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

Re: Response to Exposure Draft: "Revenue from Contract with Customer" (File Reference No. 1820-100)

Thank you for the opportunity to respond to your Exposure Draft on Revenue Recognition.

My response below is based on my long professional experience as an academic, a practicing accountant, financial consultant, and a standard setter (serving as the founding Chair of the Israeli Accounting Standard Board).

The proposed accounting rules for product warranties and liability and for credit risk would lead to a number of distortions to the financial statements, resulting in a lower quality of reporting.

General Comments

- 1. The Exposure Draft (ED) does not articulate the nature of practical revenue recognition issues relating to long-term contracts that necessitated such a comprehensive revision. The current practice, largely based on SOP 81-1, appears to work quite satisfactorily. I am not aware of investors or professional analysts being misled by the current accounting for long-term contracts or of any distortion in the financial statements caused by the current practice. Further, I am hard pressed to find (over the last decade of accounting shenanigans) a case involving long-term contracts that would have been avoided under the proposed standard. True, the current practice allows management considerable judgment, yet this is the nature of long-term projects. The alternative of more rules and "bright lines" is obviously not attractive. In short, what is it that is "broken" that needs to be "fixed" regarding the recognition of revenue from long-term projects?
- 2. The title of the ED appears to unintentionally limit its scope to revenues arising from *contracts* with customers. The title creates the wrong impression that there are revenues without a contract to which the ED does not apply. Yet, the ED requires, albeit indirectly, that revenue recognition be contingent upon the existence of a contract. This is done by the ED through the requirement that the contract be identified (and also through the background discussion see BC27 –

BC34). Given that the existence of a contract is a necessary condition for revenue recognition, I suggest that the term *contract* be dropped from the title and an explicit and central provision be added to the standard stating that no revenue be recognized in the absence of a contract.

In response to Question 5

3. In proposing to view the expected bad debt as a revenue reduction rather than an expense, the ED ignores the important distinction between an offset to revenue and an addition to expense of the same amount. Credit granting activity (and the associated loss from uncollectible accounts) is needed in order to generate the revenues. Offering attractive credit terms is an important commercial device that supplements or substitutes for other costs, such as costs associated with a better product or a better customer service. No one would suggest deducting the latter costs from revenues (even though the bottom-line profit will be unaffected by such treatment). It is therefore not clear why the bad debt expense should be viewed differently when there is no difference between these cost categories except that the bad debt expense has not yet materialized at the time of sale.

As a result of reducing revenue by the fair value of the estimated bad debt expense, users of financial statements would lose track of the cost of this important marketing device. This treatment would tend to inflate the gross margin percentage relative to the current practice (by reducing revenue) and make it difficult, if not impossible, to assess the effectiveness of the credit granting activity.

- 4. Adjusting revenues for expected credit losses will make it more difficult for the readers of the financial statements to assess the adequacy of the allowance for uncollectible accounts since its amount will be included in the general Unearned Revenue account, unless required to be disclosed separately.
- 5. Paragraph 43 calls for changes in estimates in the credit risk to pass through "income or expense" rather than revenue. This treatment again blurs the distinction between revenues and expense and creates, I believe, a precedent in that changes in estimates of one account (in this case, revenues) are not considered adjustments to that account. Neither the paragraph nor the Implementation Guide (see Example 20) clarifies the identity of these "income or expense" accounts.

In response to Question 7 as it pertains to product warranty obligations:

6. Similar to my concern regarding the treatment of bad debt expense (see paragraph 3 above), by proposing to reflect the contractual obligation related to warranties through revenue reduction rather than through expense recognition, the ED ignores the important distinction between a subtraction from revenue and an addition to expense. The cost associated with offering a product warranty is part of the costs needed to generate the revenues. Offering an attractive warranty is an important marketing tool that supplements or substitutes for other costs, such as

costs associated with a better quality control, advertising, or sales commissions. No one would suggest deducting promotion costs from revenues (even though the bottom-line profit would be unaffected by such treatment). It is therefore not clear why warranty costs should be viewed differently when there is no distinction between the above-mentioned cost categories except that the warranty cost has not yet been incurred at the time of sale.

It is true that there is a substitution between the product price and the terms of the warranty. A more generous (and thus costly) warranty may be reflected in a higher price. Yet, this substitution exists with many other cost elements – such as quality control, packaging, research and development, delivery terms, or credit terms and these cost elements are not treated as a subtraction from revenue.

If revenues were to be reduced by the fair value of the warranty, users of financial statements would lose track of the cost of this important marketing device. This treatment would tend to inflate the gross margin percentage relative to the current practice (by reducing revenue) and make it difficult, if not impossible, to assess the effectiveness of the warranty program.

- 7. The ED proposes that revenues will be deferred proportionately to the fair value of the warranty inherent in the price of the product. The problem with this is that, in most cases of durable consumer products and cars, the warranty is not a standalone service that is also sold separately, nor is the main product sold without a warranty. Inferences cannot be made about the fair value of the warranty on newly delivered products from the market for "extended" warranties (which are sold separately) since these warranties relate to older, used products. Therefore, it is difficult to objectively and reliably determine the fair value of the warranties, and hence the amount of revenues to be deferred.
- 8. According to the ED, the revenues deferred due to warranty obligations will flow to the income stream over the warranty period. This stream of revenue will be naturally matched with the actual cost of providing the warranty. The unintended consequence of the ED provisions is to convert the company's warranty activities into a profit center, which is clearly not the intent of the business in offering the warranty. Nor is such a conversion consistent with management's view of the warranty as a necessary service and not a profit-generating activity.
- 9. Another distortion arising from this unintended "profit center" arising from warranty activity is the misallocation of profits over time. Instead of showing the profit when it is economically generated, that is, in the period in which the business sells and delivers the product or service, part of the revenues will flow gradually into the income steam over future periods. Companies with no or little new business would be able, under this model, to "rest on their laurels" by showing profits from their engagement with repair work on warranties on sales that originated years earlier. (In fact, periods with a a greater incidence of defective products would appear to be more profitable in these years compared to

to other periods because of the relatively larger number of warranties being serviced.)

- 10. The view of a warranty obligation as a revenue reduction would render a key number in the income statement, revenues, less reliable by hinging it on the type of the warranty and on a fairly subjective determination of its "fair value" of the warranty. While the current practice also requires an estimate, that of the expected cost of the warranty services, this estimate is typically based on well documented experience and, therefore, quite reliable.
- 11. As a by-product of the fair value (rather than expected cost) basis for the warranty liability (classified as "Deferred Revenues"), its face value on the balance sheet (as Unearned Revenue) will exceed, possibly by considerable amount, the economic burden of fulfilling this obligation (which is the expected warranty cost), distorting the financial position of the company.

In response to Question 15:

- 12. The ED distinguishes between product warranties that cover "latent defects" at the time of delivery and those that cover "post delivery faults." This distinction, which affects the accounting treatment of the warranty-related transactions, is murky and confusing. Consider, for example, the automobile warranty provided by automakers. This warranty is typically effective for at least three years and, for practical and legal reasons, is not sold separately (that is, automobiles are not sold without a warranty). The Implementation Guidance (IG) suggests characteristics of the warrant that would help preparers distinguish between the two types. The first characteristic, a long coverage period, would suggest according to the IG that the warranty represents a contractual obligation (and thus pertains to post-delivery faults). Yet, the second characteristic would indicate, again according to the IG, that the warranty is not a contractual obligation. This is quite confusing.
- 13. Most product warranties are of a hybrid nature in that they cover both types of defects and faults. Clearly, flaws in the product discovered within the first few days following the purchase likely indicate the presence of "latent defects" while those made towards the end of the warranty period are more likely to reflect "post delivery faults." Yet, even repairs required late in the warranty coverage period may be required in part due to latent defects that are discovered only after some time has elapsed (e.g., a failure of a transmission gear that is expected to function for at least 100,000 miles yet breals dpwm three years into the warranty, after only 40,000 miles, must arise from some defect in the original equipment that was latent upon delivery). In short, the distinction between the two types of warranties is quite arbitrary and blurry.

In summary, I am concerned that the proposed accounting changes would reduce the informativeness of the financial statements by subjecting revenue and cost recognition to a greater degree of subjectivity and unreliability, distorting the distinction between revenues and expenses. The changes will further impose additional and unnecessary costs on the prepares of the financial statements.

Sincerely yours,

Dan Givoly