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Via email to director@fasb.org

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**RE: Proposed Accounting Standards Update, "Revenue from Contracts with Customers"
(File Reference No. 1820-100)**

We are pleased to provide comments on the Proposed Accounting Standards Update, "Revenue from Contracts with Customers" (the "Proposed Revenue ASU" or "the Proposal"). Given the pervasive importance of revenue recognition accounting standards to stakeholders in a broad range of companies, development of robust and durable standards that result in effective dissemination of relevant decision making information is an important undertaking.

We support the efforts of the Financial Accounting Standards Board and International Accounting Standards Board ("the Boards") to converge accounting standards, including standards for revenue recognition. We also agree with the Boards' stated objectives for the proposed ASU to remove inconsistencies and weaknesses, provide a more robust framework, improve comparability, and simplify requirements. New standards are needed to reduce and consolidate the number of standards relevant to revenue recognition under U.S. GAAP and to introduce into IFRS additional guidance on the identification and treatment of contracts with multiple performance obligations.

Overall Observations

Linkage to Underlying Principles

We believe the stated objective in the Proposal to "provide a more robust framework for addressing revenue recognition issues" could be enhanced by strengthening the linkage between the underlying principles of the Proposal and the provided application guidance and examples. For example, the "contract asset" and "contract liability" concepts as defined in the Proposal are fundamental, however it is not always clear how the provisions of the Proposal are consistent with the definitions of these concepts. We recognize there is some limited guidance in the "Basis for Conclusions" section of the Proposal, but note that this guidance is not carried forward to the Codification, so practitioners will not easily be able to refer to that guidance. In addition, many of the examples could be strengthened by adding further discussion demonstrating how the underlying principles are applied.

One example where the linkage to underlying principles should be strengthened is with respect to contract assets which are defined as a "right to consideration from a customer..." It is unclear from the proposed standard, however, how contingent consideration could be included in the transaction price and recognized as a contract asset when an entity does not have a right to any consideration from the customer until the contingencies are resolved. Paragraph BC95 explains how contingent consideration meets the definition of a contractual



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asset on the basis that the contingent right to receive consideration can be transferred to a third party for consideration. This is an important clarification with respect to application of the definition of a contract asset that should be more explicitly incorporated in the primary standard and definition of a contract asset.

A second example where the linkage to underlying principles might be strengthened relates to the use of separation criteria that are not directly based on the contract asset and contract liability concepts. As a result, revenue recognition and the resultant recording of contract assets or de-recognition of contract liabilities would not always seem to be clearly related to changes in contract assets and liabilities. See our attached response to question two for further discussion.

Improving Comparability

A stated objective of the Proposal is to improve comparability of revenue recognition across entities and industries. We believe the Proposal can be further developed into strong foundational revenue recognition principles, and support having a single foundation for these principles. We are concerned, however, that without sufficient examples and implementation guidance addressing application of the Proposal and its underlying principles to common situations encountered in practice, comparability of application could decline as a result of the proposal. We recognize that the Proposal contains a number of useful implementation examples, and applaud the Boards for including these examples. We believe additional examples and implementation guidance addressing common situations would be useful, however, to accomplishing the objective of improving comparability. For example, without additional application guidance there could be diversity in practice with respect to how software companies apply the warranty provisions in the proposal to software support arrangements. Application of the continuous transfer provisions to construction contracts is another area where additional examples would be useful and help facilitate consistency in application. We recognize that additional examples and implementation guidance might be developed subsequent to initial implementation.

We also understand that the benefits of accounting standards that place increased focus on principles and on use of estimates are perceived by some to outweigh potential concerns about reduced comparability. To the extent that the Boards decide not to provide additional examples and implementation guidance applicable to common situations encountered in practice on the basis that doing so would be contrary to certain of the objectives underlying the proposal, then we question whether the stated objective of improving comparability would be met by the Proposal.

Separation and Allocation Model

We are concerned that the separation and allocation model in the Proposal contains fundamental weaknesses that could result in allocations of revenue that do not reflect underlying economics of contracts. In particular, the transaction price to be allocated to separate performance obligations would be limited to amounts that can be reasonably estimated, but the estimated standalone selling prices do not contain similar limitations, resulting in an allocation basis that is different than the amount being allocated. Additionally, the allocation methodology results in discounts being allocated pro rata based on standalone selling prices, when in practice, discounts are more often associated with particular performance obligations. For example, when a contract contains two



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performance elements, and one has a high margin and the other has a low margin, a significant discount would typically be more closely associated with the high margin element. Allocating the discount based on relative selling prices will sometimes result in reporting an accounting loss on the low margin item even though the overall arrangement is profitable. The requirement to assess onerous arrangements on a performance obligation basis, as opposed to the total contract, exacerbates the situation and would require immediate recognition of any such losses. We do not think this result accurately represents the underlying economics of most such arrangements. Additionally we note that the Boards' stated objective in paragraph BC137 to reveal different margins on different parts of a contract is only meaningful if the allocation of those differing margins is performed in a meaningful manner.

Finally, we find the proposed guidance pertaining to assessing whether a performance obligation is distinct to be confusing and believe it could be difficult to apply. Specifically, the guidance that "a good or service has a distinct function if it has utility either on its own or together with other goods or services" is oxymoronic in nature. Due to these and other concerns related to the proposed separation and allocation methodology as further described in our attached responses to specific questions, we believe further work in this area would help strengthen the standard.

Prominence of Key Guidance

We also note that the Proposal contains many important concepts that are not as prominently described as would seem appropriate. For example, due to the nature of returns and warranties, we would expect that guidance on these topics would be provided in the primary portion of the standard in addition to the implementation guidance. In other situations, important guidance appears only in the "basis for conclusions" section. Additional examples are described in our responses to the specific questions.

* * * * *

In addition to the above general comments, the Appendix to this letter contains our more detailed responses to the questions contained in the Proposal and our other comments on specific aspects of the Proposal.

BDO USA, LLP is submitting this letter separate from the comment letter being submitted to the IASB by BDO IFR Advisory Limited. Comments and observations regarding the Proposal expressed in this letter and the letter from BDO IFR Advisory Limited differ in emphasis in some respects, as this letter has been written in the context of the US jurisdiction. However, the overall views expressed in the two letters are consistent.



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We would be pleased to discuss our comments with the FASB Staff. Please direct questions to Lee Graul, National Director of Accounting, at (312) 616-4667 or lgraul@bdo.com; and Jay Howell, Technical Partner, at (415) 490-3270 or jhowell@bdo.com.

Very truly yours,

BDO USA, LLP

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Appendix

Recognition of revenue (paragraphs 8-33)

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?

We agree with the principle of price interdependence as it relates to combining two or more contracts, including an original contract and a contract modification. We do not agree, however, that this principle should also be similarly applied to contract segmentation. Instead, we believe use of the guidance for separating performance obligations and allocating revenue between the separate obligations (as adjusted for our recommendations) is more appropriate in these situations. We note that Example 1 in the implementation guidance highlights an aspect of allocation of the transaction price where segmentation of a contract appears to result in a more meaningful allocation of the transaction price than if the transaction price had been allocated between all of the performance obligations using the methodology indicated in paragraphs 50-52. We believe this more meaningful allocation methodology can be better accomplished through changes to the allocation model as further discussed in our responses to questions two and seven.

In the event the segmentation guidance is retained, we are concerned that the criterion in paragraph 15(b) that “the customer does not receive a significant discount for buying some goods or services together with other goods or services” will be difficult to evaluate, since evidence with respect to how discounts are determined and which performance obligations they relate to is likely to be inconclusive in some situations. Consider example one provided in our response to question seven with respect to application of paragraph 15(b).

We also note that the indicators of price interdependence provided in paragraph 13 for purposes of assessing whether two or more contracts should be combined are different than the criteria for assessing whether prices in a single contract are independent in paragraph 15. As a result, contracts that have been combined might also then be required to be segmented in some situations based on the different applications of the price interdependence principle.

We do not agree that contract modifications should be recognized on a cumulative effect basis as described in paragraph 19 and scenario 2 in example 2 (paragraph IG3), since this method does not appear to reflect the economics of most such modifications. The modification example described in IG3 does not contain any contractual changes to amounts paid relating to completed performance obligations, and the entity appears to be making a business decision to provide a larger discount for the prospective services to retain the



customer prospectively. As a result, we believe prospective treatment of the modification is preferable, and do not believe the entity should be penalized in this fact pattern by requiring a cumulative effect reduction in revenue in the period of the modification. It is also unclear why the guidance in paragraph 14, which indicates the price of a contract is not interdependent if a discount is given based on an existing customer relationship arising from previous contracts, would not be applicable to scenario 2 of example 2.

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 are concerned that the principle for determining whether goods or services are distinct is not sufficiently aligned with contract asset and liability conceptual framework of the Proposal, and will be difficult for users to understand and apply in practice based on the guidance provided, including examples 8 through 10 (paragraphs IG39-IG42). Aspects of our concerns are as follows:

- a) The Proposal indicates “a good or service has a distinct function if it has utility either on its own or together with other goods or services that the customer has acquired...or that are sold separately.” This definition appears to represent an oxymoron that could result in almost any performance obligation being considered distinct and that we believe would be difficult for preparers to understand and apply. For example, a company that sells hosted software services agrees to enter into a one-year software services contract that also includes additional services to provide customized functionality of the software service to be performed at the beginning of the contract. The customer benefits from the customization services only through ongoing use of the software services. In this example, since the company separately sells the software service, the customization services would appear to meet the criteria for being distinct, however those customization services would not have value to any party apart from the software services.
- b) It is unclear from the guidance how the concept of “utility” in paragraph 23(b)(i) should be applied. Specifically, is the nature and significance of the utility important to this criteria, or would a good or service be viewed as having utility on its own if separate utility was minimal in nature, such as utility as scrap?
- c) Goods or services can be sold separately by others even though they would not seem to have a distinct function in the context of the other performance obligations in a contract. For example, in the Proposal, it appears shipping would be treated as a distinct performance obligation, even when a customer has no obligation to pay shipping charges until performance of other obligations has been completed and the customer does not receive a separate benefit from the act of shipping a product. In these situations, we do not believe shipping of a product to the customer should be considered a distinct performance obligation.
- d) Similarly, it is unclear how installation could ever be considered distinct from the related product or service to be installed as suggested by Example 9 (paragraph IG41). In most transactions, transfer of control of the product occurs before



installation services are performed. However, in the software-as-a-service industry, installation services are typically performed before the customer begins receiving the software service. If other entities also sell installation of the software, then the installation would be considered distinct, even though it does not have a distinct function. We are unclear as to the basis for treating installation services as distinct in this situation regardless of whether the installation services can be provided by third parties. Instead, we believe installation is more appropriately treated as a nonrefundable upfront fee, regardless of whether the installation occurs before or after a related product or service performance obligation has been satisfied. To the extent installation is viewed as potentially being a distinct service, then we recommend the Boards provide additional guidance to help differentiate between installation services that can be separately recognized, and nonrefundable upfront fees that do not result in the transfer of a promised good or service.

- e) Shipping and installation are examples of acts that would often meet the criteria for being distinct, because they are often sold separately by other parties, but that do not typically create a contractual asset or result in a reduction of a contractual liability when performed absent performance of the related contractual performance obligations. In this regard, the Proposal's separation and recognition criteria do not appear to be aligned with these important underlying principles.

We believe a separation model that is based on separate functionality of the completed performance obligations in the context of the remaining performance obligations in the contract would more robustly address whether performance obligations should be separated, and would be more consistent with a model that is focused on recognition and de-recognition of contract assets and liabilities. While we recognize the Boards have previously rejected a functionality based model due to perceived application difficulties, we believe it is possible to develop a robust and workable functionality based model where functionality is assessed in the context of the remaining performance obligations in the contract.

To the extent the currently proposed separation model is retained, to mitigate weaknesses of the model, we think it is important to include a contingent cap mechanism similar to existing guidance in U.S. GAAP to limit revenue recognition to amounts that are not conditional upon future performance obligations. We believe that this would also result in better aligning the Proposal with the contract asset and liability conceptual framework. We recognize that a similar concept is incorporated into the indicators of transfer of control at paragraph 30(a), and recommend that this instead be a required criterion for separating performance obligations if the currently proposed separation model is retained.

Additionally, we note that many software companies license software in combination with ongoing maintenance and support arrangements. The upgrade rights that are often included with support services are typically not available from other vendors, and customers often insist on having access to the ongoing upgrades, since they are necessary to the ongoing functionality of the software. A specific example of this would be virus protection software that includes rights to ongoing upgrades to address new viruses. It appears application of the Proposal to this type of arrangement could result in a change in practice from how these arrangements are currently being treated depending on whether the virus protection software is viewed as being distinct from the related upgrade rights. We recommend



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providing additional implementation guidance to assist in accessing whether software is distinct from the related maintenance and support in various common situations.

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 think additional guidance would help ensure consistent application of the principles, including the following:

- a) The role of transfer of legal title appears less important than under existing accounting standards. Because of the wide range of situations where transfer of legal title could be an important consideration, we recommend providing additional guidance and examples addressing this aspect. For example, under the proposed guidance, it is possible more entities will elect not to transfer title until after payment is received, even where there are other legal mechanisms to ensure payment. The guidance should address how to assess the importance of transfer of title in these situations and what factors to consider.
- b) In some situations, we believe the customer's perspective, if understood, should also be considered a factor when assessing transfer of control.
- c) The guidance setting out when an arrangement qualifies for continuous transfer is not sufficiently clear, with the associated risk of inconsistency in application and structuring of contractual arrangements.

The Proposal as drafted suggests that revenue arising from certain long term contracts, currently accounted for using a percentage of completion approach, will not qualify for recognition until the finished item is delivered to the customer. This would be the case for a substantial engineering project being performed to a relatively standard specification (for example, an oil tanker which could take a number of years to complete). This could result in the related financial statements failing to reflect the economic activity being undertaken by the supplier (which the Boards acknowledge at paragraph BC64, while also noting at paragraph BC65 that the intention was not to delay revenue recognition to contract completion). There is a risk that the guidance as drafted might also result in the structuring of contractual arrangements in order (technically) to qualify for continuous transfer (for example, through the technical delivery to the customer of individual components used as the construction activity proceeds). It also appears that a service with a deliverable on completion (such as an audit or other specialist report, where the deliverable is the signed report) would qualify for revenue recognition only on signature or delivery of the report and not as the related work was carried out, which would again result in the supplier's financial statements failing to reflect the activities carried out on partially completed contracts at a financial period end.

- d) In customer specific construction contracts where control transfers continuously, it is unclear from the guidance how customer furnished materials would be treated. It



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would seem improbable in this situation that the contractor would obtain control of these assets.

- e) It is also unclear why an entity would ever recognize revenue related to customer supplied materials that are to be used to satisfy a performance obligation to that customer. We think in substance the entity is acting as an agent for the customer to provide a product or service using the supplied materials, and that only the net fee charged to the customer should be included in the transaction price.

Measurement of revenue (paragraphs 34-53)

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 recognition of revenue based on an estimated transaction price that includes variable consideration. We are concerned, however, that there appear to be some operational issues with how the guidance would be applied in certain situations, and that additional work and application guidance is necessary to ensure the proposed approach is operational.

In particular, we think it might be more meaningful to assess whether the portion of the transaction price to be recognized to date under a contract is reasonably estimable as opposed to requiring that the total transaction price be reasonably estimable. Under the proposed guidance, limiting the transaction price to amounts that are reasonably estimable, and then allocating this price on a basis of relative estimated stand alone selling prices that do not contain this same limitation could result in allocations that would not seem to make economic sense. The following examples illustrate this concern:

1. License example

An entity enters into a contract with two distinct performance obligations as follows:

- Consulting services to be performed shortly after entering into the contract in exchange for a nonrefundable upfront payment of \$50,000,
- Non exclusive license to intellectual property being developed that will be provided to the customer upon regulatory approval, expected in six months, in exchange for royalties of \$10 per end product unit incorporating the licensed intellectual property.

The entity determines it cannot reasonably estimate the royalty based consideration because it does not have any experience with similar agreements, and the technological feasibility of commercial use of the intellectual property has not yet been established. In order to allocate consideration, the entity estimates the standalone selling prices of the services and intellectual property as \$50,000 and \$450,000, respectively. In this example, based on a transaction price of \$50,000, the entity would only allocate \$5,000 to the



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services and defer and recognize the remaining \$45,000 over the term of the exclusive license. We believe in this example the requirement to reasonably estimate the royalty based revenue results in too little revenue being allocated to the consulting services.

2. Credit example

An entity enters into a two year contract to provide services for \$200,000. The services are to be delivered evenly over the two year period, with upfront payment of \$100,000, and payment of the remainder due at the beginning of the 2nd year. The entity normally provides similar services for \$120,000 per year, and provides this customer with a significant discount for committing to a two-year term. Due to credit concerns, the entity estimates there is only a 50% chance of collection of the second year fee based on a credit assessment of the customer. Under the proposed guidance, this would result in only recognizing \$75,000 in the 1st year based on an estimated transaction price of \$150,000. However, if the customer was unable to pay the 2nd year fee, the entity would presumably exercise its right to cancel the agreement for non-payment, and would not be obligated to provide services in year two. As a result, the proposed allocation methodology does not appear to match the economics of the transaction. Note that in this example, year one and year two cannot be segmented in accordance with paragraph 15 due to the discount for purchasing two years together, and the entity concludes it can reasonably estimate the 50% chance of collection. If the entity determined it could not reasonably estimate the second year fee, it would only recognize \$50,000 in the 1st year. We believe in this example, the requirement to reduce the transaction price for credit considerations results in too little revenue being allocated to the first year of the contract.

We also note that inclusion of variable consideration, including in certain instances consideration that is subject to optional future contract renewals, in the allocation analysis represents a significant change in practice, and suggest that enhanced guidance in both the standard and application guidance be considered. For example, while example 27 (paragraph IG88) illustrates a situation where expected future renewal income might be included in the transaction price, it is unclear from the proposed principles in the standard how such consideration would be included if the Entity does not have enforceable rights relating to the renewal until it is elected by the customer.

With respect to the criteria in paragraph 38, we note that these criteria should apply only to variable consideration as opposed to amounts that are fixed in nature, and recommend clarifying this aspect.

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?

We agree credit risk should be considered in measurement, rather than treated as a recognition threshold. However, we disagree with the proposed guidance to reflect a customer's credit risk in the transaction price at the contract level, since we believe it could result in less meaningful information to users of financial statements and create unnecessary complexity for preparers. In current practice, credit risk is primarily reflected



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as bad debt expense in an income statement. Under the proposed guidance, credit risk would now be reflected in part as a reduction of revenue, and in part as an operating income or expense item. This bifurcation in presentation could make it more difficult for users of the financial statements to assess the overall impact of credit risk on an entity. In addition, for receivables from current period sales that are collected by the end of a reporting period, there currently is no practical requirement to assess and measure credit risk, however under the proposed guidance, it appears entities would now be required to assess and measure credit risk at the time of the sale for purposes of measuring revenue regardless of subsequent collection within the period. For example, a company sells a product to a high credit risk customer at the beginning of a reporting period, and fully collects the resulting receivable prior to the end of the reporting period. Under existing rules, the entity would not need to measure the credit risk in this example. Under the Proposal, however, measurement of credit risk would be required. In addition, we note that the Proposal's requirement for different income statement treatment of remeasurement of credit risk subsequent to performance is inconsistent with the income statement treatment of remeasurement of contract assets arising from other contingent consideration.

As discussed in our response to question 4, we are also concerned that the proposed approach to measuring credit risk could result in allocations of revenue that do not seem to make economic sense.

To address our concerns, we recommend that credit risk instead be measured at the performance obligation level at the time of performance as part of the measurement of the contract asset to be recorded based on a probability based approach. Further, we recommend that subsequent changes in the estimated collectibility of contract assets be recorded to revenue instead of income or expense as proposed. We note that a subsequent collection of an amount that was not initially estimated to be collectible would still seem to meet the definition of revenue in the proposal. Also, we note that this is similar to contingent consideration that is not reasonably estimable and as a result not initially recognized as revenue at the time of performance. In both cases, payment is contingent on the customer's actions subsequent and unrelated to performance.

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?

We agree that consideration should be adjusted for the time value of money.

Question 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 do not favor the proposed allocation model as we are concerned that the separation and allocation model in the Proposal contains fundamental weaknesses that could result in allocations of revenue that do not reflect underlying economics of contracts. As noted in our cover letter and responses to the above questions, there are circumstances where allocation



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of the total transaction price as determined in accordance with the Proposal can result in an allocation that does not appear to match the economics of the transaction. Paragraphs BC90 to BC95 provide the Board's considerations with respect to variable consideration. We note however, that these considerations appear to focus on the contract as a whole, and do not appear to fully take into account the effect of allocating the transaction price to the individual components in certain fact patterns. In addition to the examples in our response to question four, we provide the following additional allocation example for consideration that highlights potential concerns and weaknesses with the proposed allocation model:

Standard software and computer hardware

An entity enters into a contract to provide a standard software license and computer hardware for \$1 million. The hardware is regularly sold separately by others and the stand alone selling price of the hardware is \$600,000 based on observable price data. The entity regularly sells the software separately and the estimated stand alone price of the software is also \$600,000. The cost of the hardware is \$575,000 and the marginal cost of the software is insignificant. The entity provided a \$200,000 discount on the software in order to entice the customer to switch from a competitor's product. The entity never sells hardware at a discount because of the minimal margins involved. The entity concludes the contract qualifies for segmentation under paragraph 15 because the customer did not receive the discount for buying the software and hardware together. Only \$500,000 of the transaction price is allocated to the hardware in accordance with paragraph 16, and as a result, the entity records a \$75,000 loss on the hardware portion of the contract and a net profit margin of \$500,000 on the software. We believe in this example, application of the proposed allocation approach results in too little revenue being allocated to the hardware and the recording of an onerous contract loss for the hardware portion of the arrangement when the overall contract does not result in a loss.

The primary and implementation guidance do not appear to allow an entity to use a residual or reverse residual method to allocate consideration, consistent with recently issued U.S. GAAP. However we note that in paragraph BC125, the Boards appear to allow use of these methods to estimate a stand-alone selling price, which also, in effect, results in allowing this methodology for allocation purposes. Due to the importance of this aspect of implementation of the proposed model, we suggest that the Boards provide further clarification and guidance addressing the circumstances in which use of the residual method might be appropriate in the body of the standard and implementation guidance, as opposed to relegating this guidance to the basis for conclusions section.

We note that one of the concerns with the residual method is that it results in allocation of all of a discount or premium to the residual item. However in situations where there are observable prices for one of the performance obligations and not the other, we believe that the discount or premium most likely would primarily relate to the performance obligation for which there is no observable price data. See the example above.

Contract costs (paragraphs 57-63)

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



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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?

Yes.

Question 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 agree.

Disclosure (paragraphs 69-83)

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?

We note that contract assets might not meet the criteria to be accounted for as a receivable for one or both of the following reasons:

- a) The contract asset pertains to past performance but does not become an unconditional right to consideration until future performance obligations are met; and
- b) The contract asset pertains to past performance but does not become an unconditional right to consideration until non-performance based contingencies are resolved (e.g., royalty arrangements).

We recommend requiring additional disclosure to help understand the nature of contract assets, including the reasons a contract asset does not yet represent an unconditional right to consideration. We also note that the proposed requirement to include in revenue estimated amounts that an entity expects to receive that would not meet the fixed-and-determinable criteria in current U.S. GAAP represents a significant change in practice. Requiring disclosure of the amount of contingent revenue recognized each period based on estimates, and the magnitude of subsequent adjustments to the initial estimates recorded each period, would help users better understand the significance of this new component of revenue.

Also, we recommend clarifying whether a contract asset comprised of contingent revenue would be considered an intangible asset in accordance with ASC 805-20-55-31, particularly considering the explanatory guidance at paragraph BC95 and the economic similarity of the two assets.

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



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

Paragraph 78 of the Proposal would appear to result in disclosure of forecasted revenue information that is dependent on estimates of contingent revenue and estimates of when future performance would occur. We do not believe it is appropriate to disclose a yearly forecast of when performance obligations are expected to be satisfied within the financial statements due to inherent uncertainty in many cases of when these obligations would be satisfied and the resulting susceptibility to change and potential legal and regulatory considerations. In this regard, we note that in some cases, the specific timing of when performance obligations are expected to be completed is not contractually fixed and can be dependent on factors that are outside of a company's control. We do note that for companies using a classified balance sheet format, the current and noncurrent portions of a contract liability for remaining performance obligations would be separately reported.

Question 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?

We agree revenue should be disaggregated into categories for disclosure purposes. In addition to the guidance provided, we recommend:

1. Requiring separate disclosure of the major categories of revenue (product, service, etc.) on the face of the income statement consistent with current SEC reporting requirements.
2. Clarifying the guidance to indicate that disaggregate disclosures should be provided for each applicable category (as opposed to only one category when multiple categories are applicable) and providing an example disclosure reflecting multiple categories.

Effective date and transition (paragraphs 84 and 85)

Question 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.

We do not agree with the proposed retrospective application requirement. We are concerned that due to the complexities for many companies of implementing the proposed new requirements while also implementing other new standards that are being proposed, the required adoption date would need to be significantly later than if prospective adoption were allowed due to the additional time that would be required for many entities to adopt retrospectively. We think the benefit of entities adopting the new standards sooner outweighs the benefit and additional cost of retrospective implementation. We recommend use of a transition approach similar to what was provided in ASU 2009-13 whereby entities could elect to adopt either retrospectively or prospectively.



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Implementation guidance (paragraphs IG1-IG96)

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?

Yes, except as noted elsewhere.

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 agree with the proposed distinction between warranties pertaining to latent defects and warranties for faults that arise subsequent to transfer of control, however we have concerns regarding the proposed accounting for warranties pertaining to latent defects as follows:

- 1) We do not agree with the stated objective in paragraph BC202 regarding consistency with the accounting for rights of return since the nature of return and warranty rights are different. Return rights provide the customer with a right to return the product for a refund. Under a warranty, the customer's only right usually relates to a repair or replacement, with no right to a refund. From a contract liability standpoint, these rights appear to be fundamentally different.
- 2) We do not agree with the characterization in paragraph BC202 that transfer of a defective product should necessarily be treated as a failed sale. This does not provide recognition of sales of defective products where the customers never submit a warranty claim due to the nature of the defect, or to situations where a customer is still able to benefit from the defective product before it is repaired or replaced.
- 3) Paragraph IG15 appears to draw a distinction between warranty claims addressed by repair that does not result in replacement of any components and claims addressed by repair that result in components being replaced. We are unclear about the basis for this distinction. In addition, we are concerned about the operability of the requirement to allocate the transaction price between the good components and the components expected to be repaired. This proposed requirement in effect would result in segmentation of a contract at a lower level than the segmentation or



separation criteria would permit. For example, software companies can elect to fix a latent bug by providing a software patch that corrects the bug, or by providing a replacement copy of the complete software that contains the bug fix. For software companies, the distinction between being required to replace or repair the software does not seem significant with respect to the allocation of revenue related to warranty obligations for latent defects. Further, it is unclear from the guidance how a software entity would determine the value of the component of the software expected to be replaced by a bug fix or whether the component has been repaired instead of replaced.

- 4) Per the Proposal, the amount of revenue related to unsatisfied performance obligations is the amount of revenue associated with products that are estimated to be defective, regardless of the number of units expected to be returned by customers. Companies often ship products with known minor defects affecting all products being shipped, based on an expectation that the defects will not be important to many customers, and the number of customers submitting warranty claims will be minimal. Under the Proposal, if minor defects were known to exist in all products shipped by an entity, it appears the entity would not be able to recognize any revenue in this situation until expiration of the warranty period. Accordingly, it would seem to be more practicable to allow the warranty amount to incorporate an estimate of the amount of customers expected to submit warranty claims, or to treat estimated warranty obligations for latent defects as a cost.
- 5) In some situations, a warranty repair of a latent defect does not result in replacing any components. The proposed guidance appears to imply that in these situations no revenue deferral would be required. For example, a manufacturer estimates that 1% of its products were assembled incorrectly. Products that are returned by customers are taken apart and reassembled and the reassembly does not require any components to be replaced in this process. In this situation, based on the proposed guidance, no warranty revenue deferral would be made even though the entity has still retained a performance obligation to repair the defective product if requested by the customer.

To address the above concerns, we recommend consideration of a different approach to latent defects by first focusing on whether a customer has the ability to receive the benefit from the product when the product is defective for purposes of assessing whether control has transferred in accordance with paragraph 26. In this regard, we believe additional implementation guidance and examples would help practitioners evaluate whether transfer of control has transferred when there are ongoing warranty obligations related to latent defects. For products where control (i.e., the customer's ability to benefit) has been determined not to have transferred because of the nature of known or potential defects, we do not believe any of the allocated revenue should be recognized until the warranty contingencies have been resolved, regardless of an entity's expectations regarding the extent of claims that will actually be submitted. Where it is determined under paragraph 26, based on guidance that would be provided, that control has transferred, then we think a cost or fair value based approach to measurement of the contingent warranty liability is preferable to the allocated revenue approach proposed in the Proposal. We recognize the Boards rejected the cost based approach, because it results in recognition of 100% of the



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product margin, however in situations where control has been transferred in accordance with paragraph 26, we believe the cost or fair value methods better align with the contract liability based conceptual framework.

We don't believe an entity's decision to repair or replace a unit should necessarily be relevant to determining whether control has transferred or the method of measuring a warranty liability once control has been determined to have transferred. However the expected manner of settlement of a warranty obligation should be a consideration when evaluating whether transfer of control of the product or service has occurred. For example, to reduce a customer's waiting time, some entities will immediately replace a defective product with a previously repaired product or with a new product if there are no previously repaired units in stock. The entity then repairs the defective product to use as a warranty replacement for a future customer. In these cases, we do not think it is relevant to assessing whether a performance obligation has been satisfied to distinguish between the manners in which a company decides to satisfy the warranty performance obligation.

Question 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?

We do not agree with the distinction between exclusive and non exclusive licenses. For each of these types of licenses, the performance obligation is to allow some level of usage of the licensed intellectual property for a period of time. Once the license period has begun and the customer has access to the intellectual property, the entity does not generally have any remaining ongoing performance obligation for the licensed intellectual property (though there can be other related performance obligations). Assuming any other related ongoing performance obligations are separable from the license, we believe performance obligations related to both exclusive and non exclusive licenses are satisfied when a customer is able to use and benefit from the license.

Further, we do not believe a contractual limitation on the ability to grant similar license rights to more than one customer should be treated as an ongoing performance obligation as described in paragraph BC224. Such an interpretation would appear to represent a broadening of the Proposal's definition of a performance obligation that refers to the transfer of goods or services, and related guidance in paragraph 21 regarding what constitutes a good or service. Instead, we believe an exclusivity clause is similar in nature to an obligation to maintain and defend the intellectual property as described in paragraph IG38 since the licensor has an obligation to ensure other parties do not use the intellectual property. In the event an exclusivity provision is viewed as an ongoing performance



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obligation, we note that this obligation to not license to other parties would appear to meet the proposed criteria for being distinct from the related license since it would have utility on its own or with the license that has been delivered, and therefore could be “sold” separately” as discussed in paragraph 23.

Instead, we believe the pattern of revenue recognition should depend on whether other performance obligations related to the license such as maintenance and support exist and are separable from the license. Where such performance obligations exist and are not separable from the license, then revenue should generally be recognized over the license term. Our response to question 2 contains additional discussion of this aspect.

Lastly, we note that the interplay of the Proposed Revenue ASU as it pertains to licenses and the Proposed Accounting Standards Update “Leases” (“Proposed Lease ASU”) is not entirely clear. For example, consider a transaction in which a company enters into a one-year lease of computers that also includes a non-exclusive one-year license to specialized software that is loaded onto the computers. It is unclear from the scope provisions of the Proposed Revenue and Lease ASUs as to whether the software license component of the transaction would be separately accounted for in accordance with the Proposed Revenue ASU or accounted for together with the lease component in accordance with the Proposed Lease ASU. In the event the software and lease components are separated, then it is not clear why the lease and software components should then be recognized in different manners. In the event the software and lease components are accounted for together under the Proposed Lease ASU, it is unclear why the software component would then receive different treatment than similar software licensed without the leased computer.

Consequential amendments

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 the same recognition and measurement principles should be applied. However the guidance should more specifically state that only transactions meeting the definition of revenue included in the standard should be reported as revenue.

Nonpublic entities

Question 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?

The guidance for public and private companies should generally be the same, except we recommend consideration of reduced disclosure requirements for private companies. Users of not-for-profit organizations have different needs, and as a result we believe separate consideration is necessary with respect to these entities.

Other Comments



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Rights of return (IG5 - IG12)

Given the importance of the concept of right of return to determination of revenue recognition, consideration should be given to providing guidance on this topic in the primary standard, as opposed to only referring to the topic in the implementation guidance. Further, paragraph IG10 refers to paragraph 38-40 with respect to estimating the probability of a refund, but it is unclear from this guidance whether determination of the estimate of returns is a distinct process performed at the separate performance obligation levels, or whether it is part of the determination of the aggregate transaction price.

In many cases, the resale value of goods expected to be returned could be less than the initially measured value based on cost less costs to recover that is described in paragraph IG12. We recommend clarifying in the implementation guidance that an entity would also still need to assess the recorded value of returned inventory for recoverability. This could also impact how the asset is subsequently measured based on changes in the refund liability.

Customer acceptance (IG69 - IG73)

In some situations, a general acceptance clause in a contract can be substantively equivalent to a right of return, however it appears that the treatment in the proposed standard would be different depending on whether the contractual terms are characterized as an acceptance provision or as a right of return. We recommend either clarifying that acceptance clauses are not to be treated as a right of return, or providing guidance as to when an acceptance clause could be treated as a right of return. In this regard, note that Staff Accounting Bulletin 104 provides guidance that some acceptance clauses can be treated as a right to return.

Because of the prevalence of general customer acceptance clauses that do not contain objective criteria and the impact on current practice that the proposed approach could have, we suggest that examples also be provided in the implementation guidance to highlight the application of this guidance.

Additionally we note that many customer-specific products or services also contain customer acceptance clauses which can be general in nature without objective criteria. We recommend providing additional guidance and examples addressing the interplay between the guidance in paragraph 30(d) and paragraph IG72.

Commercial substance (10a)

The definition of commercial substance could lead to abuse in contracts that include non cash consideration since the proposed standard does not specify the amount of change in cash flows that are necessary to establish commercial substance. Further, measurement and application of the change in cash flow criterion is unclear in situations involving non cash consideration. For example, a vendor could agree to sell more services than are needed to a customer in exchange for cash and services to be provided by the customer in excess of what can be meaningfully used by the vendor. Based on the Proposal guidance, it appears that the transaction price would still be based on the full consideration including the fair value of the services received, even if those services only have limited commercial substance and value to the vendor. Accordingly, we recommend use of a more robust



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definition of commercial substance as well as inclusion of non cash consideration examples in the implementation guidance to help clarify the application of the commercial substance requirement with respect to this type of contract.

Consideration payable to a customer (48)

Paragraph 48(c) requires that an entity be able to reasonably estimate the fair value of a good or service received from a customer for purposes of assessing the transaction price, consistent with existing accounting standards. However we note that paragraph 48(b) does not contain a similar requirement, and recommend that the guidance in paragraph 48(b) be amended to require that an entity be able to reasonably estimate the fair value of the good or service received, or if the fair value cannot be reasonably estimated, the entire amount paid to the customer should be treated as a reduction in the transaction price, consistent with paragraphs 48(a) and (c). Additionally, we recommend that the guidance in paragraph 48 more clearly incorporate the measurement guidance in paragraph BC110 that any amount accounted for as a payment for goods and services be limited to the fair value of those goods or services.

Onerous performance obligations (54-56)

Under the proposed guidance, assessment of onerous performance obligations at the performance obligation level could result in recording a loss on a particular performance obligation when the overall contract is profitable, as illustrated in example 1 provided in our response to question seven. We do not believe this is an appropriate result, and recommend that the assessment of onerous performance obligations be performed at the contract level as opposed to assessing individual performance obligations. Additionally, as discussed in our response to question 7, we believe this result illustrates that allocation of the transaction price on a pro rata basis can lead to allocations that do not portray the underlying economics of an arrangement.

Another approach that could also be considered with respect to assessing onerous performance obligations might include modifying the criteria in paragraph 57 for capitalized contract costs to allow deferral and attribution of an onerous performance obligation "loss" over the period that revenue from other performance obligations is recognized. In other words, one might view the loss as a contract investment or as an "inventoriable charge" under ASC 330-10.

Additionally, we think it would be useful to provide additional implementation guidance with respect to measuring onerous performance obligations, including examples where onerous performance obligations arise due to consideration payable to a customer that is treated as a reduction of revenue in accordance with paragraph 48.

Non refundable upfront fees (IG27-IG28)

Services arrangements may only contain an initial contractual term, with no specified option to renew, or if there is an option to renew, the renewal rate can be subject to adjustment by the entity. However in both situations, there is often an unwritten nonbinding understanding that the entity will not raise prices significantly in the renewal periods that results in an implied renewal right. For example, an entity could provide a recurring service under a month to month agreement that includes a material set-up fee and allows the entity



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to change prices in any subsequent month. The transaction price including the set-up fee is often significantly higher than the stand-alone selling price of the initial one month services agreement. Example 7, scenario 2 (paragraph IG28) could be an example of this, but it is difficult to determine from that example whether or not the customer has a contractual renewal option. This type of agreement would not appear to result in a material right based on the guidance in paragraphs IG24 to IG26, and if this is the case, the entire set-up fee would be recognized in the initial one-month period, regardless of the entity's implied intent with respect to future pricing. We recommend clarifying the implementation guidance with respect to the above. In particular, when the transaction price represents a significant premium to the stand-alone selling price of the service as a result of the set-up fee, additional guidance should be provided addressing how this premium should be recognized.

Customer options (IG24-IG26)

We believe an option to sell product in the future for the same price that it is offered today could represent a material right even though the future price does not reflect a discount incremental to the range of discounts currently offered on the product if there is a expectation that the product price could rise, and the option protects the customer against the potential price increase. An example of this would be useful.

Concessions

In certain industries, entities will sometimes provide concessions to customers in the form of additional products or services that were not originally included in the contract for no additional consideration. Where there is a past history of providing such concessions and indicators are present that the practice could occur in the future, it is unclear from the guidance how this risk would be considered with respect to revenue recognition. We recommend that additional guidance be provided in this regard.

Gross versus net recognition

We believe that for purposes of allocating revenue to performance obligations in a transaction that includes one or more agency performance obligations, the stand alone selling prices and transaction price should be based on the net amounts to be retained by the entity instead of the gross selling prices paid by the customer. We suggest that this be clarified in the Proposal.

In-substance real estate

As a practical matter, we suggest the Board consider the interaction of the proposed scope of the Proposal, which defines revenue in terms of sales with customers, and EITF Issue No. 10-E, Deconsolidation of a Subsidiary That Is In-Substance Real Estate. The Task Force's tentative conclusion at the September 2010 meeting affirmed the view of some practitioners that the guidance in Subtopic 360-20 applies to more than strict sales of real estate, for example, the transfer of real estate to a creditor in connection with foreclosure proceedings—which is neither a sale, nor a transaction with a customer. If that tentative consensus is ultimately ratified by the Board, it would appear to be inconsistent with the Proposal's scope of sale transactions with customers. While the Proposal contemplates non routine sales of real estate in paragraphs BC249 to BC250, its scope would appear to narrow



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range of transactions that some practitioners believe are addressed by Subtopic 360-20. Since the Proposal would also supersede Subtopic 360-20 and exclude certain real estate transfers from the revenue recognition literature, the potential exists for the Board to provide two different answers on the same issue in a relatively short timeframe. We would prefer the Board to provide a single, consistent answer on this scoping question, if possible.

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