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Technical Director File Reference 1820-100  
Financial Accounting Standards Board  
401 Merritt 7 P O Box 5116  
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Dear Sir or Madam,

In this letter I will address question one of the proposed accounting standards update on Revenue Recognition (Topic 605), Revenue from Contracts with Customers. I am currently an undergraduate student at the University of Illinois Urbana as an accountancy major. I have had the opportunity to study topics concerning revenue recognition and I am happy to provide comments regarding the exposure draft. The question I am dealing with asks whether I agree with the principle of combining contracts and the principle of modifying contracts. I will analyze this question as well as make recommendations.

I will begin my comments by explaining why combining two or more contracts into a single contract make sense, and why it might not make sense. This area will include examples relevant to the rest of my comments. I will then move on to a discussion of how the proposed change (regarding question 1) is both consistent and inconsistent with current FASB framework and concepts. I will also describe how accounting for multiple deliverables relates to this proposed change. I then will discuss this how this proposed change relates to earnings quality, management decisions, and auditing.

The proposed framework says that an entity will “combine two or more contracts and account for them as a single contract”<sup>1</sup> when the contract meets three different criteria. First, the contracts must be entered into at or near the same time. Second, the contracts must be negotiated as a package with a single commercial objective. Third, the contracts must be performed either concurrently or consecutively. In other words, an entity shall account for multiple contracts as one single contract if the price of both contracts is interdependent with each other.

This proposed idea makes sense for two reasons. The first reason is that it makes accounting for these two contracts much simpler. Taking away one contract would require a change in another contract and make it difficult to make changes to the other, whereas with a single contract making changes is a lot simpler. In addition, making a change to one contract could result in changes to the other. One again combining the two contracts makes contract modification much simpler. Combining two contracts would also take away ambiguity between the two contracts. For example, if the price of one contract depends on the other (i.e. buy 10,000 units of A for \$5 then have the option of buying unit B for \$7). If the two entities modify the first contract (buy unit A) then the second contract might also have to be modified (buy unit B at \$7). Therefore, not combining the two makes it unclear as to what will happen if the contracts are interdependent. The proposed framework takes away the ambiguity.

The second reason that the proposed idea makes sense is that it increases accuracy. Because the proposed idea decreases ambiguity, it also increases accuracy. Like the example above, if an

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<sup>1</sup> FASB Exposure Draft p. 13

entity and a purchaser combine two contracts, a modification to the one contract would not change a similar contract.

Important to consider throughout my comments is why this proposed framework might not make sense. Although two contracts might be interdependent, an entity may want to account separately for revenue reasons. In other words, if an entity wants to separate costs, combining contracts could make it hard for an entity to make this distinction. Although paragraph sixteen of the proposed framework addresses this issue, I do not think it is specific enough. I will address this topic in more depth later.

Now that I have discussed in simple terms the sense behind the proposed framework, I will talk about how the proposed change is both consistent and inconsistent with current FASB framework and concepts. The FASB's definition of revenue is any inflow or other enhancements of an asset of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's major or central operations<sup>2</sup>. In the case of the proposed rule change if an entity combines a contract with another contract under the proposed guidelines, the ending contract will be consistent with the FASB's current definition of revenue. All contract modifications will fall under the same consistency with the FASB's definition of revenue.

Recognition is the process of formally recording or incorporating an item into the financial statements of an entity. Two contracts, when combined, must include words and numbers and the total amount included in that combined contract (FASB 6). In order to recognize a combined

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<sup>2</sup> FASB Concepts Statement No. 3

contract, it must meet the definition of revenue, have a relevant attribute measured with sufficient reliability, make a difference in user decisions, and the information must be represented faithfully and accurately. Two combined contracts meet the definition of revenue as stated in an earlier contract. The relevant attribute that can be measured with sufficient reliability would be the amount of the combined contract. However, when an entity combines two contracts, the two different but interdependent activities in the contract may have to be measured separately. This may cause a problem with the measurability of a combined contract. A combined contract would have the ability to make a difference in user decisions and therefore is relevant. I will discuss the reliability of combined contracts in a separate paragraph.

Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved<sup>3</sup>. When combining contracts, measuring the exchange of the values of the assets and liabilities involved would be more difficult to do when two interdependent contracts become one. Different assets and services make up the two different parts of the contract; therefore, these different activities would be difficult to measure as one contract.

The proposed framework (para 17-19<sup>4</sup>) indicates that a modification in a contract will apply the proposed revenue requirements if the contract has commercial substance, two parties are committed to the contract, an entity can identify each party's rights regarding the transfer of goods and services, and an entity can identify the terms and manner of payment for those goods or services. The makers of the contract must keep in mind however revenue recognition criteria.

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<sup>3</sup> FASB Concepts Statement No. 3

<sup>4</sup> Exposure Draft

While meeting all of the above requirements is necessary so are other criteria. For example, in the case of a contract, or contract modification, the sale or signing of the contract typically takes place before either party exchange assets. Revenues for those transactions cannot be recognized until an entity earns those revenues. In the case of combining a contract or modifying a contract two separate but interdependent contracts have different activities. Those two different activities could finish at different times. If company A produces product one and two for company B and both are included in the contract because of price discounts this creates a problem. Company A finishes product one before product two and then delivers product one to Company B. Company A has incurred revenue from the contract but not from the whole contract. Some of that revenue needs to be recognized. Paragraph 16<sup>5</sup> alludes to this matter but does not provide specifics concerning revenue recognition.

Now that I have related the proposed framework to current standards for revenue I will discuss accounting for multiple deliverables. The FASB *Statement of Position (SOP) 97-2* “states that if a software sales arrangement includes multiple, distinct elements, the revenue from the arrangement should be allocated to the various elements based on vendor-specific objective evidence of the elements’ relative fair value”<sup>6</sup>. In other words, in the case of software contracts, entities may account for each element of the contract separately. The proposed framework does not provide enough information for accounting with deliverables. When contracts are combined under the proposed framework, the separate elements should be accounted for separately when they bring in revenue. The SOP 97-2 provides useful guidelines for multiple deliverables with software sales and should be expanded into the proposed framework to include other exchanges

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<sup>5</sup> Exposure Draft

<sup>6</sup> *Financial Reporting and Analysis*, Fourth Edition, Revsine, Collins, Johnson, & Mittelstaedt

of assets as well. It would be advantageous to split up transactions because an entity will be able to see which areas of a contract drive costs and which areas bring in how much revenue.

The proposed framework would also have an effect on management decisions and earning quality. When entities account for multiple deliverables, they use a fair value to allocate revenue to the particular transactions. Combining contracts would not really allow this. There are advantages and disadvantages to this. “Under multiple deliverables, there is potential for premature revenue recognition and/or arbitrary income shifting from period to period”.<sup>7</sup> So combining contracts would not allow arbitrary income shifting. However, a disadvantage could be that contract may look profitable but in fact, one activity in the contract could be costing an entity a lot more than the other activity. This case applies vice versa as well. A statement user could see that the revenue that a company brought in from a contract is not what he or she expected but it was actually just a certain activity of that contract. Thus, the quality of the earning becomes jeopardized. Accounting for multiple deliverables allows financial statement users to better analyze the costs and sources of revenue for contracts. Combining contracts under the proposed framework may take away the ability to account for multiple deliverables.

The proposed framework would also have an effect on external auditors. If transactions are entered under the proposed framework, external auditors would probably want to documentation or at least disclosure regarding the multiple parts of a combined contract. Perhaps one way to provide proper documentation would be to account for contracts in two ways. One way under the proposed framework and entities should also account for the contracts as if they were indeed

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<sup>7</sup> *Financial Reporting and Analysis*, Fourth Edition, Revsine, Collins, Johnson, & Mittelstaedt

separate. This would help external auditors understand the multiple parts of combined contracts and allow them to accurately assess the financials of an entity.

Overall, the exposure draft would make it easier for companies to account for interdependent transactions. Therefore, I agree with the principle of accounting for them as one contract.

However, I do think the exposure draft needs to be more specific about the revenue recognition requirements of combining two contracts. In addition, the framework needs to address multiple deliverables in more depth. Combining two contracts has advantages and disadvantages on management decisions and earnings quality. Documentation requirements would also make it easier for external auditors who are auditing the financials of entities that combine the interdependent contracts. If you have any questions regarding my comments please do not hesitate to contact me at [matthew.nickrent@gmail.com](mailto:matthew.nickrent@gmail.com).

Regards,

Matthew Nickrent