



March 2, 2012

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116
Attn: Technical Director
(File Reference No. 2011-230)

Thank you for the opportunity to comment on the Proposed Accounting Standards Update (Revised) entitled "*Revenue Recognition (Topic 605): Revenue from Contracts with Customers*".

Hereafter, we will refer to this document as the "Updated Proposal".

On balance, we support the guidance described in the Updated Proposal and believe it represents an improvement to existing U.S. and international accounting standards.

However, we are concerned that the proposed rules will dilute certain "tollgates" that were developed over the years and were designed to prevent revenue recognition abuses. We also feel that there are certain conclusions reached in the Updated Proposal that should be reconsidered, particularly in relation to the accounting for variable consideration and the recognition of the time value of money in the transaction price. In addition, while we laud the objective of eliminating boilerplate disclosure, we feel that the Updated Proposal perhaps errs too much on the side of overly voluminous (and frankly overwhelming) disclosure requirements. Finally, we believe that further clarification on several other operational aspects of the Updated Proposal would be beneficial prior to issuing a final accounting standards update.

We would be pleased to discuss any aspect of our letter in more detail. If you have any questions, feel free to contact Scott Ehrlich, President and Managing Director of Mind the GAAP, LLC, at +1 (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

1. Weakening of Existing Tollgates Preventing "Form over Substance" Revenue Recognition

We understand that in developing the principles underlying the 2009 Discussion Paper, as well as the initial proposed Accounting Standards Update in 2010, the FASB and IASB essentially started with a "clean sheet of paper". That is, the Boards tried to develop a revenue recognition model independent of existing standards.

While we appreciate that approach, we do remind the Boards of the famous quotation from the poet and philosopher George Santayana: "Those who cannot remember the past are

Making the complex understandable



condemned to repeat it". In other words, let's not lose sight of why some of the existing rules were originally developed. For instance, long-standing SEC regulations¹ around "bill and hold" sales were designed to curtail widespread, yet improper, revenue recognition practices. Additional rules were introduced through the years to eliminate other perceived loopholes in the standards.

Our concern is that the principles-based nature of the Updated Proposal in essence will dilute many of the anti-abuse provisions that currently exist in U.S. GAAP. As a result, we could see an increase in the number of "form over substance" arrangements designed purely to accelerate revenue recognition, perhaps through channel stuffing or other means.

We recommend that the Boards consider strengthening the proposed guidelines to mitigate the potential for abusive transactions, focusing on the following areas:

- *Bill and hold arrangements:* In contrast with existing SEC guidelines, the Updated Proposal would allow for revenue to be recognized in a bill and hold transaction prior to physical delivery of the ordered goods to the customer, provided the conditions in IG53 are met.
 - Those conditions seem to focus on whether the arrangement *legally* transfers control of the goods to the customer, despite the vendor maintaining physical possession of them.
 - The conditions do not, however, consider whether the customer obtains significant risks and rewards of ownership, consistent with the transfer of control indicator added to the Updated Proposal in paragraph 37(d).

Recommendation: At a minimum, we would ask that the Boards reemphasize the "risk and rewards" notion as part of the criteria in IG53 for revenue recognition from bill and hold sales, particularly in light of the commercial realities surrounding many of these arrangements. More desirably, though, we would prefer that the Board explicitly state that transfer of control for bill and hold transactions cannot occur prior to physical delivery of the goods to the customer.

- *Reverse residual allocation method:* Paragraph 73(c), as supported by paragraphs BC181 and BC182, allows for a reverse residual method to allocate the transaction price to separate performance obligations when the standalone selling price of an undelivered good or service is highly variable or uncertain. Previous U.S. standard-setters have

¹ See In the Matter of Stewart Parness, AAER 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., et al, LR 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER 971 (September 30, 1997); In the Matter of Cypress Bioscience Inc., AAER 817 (September 19, 1996).

Making the complex understandable

banned this method because it could cause misleading financial results or lead to potential abuse.² This is because:

- Most bundled arrangements contain bulk discounts.
- Under a reverse residual method, the *entire discount* ends up being allocated to the undelivered element in an arrangement, resulting in artificially higher revenues when the first performance obligation(s) are completed.

Recommendation: We recommend that the Boards prohibit the use of the reverse residual method in allocating arrangement consideration. In fact, we would strongly prefer that arrangement consideration always be allocated using the current U.S. GAAP methodology outlined in ASU 2009-13, “*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*”. These guidelines, which were recently adopted in the U.S., appear to be working well for both financial statements users and preparers. This is true even when contract deliverables comprise intellectual property and other intangible products, which were specified as examples in BC182 supporting the reverse residual approach. In sum, the benefits of allowing for a reverse residual method do not seem to outweigh the costs of having U.S. companies once again switch their accounting processes, along with introducing the added risk of inappropriately front-loading revenue recognition.

- *Sales to distributors*: Commercially, selling to distributors is fraught with risk. The price a distributor might pay for delivered goods is subject to adjustment for rebates or other reasons (concessions, price protection, etc.). In addition, distributors often have generous stated or unstated return privileges.
 - Because of these uncertainties, existing U.S. GAAP guidelines contain criteria designed to prevent abusive revenue recognition practices when selling to distributors³, such as channel-stuffing.
 - Accordingly, many sales to distributors are currently accounted for using a “sell-through” model, which defers revenue until the product has been transferred all the way through the sales chain to the end user.
 - In contrast, the Updated Proposal may cause many entities to use a “sell-in” model, in which revenue is recognized upon delivery of product to the

² AICPA Statements of Position 97-2 “*Software Revenue Recognition*” and 98-9 “*Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*”, as well as EITF Issue No. 00-21 “*Revenue Arrangements with Multiple Deliverables*”.

³ SAB Topic 13A(4)(b), “*Revenue Recognition, Selected Revenue Recognition Issues, Fixed or Determinable Sales Price, Estimates and Changes in Estimates*”.

distributor; simply, this is the point when “control” of the product is transferred by the vendor to the customer.

Recommendation: As with our earlier concerns about bill and hold transactions, we believe there needs to be more emphasis around the transfer of risk and rewards indicator (paragraph 37(d) of the Updated Proposal) when assessing whether control over goods has been transferred to a distributor. In addition, the Boards should consider adding an example into the Implementation Guidance that highlights how certain factors could lead to a conclusion that risks and rewards, and therefore control over goods, has not transferred to a distributor despite physical delivery of goods. Such factors could include excess levels of inventory in the distribution channel, the introduction of competitors' products with superior technology or greater expected market acceptance, or other considerations set out in Question 1 of SAB Topic 13A(4)(b), *“Revenue Recognition, Selected Revenue Recognition Issues, Fixed or Determinable Sales Price, Estimates and Changes in Estimates”*.

2. “Reasonably Assured” Contingent Revenues

For contracts that include variable consideration, paragraphs 53-57 of the Updated Proposal require the transaction price to include either the expected value or most likely amount of revenues. At the same time, paragraphs 81-85 of the Updated Proposal cap the amount of cumulative revenues that can be recognized for contracts with variable consideration at a “reasonably assured” amount.

In combination, these paragraphs result in an unwieldy process that is operationally complex. Public entities will have to calculate quarterly estimates for both variable consideration and reasonably assured amounts, only to have the latter estimate trump the former when it comes to actually recognizing revenue.

In addition, we are not sure whether the notion of “reasonably assured” can be implemented consistently across companies and industries. Even after considering the guidance set out in paragraphs 81-83 of the Updated Proposal, it seems quite subjective as to whether an entity has sufficient predictive experience to decide how much contingent revenue is “reasonably assured”. The fact that the Boards considered it necessary, in paragraph 85, to specifically deem sales-based royalties as not “reasonably assured” suggests a lack of confidence as to whether the requirements in paragraphs 81-83 are sufficiently well-defined. Said another way, we cannot understand how performance bonuses could potentially be considered reasonably assured of entitlement, whereas economically similar sales-based royalties cannot.

Making the complex understandable



Nevertheless, we appreciate and understand what the Boards were trying to achieve in limiting revenue recognition when there are measurement uncertainties due to variable consideration.

In lieu of the guidelines in paragraphs 53-57 and 81-85 of the Updated Proposal, though, we believe that the measurement outcome desired by the Boards could be much more simply and efficiently achieved by retaining current U.S. GAAP guidelines around contingent revenues. Simply, contingent or variable revenues *would not be reflected in the transaction price* until the contingency is resolved.

We note that this approach will produce exactly the same result as outlined in Example 12 (Scenarios 1 and 2) and Example 13 in the Updated Proposal, and is far simpler to operationalize. It is also familiar to U.S. practitioners and would not result in any changes to policies or procedures. Therefore, we would urge the Boards to simplify this aspect of the Updated Proposal in accordance with our suggestions.

3. Incorporating Time Value of Money in Revenues

We do not agree that revenues should be adjusted for the time value of money, as the application of this principle will be confusing for users of the financial statements.

To demonstrate, Example 9 of the Updated Proposal provides an example in which the aggregate revenues recognized total \$42,685 above and beyond the \$150,000 contracted amount that was actually invoiced to and received from the customer.

- Financial statement users will surely be confused as to why an entity is entitled to recognize nearly 30% more revenues than it contractually allowed to bill. In addition, the operating section of the cash flow statement will diverge even further from the statement of operations, resulting in larger adjustments to reconcile net income to cash provided by operating activities. Again, we're not sure how investors and other financial statement users benefit from this outcome, and arguably will be confused by it.
- We recognize that users of the financial statements want information regarding the timing of cash flows, liquidity, and solvency. However, we do not believe that this information would be obtained by virtue of inflating revenues for payments received in advance. Instead, investors (as they always have) should continue to look to the statements of financial position and cash flows, as well as in the footnotes, in making this assessment.

Moreover, financial statement *preparers* will surely find it operationally complex and tedious to incorporate the time value of money into their revenue calculations, particularly for long-term service agreements that can have durations of 25 years or more.

Making the complex understandable



In short, the guidelines in paragraphs 58-62 of the Updated Proposal could be both costly to financial statements preparers and misleading to financial statements users. Therefore, our strong preference is for the Boards to eliminate the concept of the time value of money from the Updated Proposal.

Note: We have twice made this recommendation in previous comment letters, but the time value of money concept continues to be retained by the Boards (although we recognize that a one-year practical expedient and language clarifying when a financing component is significant was added to the Updated Proposal). Therefore, we accept that the Boards may be unwilling to abandon the concept. In this circumstance, and as a compromise, we'd ask that the Boards allow entities to make an accounting policy election around whether or not to incorporate the time value of money into revenues. For those entities that do choose to do so, the effects of any financing component on revenues and interest expense should be disclosed.

4. Incorporating the Time Value of Money in Costs

If the Boards do decide to retain the concept of the time value of money in revenues, we strongly suggest that the Boards also allow entities to consider the time value of money on contract costs.

In practice, vendors will sometimes manage the economic risks (including financing components) of long-term contracts with customers by negotiating corresponding terms and conditions with their subcontractors and suppliers. In these situations, it would seem inconsistent for entities to incorporate the time value of money into revenues without also considering how the time value of money impacts the costs of fulfilling those contracts.

Again, our preference is to completely eliminate the notion of the time value of money from the Updated Proposal. But if it is retained, we feel that it should be equally applicable to both the revenues earned, and cost incurred, under a contract.

5. Decision Process for Identifying Performance Obligations

The Updated Proposal suggests that entities should first analyze their contracts under paragraph 28 to identify distinct goods and services, before determining whether these goods and services should be bundled under paragraph 29. However, our understanding is that entities should first evaluate whether goods and services should be bundled, before determining whether performance obligations within the contract(s) are distinct. Therefore, we suggest swapping the ordering of the guidance in paragraphs 28 and 29 to better match the decision process for identifying distinct performance obligations.

Making the complex understandable



6. Anticipated Effect on Existing Patterns of Software Revenue Recognition

Over the life of the joint revenue recognition project, the Boards have worked closely with representatives from the construction industry to better operationalize the guidance in the Updated Proposal. We feel that the same level of diligence may be necessary to ensure the guidelines in the Updated Proposal can work with existing practices in the software industry.

Example. Assume a software vendor sells off-the-shelf software packages. The packages include licenses that are each bundled with one-year of PCS. The PCS consists of (a) publishing free patches on a central website to fix bugs, (b) offering 24 x 7 phone support, and (c) providing unspecified software upgrades that might occur during the PCS period.

Based on the guidance in paragraphs 28 and 29 of the Updated Proposal, we would conclude that each of the three PCS components is distinct because:

- Vendors of off-the-shelf software do not provide a significant integration, modification, or customization services
- The customers can benefit from each service individually.

Therefore, the guidelines in the Updated Proposal would increase the number of units of account compared to current practice.

In short, we believe the new guidance could significantly change how units of account are identified, and revenues are recognized, in the software revenue industry. While we don't necessarily disagree with the proposed changes, we did want to make sure that the Boards' outreach activities have included companies operating in this industry, as the impact of the Updated Proposal will likely be significant to such enterprises.

7. Interaction between Valuation of Revenue and Impairment Model for Financial Assets

According to the Updated Proposal, credit risk will not affect the recognition or measurement of revenue; instead, credit risk will be considered as part of a separate impairment analysis of the related trade receivable (and any impairment losses should be presented as a separate line item adjacent to revenues).

As of the date of this letter, though, the Boards have yet to finalize the credit impairment model for financial assets, including trade receivables. Without understanding how trade receivables will be tested for impairment, it is difficult for us to form a view on the appropriateness of the

Making the complex understandable



Boards’ revenue recognition and measurement proposals (i.e., an approach that excludes consideration of customer credit risk).

Example. Assume that a seller transfers control of a good to a customer and invoices \$100 per the contract terms. However, the seller only expects a 60% probability of collecting the \$100 receivable, due to the customer’s credit risk.

- Under existing guidance, the seller would not record any revenue at the time of transfer, as collectability is not reasonably assured.
- In contrast, under the guidance in the Updated Proposal, the seller would disregard the customer’s credit risk and record revenues of \$100. At the same time, however, the Updated Proposal also requires the seller to calculate the impairment loss arising from the customer’s credit risk, and to present this impairment loss adjacent to the revenue of \$100.
- It is unclear as to whether the impairment loss – to be presented adjacent to the revenue line in the income statement – would be calculated at \$100, \$40, or some other amount, as the impairment rules for financial assets (including trade receivables) have yet to be finalized.

We encourage the Boards to continue progress around the joint financial instruments project so that practitioners and users can evaluate how the impairment of trade receivables arising from contracts with customers will interplay with the Boards’ revenue recognition proposals.

8. Incremental Costs of Obtaining a Contract

We generally agree with the principles set forth in paragraphs 94-97 of the Updated Proposal around contract acquisition costs. However we are unsure as to how to apply these principles to situations where an incremental cost cannot be specifically identified to just one contract.

Example. An entity agrees to pay its sales person a commission of \$10,000 if the sales person obtains \$1 million or more of new contracts in a calendar year. Assume that the sales person does successfully execute two new long-term customer contracts:

	Contract Value	Contract Duration
May Contract	\$ 500,000	3 years
September Contract	\$ 750,000	5 years
	<u>\$1,250,000</u>	

Making the complex understandable



As the sales target has been met, the entity pays its sales person \$10,000 in sales commission. Further assume that the \$10,000 sales commission is reflected in the pricing of both contracts and expected to be recovered from the profits to be generated under those agreements.

We are uncertain as to what portion, if any, of the \$10,000 sales commission should be capitalized as an incremental cost of obtaining a contract, given that this commission is not specific to one single contract. The alternatives could include:

1. Apportioning the \$100,000 sales commission to the May and September contracts based on relative contract value, and amortizing the allocated amounts over the respective terms of each contract.
2. Assigning in its entirety the \$100,000 sales commission to the September contract, as the entity would not have incurred the sales commission expense had the September contract not been achieved. The deferred cost would then be amortized based on the term of the September contract.
3. The entire \$100,000 sales commission is expensed, as it is not incremental to one single contract.

We therefore ask that the Boards clarify how paragraphs 94-97 of the Updated Proposal should be applied to the above fact pattern.

9. Onerous Contract Provisions

We disagree with the Updated Proposal that onerous contract provisions should be assessed (a) at the performance obligation level and (b) only for those obligations that will be satisfied over a period of time greater than one year.

In our view, investors and other users of financial statements are more interested in profitability of an individual contract, or group of contracts that meet the criteria for combination in paragraph 17 of the Updated Proposal. This simply reflects the commercial reality that contracts (or group of combined contracts) are negotiated and managed with a view to achieving an overall level of profitability.

For instance, a vendor may be willing to provide "18 months of free check-up services", whose value would be quite small as determined under paragraphs 70-80 of the Updated Proposal. However, the vendor is willing to take on this "onerous performance obligation" because the overall margin on the contract is very high.

Making the complex understandable



Where a contract or group of combined contracts is profitable as a whole, it simply does not make sense, or provide meaningful information to financial statement users, to “accrue in advance” for individual contract components that happen to be loss-making.

On a related note, we don’t understand why onerous performance obligations cannot arise on for contracts with performance obligations of less than one year in duration. We believe that all loss-making contracts (or group of combined contracts) are of great interest to investors. As such, it would be appropriate to record losses for every onerous contract, not just ones with remaining performance obligations to be performed over a period of one year or longer.

In sum, we urge the Boards to consider using a contract (or group of combined contracts) as the unit of account for determining onerous contract provisions. Moreover, the Boards should not provide exemptions for contracts with remaining performance obligations of less than one year in duration.

10. Excessive and Costly Disclosure Requirements

We acknowledge that existing disclosures around revenues are unsatisfactory.

However, we worry that the Updated Proposal goes too far in the opposite direction, and will result in disclosure overload for users of financial statements at a very significant cost to preparers of financial statements.

Our specific comments on each of the disclosure proposals are as follows:

- *Disaggregation of revenue (paragraphs 114–116):* We don’t feel that preparers should be burdened with additional costs of providing the disclosures proposed in paragraphs 114-116 when existing segment/geographic disclosures of disaggregated revenues already provide relevant information for users. Said another way, we’re not sure that the marginally incremental benefits of providing the disclosures in paragraph 114-116 outweigh the heavy costs of preparing this information.
- *Reconciliations of contract assets and contract liabilities (paragraph 117), and rollforward of capitalized contract costs (paragraph 128):* We don’t believe it is necessary to provide reconciliations of these working capital-type items that are created and consumed in the ordinary course of business. In our view, this information is of little significance to financial statement users, who similarly do not expect rollforwards for other working capital accounts (e.g., inventories and many accruals). Having said this, we do support the disclosure of impairment losses to highlight any unexpected declines in the recoverability of these accounts.

Making the complex understandable



- *Backlog of performance obligations (paragraph 119):* For both conceptual and practical reasons, we disagree with the proposal to disclose the revenue backlog for remaining performance obligations. The purpose of financial statements is to provide **historical information** about an entity's performance, financial condition, and cash flows. In contrast, backlog is a prospective disclosure, and one that will be difficult for independent accountants to audit. In addition, calculating backlog (as well as estimating the periods in which it will be realized as revenues) can be quite subjective, especially if there are contingencies around variable consideration to be resolved. Even in situations without variable consideration, adjustments for time value of money will cause the disclosed backlog amounts to be different from amounts actually received from customers. For all of these reasons, investors may be confused and possibly misled into expecting that reported backlog amounts will equal future reported revenues. Finally, it will be costly for reporting entities to track and group backlog by time bands, both during initial set-up as well as on an ongoing basis. On balance, it seems to us that the costs of providing this disclosure far outweigh any benefits that would be obtained.

11. Relief from Retrospective Application

While we appreciate the benefits of retrospective transition, we believe in this instance that reporting entities should be allowed to adopt the new guidelines on a prospective basis to all new or modified contracts after the effective date.

If reporting entities elect to apply a prospective method of transition, we believe they should provide disclosure in the year of adoption of what the revenues would have been under the old guidelines versus what was actually reported in the financial statements. This disclosure should be relatively easy for companies to prepare, and would provide good comparative information for users of the financial statements.

By the following year, reporting entities that apply a prospective method of transition would have two years of comparative information in the financial statements themselves. Admittedly, the third year of information (for SEC filers) would not be comparative, but we believe that investors and other financial statement users rarely make use of the third year of data anyway.

However, if the Boards decide to retain a retrospective adoption requirement, we suggest adding another practical expedient to paragraph 133 around the time value of money (again, assuming this concept is preserved in any final Accounting Standards Update). Specifically, the Boards should consider providing relief for contracts completed before the date of initial application that have a significant financing element. Instead, entities should be permitted to

Making the complex understandable



use the transaction price on the date the contract was completed. This would be similar to the relief provided in paragraph 133(b) for contracts with variable consideration.

12. Early Adoption

We agree with the IASB's position that entities should be permitted to early adopt any final revenue standard, given that a new comprehensive revenue standard will improve financial reporting.

The FASB should, likewise, permit U.S. companies to early adopt the guidance in final revenue standard.

As there are many new accounting standards expected in due course, we see no reason to force companies to delay implementation, particularly when they would prefer to spread out the tasks of operationalizing new revenue recognition, financial instruments, and leasing standards that are expected to be promulgated around the same time.

Making the complex understandable