000 cash recd for billed tuition (8000) cash spent semester costs Total assets = 2,100	0 (Performance is complete)	5,000 (10,000*.5) Revenue recognition based on obligation performed for 2 months out of 4. Cumulative revenue to date is 10,000. Typically cumulative revenue would be lower during the life of the contract as compared to a potential refund due model.	4,000 (8,000*.5) (Expenses for 2 months)	2,100 (1,100 opening + 5000 - 4,000)

To help understand the College reporting under the PV, the JE's are as follows:

November 1

Cash	500	
Contract Liability		500
Application and fee received.		

March 1

Liability	500	
Revenue		500
Expense	400	
Cash		400
Application process complete - Report earning revenue from application process, and paying expenses of completing application process.		

July 1

Receivable	10,000	
Contract Liability		10,000
Student registers and is billed for tuition.		

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Preliminary Views on Revenue Recognition in Contracts with Customers:

NPO Contracts

August 1

Cash	10,000	
Receivable		10,000
Student prepays for the term.		

September 30

Expenses	2,000	
Cash		2,000
Contract liability	2,500	
Revenue		2,500
Sep. activity – Pay \$2,000 operating expenses and report ¼ of \$10,000 revenue as earned because College has taught one month out of four.		

October 31

Expenses	2,000	
Cash		2,000
Contract liability	2,500	
Revenue		2,500
Oct activity – Pay \$2,000 operating expenses and report ¼ of \$10,000 revenue as earned because College has taught one month out of four.		

November 30

Expenses	2,000	
Cash		2,000
Contract liability	2,500	
Revenue		2,500
Nov activity – Pay \$2,000 operating expenses and report ¼ of \$10,000 revenue as earned because College has taught one month out of four.		

December 31

Expenses	2,000	
Cash		2,000
Contract liability	2,500	
Revenue		2,500
Dec activity – Pay \$2,000 operating expenses and report ¼ of \$10,000 revenue as earned because College has taught one month out of four.		

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Preliminary Views on Revenue Recognition in Contracts with Customers:

NPO Contracts

Comparison:

Revenue & Expenses: In this example, revenue recognition under the preliminary views document will defer Day 1 and some ongoing revenue recognition. That deferral, however, will likely not affect financial statement amounts, because the revenue cycle will be completed between the beginning and the end of the financial reporting period.

Transaction #3: Special Event - NPO C holds an annual Gala.

- Tickets cost \$100, and are part exchange transaction (\$30) and part contribution (\$70).
- On November 15, donor promises to buy a ticket.
- On December 15 donor buys the ticket.
- The event is held on February 14.
- NPO C's cost for the Gala is \$25 per head.
- On November 15, the likelihood that the event will not take place is remote, and the contribution is therefore considered unconditional and recognized when promised.

	Assets	Liabilities	Revenue	Expenses	Equity
Nov 15 – Day 1: Current GAAP	70 contribution receivable	0	70 (contribution) Revenue is the same under both models.	0	70 (contribution)
Nov 15 – Day 1: Preliminary Views	100 receivable	30	70 (contribution) Revenue is the same under both models.	0	70
Dec 15 – Day 2: Current GAAP	100 cash recd	30	0 Revenue is the same under both models.	0	70 opening
Dec 15 – Day 2: Preliminary Views	100 cash recd	30	0 Revenue is the same under	0	70 opening

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			both models.		
Feb 14 – Day 2: Current GAAP	100 cash recd (25) cash spent Total assets = 75	0	30 Revenue is the same under both models.	25	75 (70 opening + 30 – 25)
Feb 14 – Day 2: Preliminary Views	100 cash recd (25) cash spent Total assets = 75	0	30 Revenue is the same under both models.	25	75 (70 opening + 30 – 25)

To help understand NPO C’s reporting under the PV, the JE’s are as follows:

November 15 (day 1)

Contribution receivable (Not covered by the PV)	70	
Contribution revenue (Not covered by the PV)		70
Receivable	30	
Contract liability		30
To report the portion of the ticket price that is a contribution, and the portion that is a performance obligation under an exchange transaction		

December 15

Cash (for contribution--not covered by the PV)	70	
Cash (contract asset)	30	
Contribution receivable (Not covered by the PV)		70
Receivable		30
To report cash received for ticket		

February 14

Expense	25	
Cash		25

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Contract liability	30	
Revenue		30
To report expense of the Gala and satisfaction of performance obligation		

Comparison:

Revenue & Expenses: Revenue recognition is the same under current GAAP and the preliminary views document, as both recognize revenue after performance of the gala and expense costs as incurred.

2. *Do any components of the proposed revenue principle in the preliminary views document present operational issues for your specific industry, such as separation of performance obligations, or determining standalone selling prices of an individual good or service? If so, please explain.*

Yes. Though the transactions analyzed in Examples 1 and 2 of this document are not unique to NPO's, they are likely more common in the NPO industry than in many other industries. Operational issues may exist pertaining to:

- Identifying and separating performance obligations
- Identifying standalone selling prices of an individual good or service.
- Identifying performance obligations satisfied using effort/product estimates, rather than based on costs incurred.

Such estimates would be subjective in certain circumstances. Also, the proposed revenue principle in the preliminary views document may create audit issues.

3. *Would implementing the proposed revenue principles require significant revisions to your accounting system? If so, please explain.*

Yes in certain circumstances. In particular, establishing systems to measure and track effort reporting would require significant revisions to accounting systems. (For example, in order to measure the portion of an R&D performance obligation that has been satisfied.)

4. *Would the revenue principle proposed in the preliminary views document provide information that is understandable by management and useful in making business decisions (as compared with current GAAP)? Please explain.*

No, in certain circumstances. This is particularly true in Example 1 and in other circumstances in which costs incurred to earn associated revenues would be expensed as incurred, while revenue recognition is deferred. Management tends to prefer assessing financial progress by comparing revenues with associated costs incurred. (For practical purposes, the differences in Example 2 would be irrelevant because colleges tend to report annually with a June year-end. The transaction cycle therefore completes itself by year end. In other circumstances, however, such as membership dues, the transaction cycle may be incomplete at year-end and revenue recognition may change.)

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Preliminary Views on Revenue Recognition in Contracts with Customers:

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5. *Does the proposed revenue principle in the preliminary views document result in a better economic representation of transactions in your industry as compared with current GAAP? Is it an improvement over current GAAP? Please explain.*

No, in certain circumstances. See our response to question #4 above.

6. *Would application of the proposed revenue principle in the preliminary views document result in restructuring of common contracts to alter the revenue recognition outcome? Please explain.*

Application of the proposed revenue principle in the preliminary views document could result in some restructuring of common contracts to alter the revenue recognition outcome.

7. *Do you have any other thoughts about the proposed revenue principle in the preliminary views document that might be helpful for the Boards' to consider in deliberating this project?*

Some NPOs, particularly smaller NPOs without adequate trained boards and staff, might be ill-equipped to comply with the conclusions in the PV. And even for NPOs with the ability to comply, we believe the costs of compliance would exceed the perceived benefits.

Appendix E

Preliminary Views on Revenue Recognition in Contracts with Customers:

Software Contracts

The following responses are a summary of information received from the software industry group on how the Discussion Paper: *Preliminary Views On Revenue Recognition in Contracts with Customers*, may affect accounting for software contracts.

This information was not approved or reviewed by the AICPA's Accounting Standards Executive Committee.

1. *Will the proposal in the FASB/IASB Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers (preliminary views document), to base a single revenue principle on changes in an entity's contract asset or contract liability change Day 1 and continuing revenue measurement for common transactions in your industry? If so, how?*

Members of the software industry group (industry group) believe that the revenue recognition principles in the preliminary views document would significantly change Day 1 and continuing revenue measurement for construction contracts.

Under current GAAP, the accounting for revenue recognition for software transactions is governed primarily under SOP 97-2, *Software Revenue Recognition*, and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. This guidance generally results in the deferring of the arrangement fee of undelivered elements of the contract until they meet conditions in SOP 97-2. The proposed revenue recognition principle would allow for recognition of revenue upon satisfaction of performance obligations which could result in more revenue being recognized earlier in the contract.

Common contracts under current GAAP and interpretation of the revenue recognition principles in the preliminary views document:

Transaction #1:

- Software bundle sold at the end of the 20X0 with a 10 percent discount plus free installation and 3 years of additional free software maintenance and support (in this example, in order to meet sales quotas, free services are added to the contract)
- Contract signed and the customer accepts the software and it is installed on 12/29/X0.

List Price of the Bundle	\$20,000,000,
Discount	\$2,000,000
Total sales price	\$18,000,000

Bundle Contents:

- Software Package - Never offered without 1 year support, 1 year maintenance, and installation and formal customer acceptance

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- Software Support for 1 Year – First year of support is always included, never sold separately. Annual renewal is offered at a list price of \$2,000,000. No one can remember this ever being discounted.
- Software Maintenance – First year always included in pricing, never sold separately. Renewal of full maintenance support is at a list price of \$2,000,000.

Special Payment Terms:

12/31/X0: 30% upfront at time of delivery and installation

3/31/X1: 40% at end of first quarter

12/31/X1: 30% at the end of the 2nd year

US GAAP VSOE

	Estimated stand-alone selling price		
Software support (1 years)	2,000,000		
Software maintenance (1 years)	2,000,000		
Therefore software & installation	16,000,000		
Normal Price	20,000,000		

Proposed Preliminary Views Document

	Estimated stand-alone selling price	Allocation %	Transaction price
PO A: Software & installation	16,000,000	50%	9,000,000
PO B: Software support (3 years)	8,000,000	25%	4,500,000
PO C: Software maintenance (3 years)	8,000,000	25%	4,500,000
	32,000,000	100%	18,000,000

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		Assets	Liabilities	Revenue	Expense
	Current GAAP	5,400,000 cash 12,600,000 receivable	16,000,000 Deferred Revenue	\$2,000,000 Revenue	Cost of Techs & Sales personnel already expensed
Dec 31, 20X0	Revenue Recognition PV model	5,400,000 cash 3,600,000 contract asset		\$9,000,000 Revenue	Routine and ordinary.
	Only one year is illustrated				

Comparison:

Revenue: In this example, there is much higher first year revenue recognized under the preliminary views document (\$9,000,000 vs \$2,000,000) as the preliminary views document is not based upon recognizing all discounts immediately but rather recognizing revenue upon satisfaction of a performance obligation (PO A: delivery and installation of the software).

This is the classic most common scenario under current US GAAP in which the main software package is never sold with PCS. It originally posed a vendor specific objective evidence (VSOE) problem until SOP 98-9 provided for the inference of VSOE on the main software package by deducting the documented and known VSOE values from the combined package price and allowing the residual value (hence the name, residual method), here \$16M, to be used as VSOE for the main software product, which was never sold by itself. (This has been true in the US since roughly 1999.)

A corollary to this prescribed methodology is that all discounts, and additional fair value of added value given free in the bundle, must be deducted first from the inferred VSOE. In this manner, SOP 97-2 as modified by SOP 98-9 is principle based and Conservatism is the over-riding rule and underlying principle. No future discounts are hidden or allowed to be skipped today and recorded later.

Transaction #2:

- Sale of a perpetual software license with PCS (maintenance and support) for a one year term that is renewable.
- Contract is entered into on December 1, 20X0, with delivery of software license on December 2, 20X0.

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- Currently discounts are given only on the license fee in order to maintain VSOE the PCS has to remain constant (dollar or percentage of license fee).
- Transaction price = \$112, paid upon delivery of the software license
- Assume there is sufficient VSOE to allocate the transaction price to the two elements of the contract:
 - Performance Obligation A = Perpetual software license = \$100
 - Performance Obligation B = PCS = \$12

		Assets	Liabilities	Revenue	Expenses
Dec 31, 20X0	Current GAAP	100 license 12 PCS	11 PCS	100 license 1 PCS	CD & Manual Labor as incurred
	Revenue Recognition PV model	100 license 12 PCS	11 PCS	100 license 1 PCS	Labor – as incurred
Dec 31, 20X1	Current GAAP	0 license	11 debit Balance = 0	0 license 11 PCS	Labor – as incurred
	Revenue Recognition PV model	0 license	11 debit Balance = 0	0 license 11 PCS	Labor – as incurred

Comparison:

Revenue: Because there is sufficient VSOE of fair value, under current GAAP the revenue from the software license can be recognized when the license is delivered, and the PCS is recognized over the term of the contract. This has the same impact as recognizing revenue on the license when it has been transferred to the customer under the preliminary views document,

Expenses: Expenses are the same as costs are expensed as incurred under both models.

Balance Sheet: Both methods have the same balance sheet impact of establishing a deferred revenue or contract liability for the unearned portion of the transaction price allocated to the PCS.

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Transaction #3:

- Sale of a perpetual software license with software license activation, and PCS (maintenance and support) for a 1 year term that is renewable.
- Contract is entered into on December 1, 20X0, with delivery of software license on December 2, 20X0.
- Assume no discount
- Transaction price = \$10,000, paid at upon delivery of the software license
- The company has not been able to show that services have fair value as there is no sufficient history of sales on a standalone basis.
- Estimate of standalone selling prices for three performance obligations:
 - Performance Obligation A = Hardware = \$5,000
 - Performance Obligation B = Software licensing activation (engineering design, etc.) = \$3,000
 - Performance Obligation C = PCS = \$2,000 (1 year)

		Assets	Liabilities	Revenue	Expenses
Dec 31, 20X0	Current GAAP	10,000 cash	9,166.67	833.33	Labor as incurred
	Revenue Recognition PV model	Cash: 5,000 hardware 3,000 license activation 2,000PCS	1,833.33 PCS	5,000 hardware 3,000 license activation 166.67 PCS	Labor – as incurred
Dec 31, 20X1	Current GAAP		9,166.67 debit Balance = 0	9,166.76	Labor – as incurred
	Revenue Recognition PV model		1,833.33 debit Balance = 0	1,833.33 PCS	Labor – as incurred

Comparison:

Revenue: Since there is no sufficient VSOE of fair value, under current GAAP the total contract revenue is recognized on a straight line basis over the one year time frame. Under the preliminary views document, revenue on the hardware and licensing activation is recognized when the assets and services are transferred to the customer. The remaining revenue on the PCS is recognized as

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the services are continuously transferred to the customer over the remaining year. This results in more revenue being recognized earlier in the contract under the preliminary views document.

Expenses: Expenses are the same as costs are expensed as incurred under both models.

Balance Sheet: Under current GAAP, the portion of the fee that is not recognized as revenue is recognized as deferred revenue. Under the preliminary views document, the only remaining contract liability is for the PCS, which is recognized as the services are continuously transferred to the customer over the year. This results in a higher liability under current GAAP at 12/31/X0, as less of the contract revenue has been recognized.

2. *Do any components of the proposed revenue principle in the preliminary views document present operational issues for your specific industry, such as separation of performance obligations, or determining standalone selling prices of an individual good or service? If so, please explain.*

Yes, members of the industry group raised several areas that could present operational issues for the software industry:

- The software industry already faces difficulty in determining selling price and standalone pricing issues since more and more of the software license deals now are bundled arrangements that may have various services, hardware, multiple warranties, and even elements from third party providers in order to create / deliver an end to end solution that the customer is looking for. This creates a lot of confusion with the sales force when accounting must come in and unbundle the arrangement and determine “fair value” for each element (incorporating discounts, marketing promotions, etc. into the mix as well) to then determine revenue recognition on each item/element.
- Being based on performance also brings into question how performance is defined and who determines when acceptance occurs (customer or seller). Or is reasonable performance determined by the seller here?
- Operationally, the most significant concern with the identification of performance obligations deals primarily with significance. Currently, the proposal does not take into consideration significance of a performance obligation and therefore, any and all obligations (some that we may have not even thought of today), may need to be separately identified and revenue allocated to each. Adding some sort of significance threshold (such as SAB104’s inconsequential or perfunctory) would potentially assist in this. Generally, in favor of the movement to be able to estimate standalone selling prices, so no operational concerns at this time.
- The stringent conservatism (principle based guideline) of SOP 97-2 is being disregarded for the easier, less conservative type of approach found in EITF 00.21. Proportions and even work at a break-even are contemplated instead of immediately reserving these problems and allowing future business to be performed at normal margins. In terms of determining selling

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prices, just estimate now instead of the stricter, more conservative rules we have operated under.

3. *Would implementing the proposed revenue principles require significant revisions to your accounting system? If so, please explain.*

Members of the industry group believe that implementing the proposed revenue recognition principles would require significant revisions to their accounting systems to account for and track separate performance obligations:

- It appears that it will become a more manual process that will require a transaction by transaction review to determine if and when all elements of any bundled arrangement have been fully performed. Some of this is faced today, but shipment would no longer be the determining factor but rather when the product/service has been performed. This also opens the door for issues around installation but then a push to use estimates for revenue recognition and customers basing acceptance on feasibility standards instead of true delivery and transfer of title. Example: If I buy Microsoft Excel and then let it sit on the shelf in my closet for a month before I install it does that then mean performance has not occurred until the license is activated instead of when it was purchased or when it was delivered to my house? The industry already faces this issue to some degree today with license only sales since to protect our copyright we require an online serial number to unlock the software does delivery not occur until the lock is open? Or is it when the customer has received the software and then chooses not to use it or install it?
- Since this proposal is not industry specific and we must follow multiple revenue guidance for our products (SOP 81-1, SAB 104 and SOP 97-2 to name a few), applying a consistent approach as this model is proposing would require us to modify our accounting systems. We are in favor of a single approach where possible, so we would support this change.
- We are currently using complex spreadsheets to manage our revenue recognition process. Next year we will begin to evaluate other softwares to manage our revenue recognition process. We will now keep the proposals in mind while evaluating and the implementing the new software. In fact we will now want to time the evaluation and implementation of the software with the finalization of the new proposal.
- Perhaps more importantly it will take a lot of retraining of the accounting personnel to apply the proposed revenue principle. The second tier audit firms are still struggling, so taking the clerks who maintain the Deferred Revenue Analysis and teaching and training them that the more stringent rules we have been using are being replaced will be problematic as anyone who has ever worked as somebody who “fixes” companies could tell you.

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4. *Would the revenue principle proposed in the preliminary views document provide information that is understandable by management and useful in making business decisions (as compared with current GAAP)? Please explain.*

Members of the industry group have differing opinions on whether the preliminary views document would provide information that is understandable by management and useful in making business decisions:

- The new game for revenue recognition appears to be more on a legal basis to structure contracts in a way that will change the economics of the transaction in only a minor way but will cause a major revenue recognition tracking issue to determine when performance has or will occur. We feel that it will become focused on how to word deals in order to get around the “promises and perform” being delivered to make it appear that acceptance/delivery has occurred in order to recognize revenue as early as possible putting more focus on aggressive accounting practices.
- The proposed document will not only provide information to management to make useful business decision but it will also help investors make valuable judgments about the company. Revenue under the proposed document seems to mirror economic reality i.e. it can be recognized based on fulfillment of performance obligation as opposed to more complex evaluation under the current GAAP. Being able to recognize revenue based on the fulfillment of performance obligation will certainly help management in making decisions.
- We think the move to permitting estimated standalone selling prices when VSOE is not determinable is a good thing as it will promote the presentation of the true economics of an arrangement. Today, we feel with lacking VSOE, a company is put in the penalty box for trying to sell products and services in the format that a customer wants. Rather than generating 50 separate POs and invoices to support standalone transactions, customers prefer one PO and one invoice for simplicity and for their cost benefit of only having to process one PO, even though all fifty products may have no relation with each other.
- One concern relates to the inability to defer costs when revenues are deferred (such as due to a lack of transfer of control). Currently, the proposal recommends recognizing costs as incurred. However, if revenues are deferred due to a lack of transfer of control, costs would still be recognized as incurred. If this occurs over multiple accounting periods, the economics of the transaction would be recognized in multiple accounting periods such that costs would be recognized in accounting period 1 and revenues in accounting period 2.
- It appears that the principle of conservatism is being blown away. Many will be confused by this weakening of the Revenue Recognition that they have been enforcing. We do understand that the rest of the world is really lagging in this area, but this compromise is very questionable.

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5. *Does the proposed revenue principle in the preliminary views document result in a better economic representation of transactions in your industry as compared with current GAAP? Is it an improvement over current GAAP? Please explain.*

Members of the industry group have differing opinions on whether the preliminary views document would result in a better economic representation of transactions as compared with current GAAP:

- It stays mostly the same. However, we feel that the perception of the change will invoke those who are not accountants to try to word smith the agreements in such a way that it makes it more and more of a judgment call than being able to determine something easily like physical possession or ownership. Control could be used to force early acceptance by the customer.
 - We are of the view that current GAAP does not represent economic realities of our business. While we fulfill performance obligation for most of our product/services in the early stages of the contract implementation, revenue is recognized over a straight line over the term of the service period (the last undelivered element) under current GAAP. This hurts Companies such as ours rather than helping us as it is not indicative of business realities. As such management at times does not rely too much on the current GAAP revenue to make business decisions. They often review proforma revenue numbers to get a feel for the topline growth. Revenue in the proposed document can be recognized based on the fulfillment of performance obligation of product and services. The proposed document will therefore more closely mirror economic realities of the business and will be more reliable to give management indication on the topline growth of the Company.
 - We feel the move to an estimated selling price when VSOE is not determinable is a good thing in that it will better reflect the economics of the transaction. So this would be an improvement. However, there are concerns over the meaning of transfer of control and the potential impacts this could have on the long-term contracts industry. As such, we feel this is actually a downgrade of current US GAAP. This is something that needs further review and clarity.
 - Much less conservatism will occur under these rules and the incentive, and easy capability, to compromise the “out years” for the benefit of the current year will return.
6. *Would application of the proposed revenue principle in the preliminary views document result in restructuring of common contracts to alter the revenue recognition outcome? Please explain.*

Members of the industry group believe that with any change in GAAP, all contracts would need to be reviewed to ensure the current accounting is appropriate. However some members of the industry group believe that it might be perceived by those who are not accountants, as a way to find a loop hole that would make it more advantageous when trying to reach certain revenue goals.

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7. *Do you have any other thoughts about the proposed revenue principle in the preliminary views document that might be helpful for the Boards' to consider in deliberating this project?*

Members of the industry group raised several issues for the Boards to consider:

- We think that the Boards are on the right track that we have to make revenue recognition more simple to understand and apply. However, we are not sure that going to a performance obligation is going to make things much easier. Also, with more and more business moving to the “one stop shop” for everything and forming partnerships many more transactions are bundled with multiple elements that make it difficult to determine standalone pricing. In fact, it appears at times the marketing and sales construct offering in such a bundled as to make it difficult if not almost impossible to determine a standalone selling price. Thus, would this then open the door to encourage the use of estimates and to be aggressive in quarters when not reaching certain targets and more conservative when exceeding targets?
- In the start of the “Principles” section of the preliminary views document, the authors keep talking about the assets and liabilities as if they are going to actually book them. Please confirm that we are talking about illustrative assets and liabilities only and that we are not going to insanely gross up the left and the right side of the balance sheet. This should be clarified.
- Hopefully the proposed document will incorporate all classes of revenue (and is not limited to only certain class) – software under SOP 97-2, multiple elements, hosting services to name a few.
- We believe that the Boards should expand on the determination of standalone selling price for elements that are not sold on a standalone basis. It could perhaps also include estimated selling price as indicated on the price list. Determination of the price as indicated on the price list is an outcome of competitive market forces and is not sustainable if made without regard to what the market can bear. This is economic reality of the business. This also includes estimates of costs, margins, current competitor pricing and what new entrants would charge if margins are too high. Therefore explicit inclusion of price list in determination of standalone value would be helpful and would also be indicative of economic reality of the business.
- Pertaining to performance obligations, as noted in Question 2, we are a bit concerned over its true meaning. In addition to the significance aspect, we are also concerned about what is a performance obligation that would fall under the scope of this proposal. Currently, nothing is scoped out, even though there is significant guidance pertaining to obligations that may fall into a customer contract, for instance warranty. We apply FASB Statement No. 5, *Contingent Liabilities*, in assessing, determining, accounting and disclosing warranties for our products. However, this proposal currently would require a standard warranty to be a performance obligation and therefore allocate revenue to it, and thus would not look to currently existing guidance (SFAS 5) to account for such warranty. This is just one example, but is a general

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concern I have in that we should follow pre-existing guidance for deliverables falling within the scope of that guidance.

- Limit the footnote disclosure to those that are absolutely essential to the decision making process by investors.