

From: [Gregg Nelson](#)
To: [Director - FASB](#)
Subject: File Reference No. 1820-100
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October 21, 2010

Leslie F. Seidman, Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

(Submitted via email to "director@fasb.org")

Re: File Reference No. 1820-100, Proposed Accounting Standards Update,
"Revenue from Contracts with Customers"

Dear Ms. Seidman:

The International Business Machines Corporation ("IBM" or "the company") appreciates the opportunity to comment on the proposed Accounting Standards Update, Revenue from Contracts with Customers (the "proposed ASU" or "Exposure Draft").

The company continues to support the FASB and IASB ("the Boards") in their efforts to converge, simplify and clarify principles for recognizing revenue. We support the overall principles of a performance obligation model based on the transfer of control of a good or service to the customer. Furthermore, we support the allocation of the transaction price to contracts with multiple performance obligations based on the standalone selling price (estimated if necessary) underlying each obligation. We believe that this approach will result in the recognition of revenue that more closely reflects the economics of a transaction.

We understand the Boards intend to finalize a standard on revenue recognition as soon as June 2011, consistent with the revised convergence roadmap. We want to emphasize that while we support the efforts of the FASB and IASB to issue identical standards simultaneously, many of the changes proposed would have significant impacts on current practices and financial reporting. Therefore, we urge the Boards to re-deliberate the significant issues raised by constituents carefully and to provide the time necessary to develop solutions to these issues. We believe that finalizing a high quality standard on revenue recognition is more important than issuing a final standard by a targeted date and should not impact an SEC decision on the acceptability of current IFRS for use in the U.S. market. We do have concerns with some of the requirements in the proposed ASU, notably the accounting for warranties, variable consideration, the time value of money, onerous performance obligations, disclosures and transition. In other areas, we request additional clarification on certain aspects of the proposed ASU. Our detailed comments are discussed below.

Issues regarding the proposed ASU:

1. Objective of the proposed ASU

We are concerned that the objective of the proposed ASU as stated in paragraph 5 for an entity to report useful information about the "... uncertainty of revenue and cash flows" does not reflect the expectations of users. Certain proposals (e.g., variable consideration), which are discussed in greater detail below, would require companies to recognize current revenue based on estimates of future transactions. As a result, revenue could be recognized years before the company has a valid receivable from the customer. In addition, that future cash flow will be dependent on events outside of the company's control. Furthermore, when estimating the transaction price for contracts with variable consideration, the use of probability-weighted amounts would likely lead to recording revenue at an amount that is not a possible outcome under the contract.

We believe the proposed model should continue to focus on recognizing revenue at the amount that is due the company or earned by the company based on past events, not highly predictive future events.

2. Warranties

When offering a warranty to its customers, IBM, like most companies, does not make any distinction between latent defects and other defects; such a distinction is irrelevant to the rights of the customer and the obligations of the company. Most companies provide a standard warranty to cover all defects which is not separately priced or sold. Therefore, the bifurcation of warranty into these two categories with separate accounting models for each would not provide any decision-useful information to users of financial statements.

In addition, the determination of whether a defect existed before a product was delivered to a customer, arose after delivery or was due to a combination of both factors is arbitrary. The monitoring of defects, as suggested by the proposed ASU, would require that companies expend incremental cost to implement systems that would track defects in accordance with the proposed requirements. These costs would far exceed the financial reporting benefits that would be derived from implementing a more complex warranty accounting model.

We recommend that either 1) standard and extended warranties remain a separate performance obligation as proposed in the original Discussion Paper; or 2) standard warranty accounting remains on an accrual basis as it is under current US GAAP.

3. Determining transaction price

a. Variable consideration

We are concerned that the guidance in the Exposure Draft on variable consideration is not clear enough to help companies distinguish between situations where expected future consideration should be included in the current recognition of revenue (i.e., variable consideration) and when expected future consideration should not be included in current revenue recognition (i.e., optional consideration). For example, a company may have a contract to deliver 100 units which are priced at \$1 per unit. The company has no additional performance obligations. The customer may purchase additional units which are also priced at \$1 per unit. There is no guaranteed minimum purchase. Some have viewed the guidance in paragraph 38 to suggest the company should estimate the total number of units it would sell to determine the transaction price. Others believe this example is not in the scope of variable consideration as the customer has the option to purchase additional units; the company has a future obligation (to deliver

units) and, therefore, has not earned anything over the amount currently owed to the company.

The proposed guidance in paragraphs 38 and 39 of the Exposure Draft seems to indicate that entities can recognize expected future royalty payments as current revenue if a reliable estimate of the future royalty stream can be made. We do not support this conclusion for several reasons. Although the entity has satisfied its performance obligation by transferring intellectual property (IP) to a customer, the events which will lead to the royalty payments (i.e. the sale of products to third parties by the customer that utilizes the IP) have not yet occurred. We believe financial statement users do not want the revenue category to include "contingent" revenue. Therefore, we do not believe that an entity has a right to recognize such royalty payments until the actual third party sales occur, even if such sales can be reliably estimated. As an alternative to the variable consideration model in the proposed ASU, we recommend that variable consideration be limited to past events and not future events, whether by the vendor or the customer.

While most companies will do their best to place strong controls around estimating variable consideration, the Boards should not ignore the fact that requiring companies to record revenue based on estimates of future transactions opens a very wide door for both earnings management and the use of hindsight. On the latter, we agree with the conclusion in the proposed Judgment Framework that while the use of hindsight has its place, it should only be used based on facts reasonably available at the time the financial statements were issued. In the case of revenue, which is a focus for many users, any deviations in estimates, even if supported by strong facts, would likely result in negative market impacts to the company and its shareholders.

b. Transaction prices based on probability-weighted estimates

We are concerned with the use of a value-based approach to measuring revenue through the use of a probability-weighted calculation. We support the use of management's best estimate as a more appropriate measure to communicate future cash flow to users. We note that the Boards' fair value documents define "best estimate" as a probability-weighted measure. However, we continue to believe that users of financial information are seeking expected cash flows, not fair value-based calculations. Again, we do not believe this calculation provides users of financial statements with the information that best communicates the revenue earned by the company.

We further believe that the mandate of a probability-weighted measure attempts to convey a level of accuracy that just does not exist for most estimates. The implementation of a mandated calculation will add considerable work load and require system changes to calculate and document information on measures that are inherently judgmental.

4. Collectibility

We believe that collectibility is an issue that should be covered in the financial instruments project and not in this proposed ASU. The criteria for assessing collectibility in the revenue model are not clear, and it is not apparent in the proposed ASU whether the criteria are the same or different from the criteria in the financial instruments impairment model. Collectibility relates to a company's assessment of the financial instrument (receivable) which is created in the revenue generating process. It is this receivable that should be adjusted based on expectations of collection.

Revenue should reflect the total value of goods and services provided to a customer. Bad debt expense should reflect the company's assessment and ultimate experience related to receivables consistent with current US GAAP. As a result, users of financial statements will have a more complete picture of an entity's revenue generating activities and collections process.

We also propose to maintain the current SEC guidance which permits revenue recognition only when collectibility is reasonably assured. This ensures that revenue is not recognized in extreme cases.

If the Boards ratify the guidance as exposed, we do recommend that all subsequent adjustments to the initial revenue estimate be recorded in revenue and not in other income/expense. This will ensure that the revenue recognized is consistent with the cash that is ultimately received from the customer. All revenue generating activities should be reflected in the revenue line in the statement of comprehensive income. Entities should not be penalized for initial estimates which are too low or rewarded for estimates which turn out to be too high.

In addition, potentially costly system and operational changes will be required to track revenue recorded versus amounts billed to customers. For example, receivables collectively assessed for expected credit losses would have to be tracked at an individual customer level in order to correctly apply the split between revenue and other income/expense.

5. Time value of money

We agree that when an entity provides a customer with material financing (whether implicit or explicit), that financing should be accounted for as a separate performance obligation. However, we do not agree with adjusting the transaction price and imputing revenue on prepayments of the transaction consideration. This would result in the recognition of revenue in excess of the cash received from the customer. While we agree that access to cash before performance obligations are satisfied provides an opportunity for the entity to earn additional income, we believe that this income relates to the entity's investing activities and not its operating activities. We also believe that any income recorded should be based on the actual return the entity makes on investing that cash as part of its cash management process, not a hypothetical return similar to an expected return on pension plan assets.

Furthermore, the recognition of interest expense artificially inflates a company's financing costs. A company with no debt would present finance costs because it collects cash earlier. We do not believe this presentation would provide relevant information to users. In addition, the ultimate impact on retained earnings from these hypothetical transactions (a debit to interest expense and a credit to revenue) is zero. This creates administrative burden without any additional beneficial information for financial statement users.

6. Onerous performance obligations

Under current US GAAP, many companies do not recognize losses on contracts unless there is specific guidance that requires such losses to be recognized (such as the guidance in ASC 605-35). We disagree with the Boards' view that the proposed guidance for onerous performance obligations will not represent a significant change in practice for most entities. In our view, operational losses on contracts should be reflected as the

revenue on the contract is recognized. Each period, a company's statement of comprehensive income should reflect the results of the continuing operations of the entity. To pull forward estimated losses on a multi-year contract to one reporting period and then reflect a "zero margin" in future periods does not reflect the period-to-period cash flows and economics of the contract. We recommend that the Boards reconsider this topic and develop guidance that will ensure the accounting is more reflective of the economics of the transaction.

We note that the unit of account for recognizing a loss under the proposed ASU is at the performance obligation level, not at the contract. Therefore, an entity may need to recognize a loss for a performance obligation contained within a contract that is expected to be profitable overall. Current accounting guidance focuses on whether a contract (i.e. not individual performance obligations within the contract), or in certain cases a group of contracts, is onerous. We feel that recording a loss at the performance obligation level for contracts that are expected to be profitable is misleading to investors because it gives the financial statement user the impression that the entity is incurring greater losses than is actually the case because the overwhelming majority of contracts are profitable for most entities. If the Boards proceed with the current view, we recommend maintaining the basis for recording onerous losses at the contract level as it is a better representation of the economics of the transaction as a whole.

7. Exclusive vs. non-exclusive licensing arrangements

We have some concerns about the different accounting treatments for exclusive licenses (ratable revenue recognition) vs. non-exclusive licenses (up front revenue recognition). We believe that exclusivity is not necessarily the only determining factor in ascertaining whether to record license revenue ratably or up front. In our opinion, this distinction is a bright line which does not necessarily represent the underlying substance of transactions. Other factors such as renewal and cancellation clauses should also impact how revenue should be recorded. Additionally, the length of time the customer receives the benefit from the license and the vendor's additional performance obligations associated with that license should be considered in determining how the revenue should be recognized. We recommend that a final standard include more principles-based indicators to help entities determine whether license revenue should be recorded up front or ratably over the license period. Exclusivity, which can be defined in many ways, should not be the determining factor for different revenue recognition patterns.

8. Contract segmentation

We understand that the Boards included the segmentation principle in the proposed standard (a) to simplify separating goods or services that are priced independently and fall within the scope of other standards and (b) to alleviate the need to reallocate a variable transaction price across multiple performance obligations that are priced independently. However, we question the necessity of this additional step and whether the accounting result would be different in most cases than if an entity simply identified separate performance obligations. While we agree the segmentation of a contract may be important when variable consideration included in the transaction price relates to only one performance obligation in a contract, we believe the guidance could be revised such that variable consideration is only allocated to the performance obligations to which it relates, eliminating the need for contract segmentation. However, if the Boards decide to continue with the guidance

as proposed, we request further guidance on the definition of “regularly,” as that term is used in paragraph 15(a) of the proposed standard.

9. Disclosures

The disclosure requirements contained in the proposed ASU represent a significant expansion from current practice and are much too proscriptive. While the Boards’ objectives are reasonable, the proposed requirements are excessive and the overall volume of information required may overwhelm both preparers and users. We recommend that the Boards adopt a more principles-based approach toward disclosures. If the proposed ASU achieves an improved and more uniform revenue recognition model, consistent with the Boards’ objective, the quantity of required disclosures should actually decrease rather than increase as they have in this exposure draft.

We also believe that the proposed requirement to disclose the total amount of outstanding performance obligations and the expected timing of their satisfaction for contracts with an original duration greater than one year, as currently defined, would not provide the most relevant information to financial statement users or add to 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 and cancellations, contracts with an original duration of less than one year, etc., the disclosure will not have full predictive value of future revenue streams. However, we believe that readers of financial statements may be misled into believing that they do have full predictive value by virtue of the fact that they are included in the audited financial statements. We are also concerned about the auditability of predictive amounts, how to create a control process for such disclosures and the inclusion of “forecasted” information in the audited financial statements. Lastly, this “one size fits all” requirement is limited to the proposed ASU’s definition of a performance obligation and may not enable entities to reflect the varying metrics of their particular industry. The objective of this disclosure has merit; however, as currently defined in the proposed ASU, it is likely to fall short of meeting that objective.

We do not believe that the required reconciliations for contract assets, contract liabilities and onerous performance obligations will provide useful information for financial statement users and are inconsistent with the proposed ASU’s objectives. What these requirements will drive is increased cost for preparers to develop new systems and processes that will outweigh any perceived benefits these disclosures are intended to provide. In addition, we recommend that any requirements regarding tabular roll-forwards should be taken up as part of the financial statement presentation (FSP) project and not the revenue recognition project. In the FSP project, tabular roll-forwards are only required for those balance sheet line items deemed important for understanding the current period change in the entity’s financial position. Under the revenue recognition project, however, these roll-forwards would become mandatory even if not deemed significant by an entity.

Although interim reporting requirements are not discussed in the proposed ASU, our assumption is that the Boards will follow their current practice and require all disclosures to be included in both interim and annual financial statements. We recommend that the level of disclosure in interim financial statements be less proscriptive and follow the general guidelines of ASC Topic 270, Interim Reporting. Interim financial statements should focus on the progress of the company and any material changes since the last annual financial statements were issued.

10. Retrospective Application

We are concerned about the practicability of full retrospective application of this guidance. In each reporting period, IBM has a significant number of large, complex multiple-element arrangements. In our services business we have thousands of outstanding multi-year contracts that can span up to ten years or longer. Even reviewing only material contracts for changes due to the new guidance will be burdensome. In addition, implementing changes such as onerous performance obligation liabilities and variable consideration will be extremely difficult to accomplish with full hindsight of what has actually occurred. Full retrospective application will require preparers to maintain dual reporting systems for the retrospective period. This will drive significant incremental cost in resources, systems and audit fees. Therefore, we believe that the effective date of this proposed ASU should be at least three to five years from the issuance date so that entities can develop the proper systems, processes, controls and policies.

We recommend that the Boards permit a transition alternative consistent with the alternative that was contained in the following Accounting Standards Updates: No. 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements, and No.2009-14, Software (Topic 985) : Certain Revenue Arrangements That Include Software Elements. These updates required the disclosure of comparative information sufficient for investors to understand the impacts of the changes on the reporting entity. Similar to these updates, the Boards could permit full retrospective application.

Another alternative that the Boards could consider is to permit entities certain exemptions (a "simplified retrospective approach") that would streamline and focus the work effort required. Those items exempted from full retrospective application should only be applied to new or materially modified contracts after the date of adoption of the new standard. We recommend that, at a minimum, time value of money, variable consideration, contract modifications and onerous contract accounting for individual performance obligations be part of the exemptions that the Boards consider.

In addition, the transition requirements of all the convergence projects need to be harmonized in order to avoid any unintended consequences of adoption and to minimize the time that preparers must focus on maintaining dual accounting records for historical periods. We urge the Boards to consider this issue as part of their outreach on the timing of and adoption of convergence projects.

Additional clarification requested in the proposed ASU:

11. Nonrefundable upfront fees

Scenario 2 of Example 7 suggests that a nonrefundable setup fee is recognized as revenue during the period that the entity expects to provide services to the customer. This differs from paragraph IG28, which states that the revenue recognition period would only extend beyond the initial contractual term if the entity grants the customer the option to renew that contract and the option provides the customer with a material right. Since the period that the entity expects to provide services to the customer may extend beyond the initial contractual term, we request additional guidance to clarify whether the revenue recognition period would ever be longer than the original contractual period if the contract does not provide for a renewal option with a material right.

12. Construction contracts - contract management services

Under the construction contract in example 11, some of the tasks are highly interrelated, requiring the entity to provide a significant contract management service. For purposes of determining its performance obligations, the entity combines the contract management service with the related tasks with inseparable risks because that service is not distinct. While we note there is additional guidance on this topic in the basis for conclusions beginning with paragraph BC53, we would appreciate further guidance to help determine when the existence of contract management services necessitates the combination of all tasks with inseparable risks into a single performance obligation versus the combination of a portion of the contract management service with specific tasks, resulting in more than one performance obligation. In this regard, it would be helpful to have further guidance regarding how to determine when tasks are considered interrelated and when a contract management service has distinct risks.

13. Continuous transfer of goods or services – consulting services agreement

With respect to consulting services agreements in which a final report will be issued at the end of the contract period, we are concerned that the proposed guidance is not detailed enough to determine when control transfers. In this regard, only two of the control indicators outlined in paragraph 30 of the proposed ASU are relevant to services arrangements. For these types of arrangements, we would appreciate further guidance to help determine whether control passes on a continuous basis, i.e., the consultant's performance obligation is to provide consulting services over the contract period on a continuous basis, or whether control passes at the end of the contract upon delivery of the report.

Thank you for the opportunity to comment on this proposal. If you have any questions, please do not hesitate to contact me at 914-766-3190 or at gln@us.ibm.com.

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