

COMMITTEE ON CORPORATE REPORTING

October 22, 2010

Leslie Seidman, Acting Chairman Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, Connecticut 06856-5116

Sir David Tweedie, Chairman International Accounting Standards Board 30 Cannon Street London EC4M6xh United Kingdom

Submitted via electronic mail to director@fasb.org

Re: File Reference: No. 1820-100, Exposure Draft: Revenue from Contracts with Customers

Dear Madam and Sir:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to provide its views on the Proposed Accounting Standards Update, *Revenue from Contracts with Customers* (the "Proposed ASU"). FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

In our comment letter on the Board's Discussion Paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, we were supportive of the project's overall goals of convergence, simplification and comparability of revenue across companies and geographical boundaries. Those goals remain important to us. We continue to support the convergence of U.S. GAAP and IFRS. We believe that the volume of existing revenue recognition guidance under U.S. GAAP is unnecessarily complex and can produce conflicting results for economically similar transactions. We also observe that there is diversity in practices and interpretations associated with revenue. Because of these reasons, we are supportive of one revenue recognition model to be applied by all entities and industries. While we are generally supportive of the model currently proposed by the Boards, we struggle with an entity's application of a number of the proposed requirements to business operations. We believe the model will better achieve the Boards' objective to establish a standard that an entity should apply to report useful information to users of its financial statements about the amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer, while remaining operational, by:

- Providing a more principles-based approach to measuring the transaction price;
- Retaining existing GAAP for the accounting for warranties provided to customers;
- Limiting the required disclosures to those that provide users with decision useful information; and
- Allowing prospective application upon the date of adoption.

Our suggestions are further explained in the following paragraphs; our detailed responses to the questions presented in the Proposed ASU are included in the Appendix to this letter.

Measuring the Transaction Price at the Probability-Weighted Amount of Consideration That an Entity Expects to Receive From a Customer May Not Result in the Recognition of Revenue that an Entity Has Received or Expects to Receive

We do not believe that a probability-weighted estimate of consideration would result in the most useful measure of the performance obligations in a contract in all circumstances. Probability-weighted estimates may result in a transaction price that is not indicative of actual amounts expected to be received, inappropriately overstating or understating revenue if management expects to receive a specified amount or where probabilities are more heavily weighted towards a particular outcome. The proposed Update does not provide any clarity on how the weighted-probability approach would be appropriate in these circumstances.

We recommend the use of management's best estimate as the underlying principle for measuring the transaction price. We acknowledge that the use of management's best estimate would require judgment; however, a model that only allows the probability-weighted approach simply shifts this subjectivity, while adding unnecessary complexity to the assessment of possible outcomes and probability weightings to circumstances where it may not be appropriate. We believe that the use of management's best estimate would provide a principle that could be applied by all entities in all industries to determine a transaction price that is the most useful measure of the performance obligations in a contract. This approach would allow for the exercise of appropriate management judgment to determine the transaction price, rather than prescribing a set rule to follow, regardless of the nature of the revenue arrangement. We believe the use of management's best estimate will help the Boards achieve the model's core principle to reflect the consideration received, or expected to be received, in exchange for goods or services.

Distinguishing Warranties Between Those That Exist Upon Transfer of Control and Those That Occur After the Transfer of Control May Not Reflect the Underlying Economic Substance of the Revenue Transaction

The proposed standard would require entities to differentiate between latent defects that exist when the product is transferred to the customer and for defects that arise after the product is transferred to the customer. Most companies do not distinguish between these types of warranties and for many; it would be impractical to do so. Rather, warranties are identified as those that are incurred in connection with the sale of goods and services and those that are sold separately. Most companies represented by CCR provide standard warranties in connection with the sale of a product. We do not view the provision of these types of warranties as a revenue generating activity; rather, that these warranties are an inherent cost of the sold product. The performance obligation in the arrangement is the transfer to a customer of a good or service that is not defective; the warranty on that product is not considered to be a separate performance obligation.

We recommend that the Boards retain the existing guidance in Accounting Standards Codification ("ASC") 450: Contingencies, ASC 460: Guarantees and ASC 605: Revenue Recognition on how to account for warranty obligations that are incurred in connection with the sale of goods and services and those that are sold separately. We do not believe that there are any weaknesses or inconsistencies with either the conceptual basis or application of current GAAP. We believe that this guidance, rather than the

defined proposals included in the Proposed ASU, is more representative of the economic substance of the revenue transaction and promotes the project's core principle that revenue should be recognized to depict the transfer of goods or services to customers.

Certain Disclosure Requirements in the Proposed Update Will Not Meet the Boards' Objective of Helping Users of Financial Statements Understand the Amount, Timing and Uncertainty of Revenue and Cash Flows From Contracts With Customers

The disclosures proposed in the Proposed ASU are much more extensive than those provided in current practice. We believe that many of the proposed disclosures would facilitate a user's understanding of the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. However, we believe that the Boards have included certain disclosures that will not provide useful information to the users of financial statements. We recommend that the Boards remove the requirement to disclose the reconciliation of contract balances, reconciliation of onerous performance obligations and the total amount of performance obligations along with the expected timing of their satisfaction.

We do not believe that the reconciliations of contract balances and onerous performance obligations are necessary to meet the Boards' objective of understanding the amount, timing and uncertainty of revenue and cash flows. In addition, entities will most likely have to either track the information off-line or implement new systems solutions that are capable of capturing the required information. We believe the benefit of either alternative does not outweigh the cost of providing the information to users and that these reconciliation requirements do not assist the Boards in meeting their objective.

We also do not agree with the requirement to disclose the total amount of performance obligations and the expected timing of their satisfaction. We believe that the intent of this requirement is to give users information to understand an entity's future revenue streams. However, this disclosure would be limited to the Boards' definition of a performance obligation and accordingly, would not include potential performance obligations that would result from, for example, contracts that are cancelable or where a contract has been awarded but not signed. As such, it would not enable an entity to reflect the economics specific to their company or industry to provide one indicator of future revenue. Although it would be helpful to many preparers that the disclosure would only be applicable to contracts with an original expected duration of more than one year, we still believe that the substance of the disclosure will not provide predictive value to the users of financial statements in understanding the amount, timing and uncertainty of revenue and cash flows.

The Proposed Transition of Retrospective Application Will Require a Significant Investment by Preparers

We agree that retrospective application may provide users of financial statements with useful trend information. We also agree with the Boards' acknowledgement that retrospective application could be burdensome for some entities. For many financial statement preparers, particularly those with large and complex multiple-element arrangements and those with construction or other long-term contracts, retrospective application would require such preparers to maintain dual reporting systems under both current GAAP and the proposed model for the retrospective period. This will require a significant investment in systems by entities, completion of which may not be possible in the period of time from when the final standard is issued and the first comparative period begins. We do not think these concerns will be addressed by the exceptions in ASC 250: Accounting Changes and Error Corrections as there are very limited situations when it would be acceptable to state that retrospective application is impractical to perform.

We recommend that the Boards implement a transition alternative similar to that allowed in Update No. 2009-13 Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements and Update No. 2009-14 Software (Topic 985): Certain Revenue Arrangements That Include Software Elements. This

transition alternative would require prospective application upon the date of adoption with the requirement to disclose comparative information for either the period of change or the period immediately preceding the change. Retrospective application, however, would still be permitted. We believe that disclosing at least one period of comparative information about the change in accounting for revenue recognition provides sufficient information to investors about how the change affects a particular entity.

We appreciate the invitation to participate in the round table session for the Proposed ASU on November 4th. We will be represented by Liesl Nebel, Accounting Policy Controller at Intel Corporation. Please contact Lorraine Malonza at 973.765.1047 or lmalonza@financialexecutives.org with any questions.

Sincerely,

Loretta V. Cangialosi

Chairman, Committee on Corporate Reporting

Loretta Congralon

Financial Executives International

Appendix

Question 1

Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

Generally, we support the concept of using price interdependence as a key determinate in combining contracts or accounting for a contract modification. We believe that the determining factor that should carry more weight than others is the negotiated business intent at the time the contract is consummated, that is, whether the contract was negotiated with a single business objective or multiple business objectives with regards to pricing.

We believe that the Boards have included the segmentation of contracts in the scope of this guidance in an effort to provide entities relief from having to reallocate a variable transaction price across multiple performance obligations when those performance obligations are priced independently. We agree with the Boards that there needs to be a way for companies to allocate a change in transaction price to a specific performance obligation; however, we do not believe that the proposed requirements for segmenting contracts will achieve its intended purpose. We recommend that the Boards remove the requirement to segment contracts from the scope of this guidance and provide further guidance on how to reallocate a change in the transaction price to specific performance obligations.

Question 2

The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

We support the Board's proposal that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23(a) states that a good or service is distinct if the entity, or another entity, sells an identical or similar item

separately. This principle is appropriate as it provides the clearest evidence that a good or service should be considered distinct and should be relatively straightforward to apply in practice.

If an entity is not able to prove the requirement in paragraph 23(a), paragraph 23(b) indicates that a good or service would be considered distinct if the entity could sell the good or service separately because the good or service has both a distinct function and has a distinct profit margin. The concept of a distinct function is comparable to existing guidance in ASC 605-25. However, the concept of a distinct profit margin does not exist in ASC 605-25. We are concerned that the requirement that a performance obligation have a distinct profit margin as described in paragraph 23(b)(ii) and BC55 may result in an inappropriate restriction in the identification of separate performance obligations.

Based on the proposed guidance, it appears that in the absence of an observable selling price, the Boards have concluded that an entity would only be able to estimate a selling price of a good or service if the entity can identify the distinguishable resources needed to provide the good or service. This conclusion appears to assume that all actual selling prices are based on the costs of distinguishable resources and that all estimated selling prices should be based on such costs. The selling prices of many products, specifically certain intangibles, are not based on cost. Based on preliminary summaries of the Proposed ASU and its requirements, several large public accounting firms anticipate that certain intangibles not regularly sold on a standalone basis, such as software that is always bundled with post-contract customer support (PCS), may have to be combined into a single performance obligation. This is because the same resources may be used to create the software as are used to provide the PCS. We believe that the identification of separate and distinct resources or costs should not be required to identify and account for performance obligations separately because a single set of resources can, and often do, deliver distinct performance obligations when they are sold separately. Intangibles, including software and certain types of related PCS, often have very high margins, and related costs are not the primary consideration when actual pricing is established. In this example, the proposed accounting for the good and the service as one performance obligation would not reflect the economic substance of the transaction. It is likely this same conclusion will be reached for other transactions involving intangibles.

We recommend that a good or service be considered to have a distinct profit margin if the entity has a reasonable basis in estimating the margin it would expect were the entity to sell the good or service on a standalone basis. A reasonable basis for such an estimate may often focus on the distinct costs an entity expects to incur in providing the good or service. However, in circumstances when costs are not the primary focus of product pricing, such as the sale of many intangibles, a reasonable basis for such an estimate could be supported by the entity's own experience with similar products in similar markets or by the observable experience of other entities with similar products in similar markets. Such an approach would provide the entity with a reasonable level of flexibility in identifying distinct margins yet still require the entity to provide a reasonable basis for its assumptions.

Question 3

Do you think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

We support the proposed guidance in paragraphs 25-31 for determining when control of a promised good or service has been transferred to a customer. However, we are concerned with some of the

implementation guidance provided by the Boards as it seems to be more rule-based in nature and potentially inconsistent with the principles in the standard. Examples include the guidance provided in IG31-39 on how to account for the sale of licenses and the reliance on the distinction between licenses that are exclusive versus those that are nonexclusive and the specific criteria in IG60 and IG61 that must be met for an entity to recognize a bill-and-hold sale. We recommend that the Boards list criteria or characteristics that an entity should consider in making an assessment of a revenue-generating arrangement rather than requiring specific revenue treatment for certain arrangements or listing explicit criteria that have to be met for particular situations.

Question 4

The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

We agree with the Boards that if the amount of consideration is variable, an entity should include it in the measurement of the transaction price that is allocated to performance obligations if it can be reasonably estimated. However, as stated in our cover letter, we do not believe that the probability-weighted approach is the appropriate principle for measuring the transaction price. Instead, we recommend the use of management's best estimate.

Although we agree with the inclusion of variable consideration in the measurement of the transaction price if it can be reasonably estimated, we are concerned with the lack of clarity and as a result, the varying interpretations, on how variable consideration specific to royalties should be recognized. Although the variable consideration specific to royalties may be estimable, it is unclear if the intent of the Boards is that this revenue be recognized, for example, upon the sale of the related license, or if revenue would not be recognized until the sale underlying the royalty has occurred. We recommend that the Boards include some implementation guidance on the treatment of royalties.

If an entity is not able to support an estimate for variable consideration included within a contract, no revenue would be included in the amount of the transaction price to be allocated to those performance obligations where the transaction price is measurable. If an entity is not able to estimate revenue for performance obligations that are subject to variable consideration, we would expect that those performance obligations would be bifurcated from the other performance obligations in the arrangement so that no revenue is allocated to them until management can reasonably estimate the variable consideration. It would be helpful for the Boards to include implementation guidance on this scenario to confirm our understanding.

Question 5

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

As articulated in our cover letter, we do not support the probability-weighted approach to determining the transaction price. We have proposed that the Boards allow an entity to measure the transaction price based on management's best estimate. We do not believe that a customer's credit risk should be reflected in this estimate. While we do agree with the Boards that collectibility should not impact *when* an entity recognizes revenue and that revenue should be recognized when the customer obtains control of the good or service as currently proposed, we believe a customer's credit risk should be accounted for through bad debt expense and a corresponding allowance for bad debts.

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

On a conceptual level, the proposed guidance has merit. However, the guidance does not consider the economic substance of the arrangement and parties when entering into these arrangements. We recommend that the Boards develop a principle that would require entities to determine if their contracts include a material financing component only if that was the intent of the entity and their customer when entering into the contract. In the case that there is a material financing component, an entity would account for it accordingly.

It is also unclear what disclosures would be required of entities that have adjusted the promised consideration to reflect the time value of money. We recognize that this may require companies with a small number of significant contracts to disclose customer specific contractual information that may result in a competitive disadvantage.

If the Boards retain the requirement to adjust the amount of promised consideration to reflect the time value of money, we expect that implementation may present many operational difficulties. For example, it may prove very challenging to determine the time value element in a contract with multiple-deliverables as products/services are delivered and cash is received throughout the arrangement period. We recommend that the Board only require an entity to adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component and if the contract is long-term in nature, i.e., the contact term is greater than 1 year. This may be apparent in certain contracts because payment from the customer is due either significantly before or significantly after the procurement, production and/or transfer of goods or services to the customer. This would increase the operationality of this requirement.

Ouestion 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

We generally support the allocation of the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis). We support the Boards' decision against specifying a hierarchy of acceptable estimation methods. We agree that as long as the method is consistent with the basis of a standalone selling price and maximizes the use of observable inputs, that no method should be precluded or prescribed to determine an estimated standalone selling price. We recognize that this approach could be difficult for some entities that have not yet adopted ASU No. 2009-13 Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements and/or where an entity is not able to estimate a standalone selling price. We note that in BC125, the Boards confirmed that the residual method should not be used to allocate the transaction price to separate performance obligations but that "a residual or reverse residual technique may be an appropriate method for estimating a standalone selling price if there is a directly observable price for one performance obligation but not the other." We recommend that the Board clarify whether the residual method would be allowable under the proposed guidance and under which circumstances.

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, *Intangible Assets*), an entity should recognize an asset only if those costs meet specified criteria.

Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

See the combined response to both Question 8 and 9 below.

Ouestion 9

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

We appreciate that the Boards have included guidance in the proposed standard regarding contract costs that may be recognized in completing performance obligations. However, because the proposed standard will supersede existing U.S. GAAP that specifically supports deferral of certain costs related to work-in-process on long-term construction/production-type contracts, we believe it necessary to include such support in the new standard. While reference is made to a number of other standards in both U.S. GAAP and IFRS that will be unchanged upon adoption of the proposed standard, there are elements of these standards that are different, and it may not be appropriate for an entity applying U.S. GAAP to refer or rely on IFRS to support the deferral of certain costs and vice-versa.

For example, consider entities that currently use the "units-of-delivery" method under U.S. GAAP, which uses unit sales values and costs to record revenue and cost of sales. In this context, revenue may be determined based on contract-specific per unit pricing or an average price per unit based on overall contract value. Likewise, unit costs for the product/service may be based on actual unit cost, an average-unit-cost approach based on total costs at completion divided by the number of deliverables in the contract, or other reasonable methods. It is not unusual under a construction or defense industry contract currently applying ASC 605-35 for actual cost per unit to decline significantly over the life of the contract due to the custom-built nature of the units and relatively low number of units produced, thus making the average-unit-cost method more reflective of actual economics. In cases where actual costs per unit are utilized (rather than average cost per unit) and the contract is profitable, cost of sales is recorded at an amount equal to the sales value, and the excess of actual costs over recorded costs is deferred and spread over future units once break-even is reached. If the contract is in a loss position, the loss is recognized in the period in which it is identified. This is consistent with current practice, as described in Section 3.20 of the American Institute of Certified Public Accountants Federal Government Contractors Audit and Accounting Guide.

In the absence of guidance that supports the measurement of revenue and cost of sales in a manner similar to that used today under the units-of-delivery method of accounting, entities may infer a need to record losses on early production units and profits on later production units under contracts for which an overall profit margin was contemplated when negotiated with the customer. We believe the Boards should add guidance supporting the use of average-unit-cost or provide more specific language that would allow deferral of normal manufacturing costs expected to be recovered on the contract. For example, ASC 330, *Inventory*, supports several methods (e.g., LIFO, FIFO, average) for determining inventory cost and states that in choosing a method, "the major objective...should be to choose the one which, under the circumstances, most clearly reflects periodic income." This concept is consistent with current practice, as discussed above, on certain long-term construction/production-type contracts that use net realizable value for determining the upper limit of costs to be deferred. We request similar guidance in the proposed standard, thereby allowing entities to account for revenue and related costs in a manner that best reflects the overall economics of their arrangements with customers. If entities interpret the proposed model to

prohibit the average-unit-cost method, the outcome will be dramatically different from the way these entities have been reporting sales and contract margins and will likely cause concern among financial statements users. This could drive the need to report non-GAAP measures to provide supplemental decision useful information to financial statement users. We believe this would not be an intended or helpful outcome of the project.

Considering the above, we suggest that the Boards consider including language similar to the following in paragraph 58 either as a separate item, or as an inclusion to one of the existing items:

"Costs allocable to undelivered units produced as part of a continuous or sequential production process to a customer's specification accounted for using an average units-of-delivery model, to the extent such costs do not create an onerous performance obligation."

The proposed cost guidance could also contribute to recording an onerous liability for a performance obligation at inception of an overall profitable contract. We do not believe that recording loss provisions at contract inception for profitable contracts provides decision useful information. We understand the Boards feel it is preferable to apply the onerous test at a performance obligation level to ensure that adverse changes in circumstances are reported on a timely basis. However, if losses are expected to be realized on early performance obligations followed by profits on later performance obligations, we do not believe up front recognition of the anticipated losses would depict an adverse change in circumstances. Rather, decision useful information would be to understand when a contract, due to cost overruns or unanticipated production issues, has fallen into an overall loss position. This would truly represent an adverse change in circumstances for which a liability should be recorded and the change in circumstances disclosed in the financial statements. Further, we believe that in some cases where a day one loss would be required for onerous performance obligations on an overall profitable contract, some, if not all of those costs in excess of revenues represent an asset in the context of paragraph 57. We believe that an investment has been made and an asset created in production of those early units that will benefit production on later units.

In addition to the foregoing, we believe that the term "abnormal costs" as used in both paragraph 33(b) and paragraph 59(c) needs further definition. In the construction and defense industries, contractors are required to anticipate and make their best estimate of all of the costs required to complete a contract at the outset of the performance of the contract and to monitor such cost estimates over the contract performance period. It is not uncommon for cost estimates to vary over the performance period as actual costs become known, and for new, unexpected costs to develop that are specifically related to the performance of a given contract. In this context, it is very difficult to attempt to identify whether such changes in cost estimates result in "abnormal costs" as there is no clear distinction as to what constitutes "abnormal costs", particularly if such costs are required and relate directly to the requirements of a specific contract. We acknowledge however, that costs that relate to excess/idle capacity or similar costs that, provide no utility to contract performance, or are material and infrequent/non-recurring costs such as those related to work stoppages, natural disasters, or other force majeure incidents not anticipated in the normal course of business are "abnormal" in nature and should be expensed as incurred.

If, however, "abnormal costs" are also intended to include costs due to the realization of risks that were possible at the inception of a contract (but not considered highly likely), such as rework, work-arounds, unplanned scrap, re-design costs and similar items, which we currently include in contract cost estimates and impact the overall profitability of the contract, we are concerned that separate designation of such costs as period costs could result in an opportunity to manipulate the underlying contract margin rate and produce results that are not decision-useful to investors. For example, under existing GAAP, if actual rework costs on a contract exceeded the initial estimated amount for a contract with an initial margin rate of 10%, these incremental costs would be included in the contract cost estimate and reduce the contract

margin rate. However, if a contractor were permitted to treat these rework costs as "abnormal costs", the proposed standard implies the contractor could expense the rework costs under a separate financial statement line item and still report a 10% gross margin on the overall contract. In this manner, the financial statement line item "abnormal costs" appears similar to an "extraordinary item" that financial statement users should exclude in contemplating the contractor's operating results, which would cause significant potential confusion. This appears to skew reported results in a manner that does not reflect the economic substance of contracts with customers and renders any assessment of future performance less predictive. In addition, this approach presents application challenges, as increased cost estimates are often identified after the initially incurred effort (i.e., initial performance of effort in one quarter is later determined in another quarter to be deficient; and many of these increases historically relate to estimated future profit and related costs). The mere fact that such changes in contract cost estimates could be allowed to be evaluated to determine whether such costs are "abnormal" and could thus be excluded from contract margin rate performance seems to open the door for a wide variety of practices which would result in variability in reporting practices and reduce the effectiveness of the comparability of information between similar companies in the construction and defense industries.

Question 10

The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

As stated in our cover letter, we generally believe the majority of the disclosure requirements meet the Boards' objective to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. However, we do not believe that the requirements to disclose a reconciliation of contract balances, a reconciliation of onerous performance obligations, and the total amount of performance obligations along with the expected timing of their satisfaction for contracts with an original duration expected to exceed one year would provide significant enough benefit to the user to outweigh the onerous costs and administrative and systemic burden to the preparer.

We believe that the reconciliation of contract balances and onerous performance obligations are not necessary to meet the Boards' disclosure objective to enable users to understand the magnitude, the potential timing, and uncertainty of revenues and cash flows arising from contracts with customers. We believe that for many companies much of the information required to complete the reconciliations would be tracked in multiple off-line repositories or systems. Therefore, aggregation of this information would require a significant administrative effort and significant cost to update systems to provide the necessary information. The Proposed ASU already requires substantive quantitative and qualitative disclosures. If the Boards decide in favor of requiring these disclosures, despite our objections, we request that such information not be required to be included in interim reports but on an annual basis only. In our view, requiring the tabular reconciliations in interim periods would not provide significant incremental benefits and would significantly increase the volume of disclosure and complexity of application. Moreover, due to the systemic issues that could arise in the process to compile this information for many companies and the tight timing for quarterly reporting, compliance with interim requirements would be particularly burdensome to preparers and would provide little, if any, incremental benefit to investors above existing interim disclosures in this area.

We also believe that the proposed requirement to disclose the total amount of performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year would not provide meaningful information to the financial statement user or add to the users understanding of the amount, timing, and uncertainty of revenues and cash flows. Due to many outside factors that could affect the amounts in the disclosure (such as currency fluctuations, contract amendments/cancellations, contracts with a duration under one year, etc.), we question the value of the disclosure to the users of the financial statements. CCR companies, as previously offered, can discuss with the Boards as to why the performance obligation disclosure would have no predictive value of future performance. The majority of CCR's members do not have financial systems that would be able to capture the expected timing of satisfaction of performance obligations. In order to produce the disclosure, companies would have to incur large expense to change systems and procedures to capture the appropriate data. The cost of readying the systems and procedures to prepare such disclosure would far outweigh the benefit of the disclosure.

Question 11

The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

See the combined answer to both Question 10 and 11 in the previous response.

Ouestion 12

Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

CCR is generally supportive of the Boards' view that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. It is CCR's belief that most companies either already provide such information in their financial statements or disclosures or have the wherewithal to provide such disclosures at minimal cost.

Ouestion 13

Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

As asserted in our cover letter, we do believe that an entity should be required to apply the proposed guidance retrospectively. We recommend that the Boards implement a transition alternative similar to that allowed for in Update No. 2009-13 Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements and Update No. 2009-14 Software (Topic 985): Certain Revenue Arrangements That Include Software Elements. This transition alternative would require prospective application for all new arrangements entered into and those materially modified after the date of adoption with the requirement to disclose comparative information for either the period of change or the period immediately preceding the change. Retrospective application, however, would still be permitted. We believe that providing at least one period of comparative information about the change in accounting for revenue recognition provides sufficient information to investors about how the change affects a particular entity.

For many financial statement preparers, particularly those with large and complex multiple-element arrangements and those with construction or other long-term contracts, the retrospective application would require such preparers to track these contracts under both principles for the period to be applied retrospectively. This would inherently increase the amount of time needed to adopt the proposed requirements or, alternatively, would require impractical and onerous judgments to estimate the period specific effects of applying the new requirements to previously reported results. The costs to track and report under dual principles for extended periods of time would be prohibitive. Many companies have had to build significant custom solutions, which may span multiple ERP's, to account for revenue recognition appropriately and these proposed changes will require modifications to those systems. The lead times to make the system changes and provide three years (and potentially five years including financial highlights) of comparative financial data would be significant.

In BC232, the Boards acknowledge that the retrospective application of this proposed standard would be burdensome; however they note the following mitigating factors:

- (a) Topic 250 and IAS 8 limit the retrospective application of an accounting policy if it is impracticable; and
- (b) The Boards contemplate a long lead time between issuing a standard on revenue from contracts with customers and its effective date, which would reduce the extent of hindsight needed in applying this standard

With respect the mitigating factor (a) above, based on our past experience, the threshold that regulators would hold public financial statement preparers to on impracticability is so high that it offers no relief to such public filers. Mitigating factor (b), although helpful, does not mitigate the cost and effort involved in compiling the comparable information.

The Boards should conduct significant field trials to understand the complexity and lack of existing system capabilities before concluding on retrospective application. We would also ask the Boards to fully understand the information needs of the financial statement users. We believe the Boards need to undertake a robust cost/benefit analysis before concluded that retrospective application is required.

Question 14

The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

The implementation guidance only covers a small sample of possible, simplified transactions that would be sufficient to make the proposed guidance operational. We believe that based on the current guidance provided, there is a risk that preparers will develop varying interpretations of the guidance or utilize accounting firms to help define the appropriate accounting when specific circumstances occur that are not addressed in the implementation guidance. We would expect that the Boards recognize the possibility that this could result in financial statements that are not comparable, based on how a preparer has interpreted the guidance. We recognize, however, that this is a fundamental risk of moving to more principles-based accounting standards.

Question 15

The Boards propose that an entity should distinguish between the following types of product warranties:

- (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.
- (b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

We do not agree with the Boards that an entity should distinguish between warranties for latent defects and those that cover defects that arise after a product is transferred to customers. As articulated in our cover letter, most companies do not differentiate warranties between these two categories; rather they look to whether a warranty is incurred in connection with the sale of a good or service or is sold separately.

Because entities do not currently differentiate between latent defects and those defects that arise subsequent to a sale, this distinction would be very difficult to operationalize. In practice, it would be hard to make the distinction between whether a defect existed at the date of transfer or occurred at a later date. Companies generally provide base warranty coverage for a specified period of time during which the manufacturer is willing to fix a defective product; however, no distinction is made as to whether the defect existed at the product shipment date or developed thereafter. The Board's proposed differentiation between these two types of defects will be difficult to apply since the data to make this distinction is not captured and in most cases, would unlikely be determinable.

As previously mentioned, most companies represented by CCR provide standard warranties in connection with the sale of a product. The proposed guidance would identify these warranties as performance obligations. We do not agree that standard warranties are performance obligations. Standard warranties provide customers with a contractual right which guarantees that the delivered product will function according to specifications for a certain period of time. The contractual promise embodied in the arrangement, in our view, is a functioning product. In that regard, standard warranties are indiscernible from the delivered product and do not provide customers with additional assets beyond the delivered assets. Said another way, the guarantee does not provide the customer with an asset absent the associated product. We believe that the proposed guidance in the Proposed ASU does not accurately reflect the economic realities associated with entities' obligations to their customers, and will not necessarily result in more decision-useful information to users of the financial statements. Again, we believe it would be more representative to account for these warranty obligations as a contingent cost and to accrue the cost when the conditions in ASC 450 are met.

We do acknowledge that if an entity sells an incremental warranty service with the objective of providing a separate service to their customers that is not included as a component of the base product sale and standard warranty, this would warrant the identification of a separate performance obligation and the recognition of the related revenue over the period of service, consistent with the current requirements of ASC 605-20.

Ouestion 16

The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

With respect to the pattern of revenue recognition for licenses of intellectual property that are not considered to be sales, we disagree with the proposed conclusion applied broadly that the pattern of revenue recognition should depend on whether the license is exclusive. We believe exclusivity affects the perceived value of a product or service and does not have bearing on when revenue should be recognized. For example, in the motion picture and television production industry, the primary method by which a media company monetizes its intellectual property (e.g., films, television series, characters) is through license agreements. The terms of these license agreements are long-term (generally greater than 3 years but often much longer). Such license agreements may include the right to exploit a motion picture in various markets or territories or the rights to exploit one of its characters for use in a video game or other consumer product. The media company is also able to simultaneously license the right to use the same intellectual property to other third parties however; such licenses are usually for different territories, mediums or time periods. Because of the seemingly infinite number of territories, mediums or time periods in which a media company can license its intellectual property, the same intellectual property can be licensed simultaneously in a significant number of arrangements. As a result of the broad definition of the term "exclusive" in the Proposed ASU, a great deal, if not most, of a media company's license arrangements will be deemed to be exclusive.

Pursuant to the proposals, in an exclusive license agreement, a company has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license agreement. As a result, under the Proposed ASU, revenue associated with media and entertainment licenses such as motion pictures and television series would be recognized over the terms of the licenses when those licenses specify rights for a particular duration, geographic territory or through a particular medium (e.g., television, digital). Conversely, if the same license did not limit the rights to a particular time, geography or medium the performance obligation would relate to a transfer of the right as opposed to permission to use the property and thus revenue recognition would occur once the licensee was able to use the right. We do not believe this accounting is appropriate for a license of intellectual property, whether it be in the film, bio tech, software or other industries that license intellectual property. Specifically, once the intellectual property (i.e., the motion picture) has been licensed and is available to the licensee, the motion picture studio has fulfilled its performance obligations. The notion of requiring revenue to be spread over an exclusive period does not reflect any different economics from that of a nonexclusive license for which revenue would be recognized immediately. As such, we are not persuaded by the proposed approach that there should be different revenue recognition patterns based on exclusivity. Rather we believe that the determining factor for revenue recognition should be based on an entity's performance obligations in an arrangement. Once the performance obligation has been fulfilled, revenue should be recognized immediately.

Question 17

The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

We agree with the proposal to extending the revenue recognition principles in the Proposed ASU to the sale of operational assets not owned for sale in the ordinary course of business. While we can think of no compelling reason for any other conclusion, we recommend that the Boards clearly define the boundary for where revenue recognition guidance ends and other guidance begins. For example, there are standards

governing the sale of a business, discontinued operations and the disposal of a segment and we believe any guidance in the final revenue recognition standard should make it clear it does not apply to asset disposals in those situations.

Ouestion 18

Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

As you are aware, CCR's mission does not extend past the financial accounting for public corporations. FEI's Committee on Private Company Standards is preparing a comment letter of their own on this Proposed ASU.

With respect to not-for-profit organizations and based on our general business experience, we believe the Proposed ASU should apply to only certain elements of their revenue streams, namely those revenues that relate to the delivery or goods and services for a fee where there are for-profit enterprises offering similar services. Examples might include patient billings for hospitals, tuition and fees for students in higher education institutions, customer revenues for municipal owned public utilities and the like. We do not believe it appropriate to comment on other revenue sources frequently encountered in not-for-profit environments such as revenue from contributions and grants.

Other Comments

It is our expectation that collaboration arrangements would not be included in the scope of the proposed revenue recognition standard. These arrangements are entered into with business partners to share risks and/or development costs. We do not view these business partners as customers. We recommend that the Boards move the guidance provided in BC17 to the Scope of the Proposed ASU, currently paragraphs 6 and 7.