

March 9, 2012

Ms. Susan M. Cospers
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2011-230

Dear Ms. Cospers:

McGladrey & Pullen, LLP is pleased to comment on the Proposed Accounting Standards Update (ASU), *Revenue Recognition (Topic 605), Revenue from Contracts with Customers, Revision of Exposure Draft Issued June 24, 2010* (the “revised ED”). Overall, we support the efforts of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (the Boards) to provide a single source of comprehensive guidance on revenue recognition. While we believe the revised ED represents a significant improvement over the original ED, we also believe further improvements are warranted. In that regard, we have included in this letter responses to each of the “Questions for Respondents” posed in the revised ED. In addition, after our responses to those questions, we have provided a number of other recommendations and suggestions for the Boards’ consideration.

A number of our responses and recommendations include requests for additional implementation guidance from the Boards. While we realize that the volume of implementation guidance can quickly become unwieldy if an attempt is made to address every conceivable variation in facts, we also believe that the implementation guidance plays a critical role in making the concepts understandable and in achieving consistent application of those concepts. We kept that balance in mind when considering whether we should recommend the Boards provide additional implementation guidance on a particular matter.

Comments on Questions for Respondents

Question 1: *Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognizes revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?*

We agree in concept with the guidance in paragraphs 35 and 36 regarding how to determine whether an entity transfers control of a good or service over time. However, we believe additional guidance should be provided either in paragraph 36 or the implementation guidance related to determining whether an asset has an alternative use to an entity. In this regard, we recommend that the following concepts from the basis for conclusions (paragraphs BC93 and BC94) be moved into the body of the ASU:

- In many cases, an asset will have an alternative use because it is a standard inventory-type item and the entity has discretion to substitute the item across contracts with customers.

- If an entity creates an asset that is highly customized for a particular customer, then the asset would be less likely to have an alternative use because the entity likely would incur significant costs to reconfigure the asset for sale to another customer (or would need to sell the asset for a significantly reduced price).
- In some cases (e.g., some real estate, software, or some manufacturing contracts), an asset might be standardized but yet still might not have an alternative use to an entity as a result of contractual or practical limitations that preclude the entity from readily directing the asset to another customer.

In addition, if the primary determinant of whether an asset has an alternative use to an entity is whether the entity could readily direct the asset to another customer, then the notion of whether the entity could readily direct the asset should be explicitly discussed each time a determination is made about whether a good or service has an alternative use (similar to what was done in the last bullet point).

Question 2: *Paragraphs 68 and 69 state that an entity would apply Topic 310 (or IFRS 9, if applicable) to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?*

When a collectibility threshold (e.g., collectibility is reasonably assured) does not have to be met to recognize revenue, we agree that amounts assessed as uncollectible should be presented adjacent to revenue. While the model in the revised ED does not explicitly include a collectibility threshold, it is unclear as to whether a collectibility threshold implicitly exists as a result of the following discussion about the commercial substance of a contract in paragraph BC169: "Instead, the Boards propose to address concerns about collectibility by requiring the following: (a) The contract with a customer should have commercial substance (as discussed in paragraph BC34)...." If uncertainty with respect to collectibility can rise to a level that it draws into question whether the contract has commercial substance, we believe that point should be made in the body of the ASU instead of the basis for conclusions, and we believe further guidance should be provided to assist in determining the point at which collectibility risk is significant enough to conclude the contract lacks commercial substance. We are not proponents of a bright line being drawn, but rather factors provided that should be considered in assessing whether the level of uncertainty is great enough to conclude the contract lacks commercial substance.

We have the following further comments related to the guidance in the revised ED on collectibility:

- Paragraph 69 indicates: "If the contract does **not** have a significant financing component in accordance with paragraph 58, an entity shall present any impairment of the receivable (or change in the measurement of an impairment) in profit or loss as a separate line item adjacent to the revenue line item." [emphasis added] However, paragraph 69 does not go on to provide guidance on how an entity should present the impairment of a receivable recognized in conjunction with a contract that **does** have a significant financing component. We believe that guidance should be provided so that the revised ED discusses how an entity should present the impairment of all receivables that arise from contracts with customers. While there is some discussion in paragraph BC175 on how to present the impairment of a receivable arising out of a contract with a significant financing component, we believe that discussion needs to be clarified and, along with an example, included in the body of the ASU (e.g., in paragraph 69 or the implementation guidance) rather than in the basis for conclusions.

- Paragraph 69 indicates that uncollectible amounts should be presented in profit or loss as a separate line item adjacent to the revenue line item. We believe some may interpret this guidance to mean uncollectible amounts should be presented as contra revenue. Regardless of whether that was the Boards' intent, the guidance should be clarified and an example provided to illustrate how uncollectible amounts should be presented on the income statement. If the Boards' intent was to present uncollectible amounts as contra revenue, we believe the Boards should allow parenthetical presentation of the uncollectible amounts next to revenue on the income statement (e.g., "Revenue [net of uncollectible amounts of \$XXX].") In addition, we believe the Boards should address how the uncollectible amounts should be presented to the extent an entity presents more than one revenue line on its income statement (e.g., products and services). In other words, should uncollectible amounts be presented as an aggregate amount or should there be uncollectible amounts for each revenue line presented on the income statement?

Question 3: *Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognizes to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognize for satisfied performance obligations? If not, what alternative constraint do you recommend and why?*

We agree in concept with a constraint that limits the cumulative amount of revenue recognized to the amount to which the entity is reasonably assured to be entitled. However, we propose an alternative approach to the constraint captured in paragraph 85 for consideration based on the customer's subsequent or future sales of a good or service (e.g., a sales-based royalty). We also request clarification of, or additional guidance on, certain concepts integral to the overall constraint (i.e., highly susceptible and long period of time).

Constraint on variable consideration based on customer's subsequent or future sales

Paragraph 85 indicates that if an entity licenses intellectual property and there is variable consideration based on the customer's subsequent sales of a good or service, the entity is not reasonably assured to be entitled to that variable consideration until the uncertainty is resolved (i.e., the customer's subsequent sales occur). In short, this guidance is prohibiting the recognition of certain variable consideration until the uncertainty is resolved. Paragraph BC203 provides explanation for why this prohibition was provided:

For instance, with many sales-based royalties, an entity's performance occurs at the beginning of the contract, but the amount of consideration is based on the customer's subsequent sales of goods or services. In those cases, both users and preparers thought that it would not be useful for an entity to recognize revenue at the inception of the contract for the total amount of the consideration to which the entity expects to be entitled. That is because that approach inevitably would require the entity to report, throughout the life of the contract, significant adjustments to the amount of revenue recognized at inception of the contract as a result of changes in circumstances. For those contracts, users and preparers explained that the most useful information would be to recognize revenue when there is no longer uncertainty about the amount of consideration to which the entity is entitled. To address those concerns, the Boards decided that for the circumstances described in paragraph 85 an entity should not recognize revenue for the uncertain amounts until the uncertainty is resolved (that is, when the customer's subsequent sales occur).

With respect to the guidance on prohibiting an entity from concluding that it is reasonably assured of being entitled to sales-based royalties on licenses of intellectual property, we have the following questions and concerns:

- Why does this prohibition apply only to licenses of intellectual property? In other words, why is this prohibition necessary for licenses of intellectual property with sales-based royalties but not for sales of goods or services for which some or all of the consideration is based on future sales of the customer?
- Why does the volatility or uncertainty associated with sales-based royalties on intellectual property licenses warrant exclusion from the financial statements? In other words, why is it appropriate to reflect the volatility or uncertainty associated with other aspects of the guidance in the revised ED (e.g., changes in expectations about other variable consideration) and other accounting topics in the *FASB Accounting Standards Codification* (the Codification or ASC), but not appropriate to reflect the volatility or uncertainty associated with changes in these sales-based royalties?
- Why should sales-based royalties on intellectual property licenses that may effectively represent deferred payment terms (because the likelihood of the entity being entitled to them is high) be excluded from revenue until the customer's future sales occur? In other words, why should different accounting result in the following two situations: (1) the customer pays \$1.2 million for a license of intellectual property at the initiation of a one-year contract, and (2) the customer enters into a one-year contract and will pay 1% of its revenues per month (up to a maximum of \$100,000 per month) on a product that includes the intellectual property, and the entity can reliably estimate the monthly payments due from the customer to be \$100,000 based on its past experience and expectations (as evaluated under paragraphs 81 through 83) that the customer's sales will be well in excess of \$10 million per month?
- Why would an entity that sells insurance policies on behalf of an insurance company be in a better position to estimate the renewal rate of the insurance company's policyholders (see Example 14 in paragraph IG71) than an entity that licenses intellectual property would be in to estimate its customers' sales of a product or service that incorporates the intellectual property? In other words, what is the rationale for having the prohibition in the case of licenses of intellectual property with sales-based royalties but not having the prohibition in the case of the entity that sells insurance policies with variable consideration based on the renewal rate of the insurance company's policyholders?

In general, we can see that there would be some (perhaps even many) situations in which an entity would not be able to conclude that it is reasonably assured to be entitled to a sales-based royalty on the license of intellectual property. However, we can also see situations in which an entity would be able to conclude the opposite. We believe that instead of including the prohibition in paragraph 85, the Boards should provide examples in the implementation guidance that illustrate: (1) a situation in which an entity is not able to conclude it is reasonably assured to be entitled to a sales-based royalty and (2) a situation in which an entity is able to conclude it is reasonably assured to be entitled to a sales-based royalty.

Meaning of "highly susceptible" as it is used in the constraint

Paragraph 82(a) indicates if the amount of consideration to which the entity will be entitled is highly susceptible to factors outside the entity's influence, then the entity's experience (or other evidence) may not be predictive of the amount of consideration to which the entity will be entitled. We understand that susceptible is used in other areas of the Codification when evaluating the reliability of

an estimate. However, it is not clear when an entity should conclude that an estimate is susceptible versus highly susceptible to a particular factor. In addition, we are not certain that the “bar” in paragraph 82(a) needs to be set at “highly” susceptible. If the intention was to set the bar higher in paragraph 82(a), then we believe additional guidance should be provided on what would constitute a high level of susceptibility.

Meaning of “long period of time” as it is used in the constraint

Paragraph 82(b) indicates if the uncertainty about the amount of consideration is not expected to be resolved for a long period of time, the entity’s experience (or other evidence) may not be predictive of the amount of consideration to which the entity will be entitled. In Example 14 in paragraph IG71, the uncertainty about the amount of consideration to which the entity is reasonably assured of being entitled is not expected to be completely resolved for 4.5 years. We believe it would be instructional to include within Example 14 a discussion regarding how paragraph 82(b) was analyzed with respect to the 4.5 year resolution period. We believe it would also be instructional to include an example in which a lengthy period of time to resolution draws into question whether the entity’s experience (or other evidence) is not predictive of the amount of consideration to which it will be entitled.

Question 4: *For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognize a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?*

Level at which onerous test is performed

In general, we believe the onerous test should be performed at the contract level instead of the performance obligation level. If contracts are combined as a result of applying the guidance in paragraphs 16 and 17, we believe the onerous test should be performed at the combined-contract level. Our primary reason for believing the onerous test should be performed at the contract level is that if the onerous test is performed at the performance obligation level, it is possible that an onerous liability and loss will be recognized for a performance obligation that is part of a contract that is not onerous in its entirety. When negotiating a contract, an entity is likely not evaluating the economics of each performance obligation because that phrase is an accounting-specific convention that might not even be relevant when the terms of a contract are being negotiated with a customer. Instead, the entity is likely evaluating the overall economics of a contract or perhaps even a group of contracts. To require the onerous test to be conducted at the performance obligation level instead of the contract level creates an unnecessary inconsistency between the accounting for and the economics of a contract.

We also believe the FASB should reconsider providing an alternative model for entities that: (a) enter into a large volume of homogenous contracts within a relatively short period of time (i.e., a pool of contracts) and (b) apply a business model to these contracts that is based on spreading the related risk over the pool of contracts. For example, an insurance agency that sells travel insurance policies on behalf of an insurance company sells hundreds (if not thousands) of similar individual policies within a specific month. If a claim is submitted on an individual policy, the rebooking and related costs incurred to process the claim would exceed the commission earned on that individual policy. The insurance agency’s business model is based on spreading the loss on that individual policy and the related risk of providing its services over the pool of similar policies. Applying the onerous test at the policy level in this situation would produce an accounting result (i.e., losses on individual policies) that is inconsistent with the economic reality of a profitable pool of policies. To better align the accounting and economics in these situations, we believe it may be appropriate to perform the onerous test on a

large pool of homogenous contracts instead of individual contracts or separate performance obligations.

Excluding performance obligations satisfied over one year or less from the onerous test

We agree with excluding performance obligations that will be satisfied over a period of one year or less from the scope of the onerous test. However, it is not clear how the one-year-or-less threshold should be applied to performance obligations such as those in Example 25 in paragraph IG80. In that example, it appears the entity may either account for the customer contract as: (a) three separate performance obligations (those being the one-year contract and two one-year renewal options) or (b) one performance obligation (maintenance services provided over a three-year period). Should applying the one-year-or-less threshold result in the performance obligations in (a) not being subject to the onerous test because they are each satisfied over a period of one year? Should applying the one-year-or-less threshold result in the performance obligation in (b) being subject to the onerous test because that performance obligation is satisfied over a three-year period? Should whether the onerous test applies depend on how the entity elects to account for the customer contract?

If the Boards retain the onerous test at the performance obligation level, we believe implementation guidance should be provided to illustrate how the one-year-or-less threshold should be applied in Example 25 and other similar situations. If the Boards change the onerous test to the contract level, we believe implementation guidance should be provided to illustrate how contract renewals should be considered when determining whether a one-year contract with renewals exceeds the one-year-or-less threshold. We believe the implementation guidance on this subject should also illustrate how renewal fees would be treated in the onerous test.

Paragraph 86 suggests the determination as to whether a performance obligation will be satisfied over a period of time greater than one year should be made at contract inception. It is not clear to us why this determination should only be made at contract inception. In other words, if expectations about the period of time over which a performance obligation is going to be satisfied change after contract inception, why shouldn't that change in expectations affect whether the performance obligation is subjected to the onerous test?

Determining the amount an entity would pay to exit a performance obligation

Paragraph 87(b) refers to the amount that the entity would pay to exit the performance obligation if the entity is permitted to do so other than by transferring the promised goods or services. In most cases, we would expect the penalty for not transferring the promised goods or services to a customer to be at the contract level. In other words, the entity is typically obligated to pay a penalty to exit the contract not to exit an individual performance obligation. When a contract includes multiple performance obligations and a penalty for cancelling the contract, it is unclear how the amount referred to in paragraph 87(b) should be determined at the performance obligation level. If the onerous test is left at the performance obligation level, we believe the Boards should provide additional guidance and (or) an example illustrating how the amount in paragraph 87(b) should be determined when there are multiple performance obligations and a contract level cancellation penalty.

Question 5: *The Boards propose to amend Topic 270 and IAS 34 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial statements. The disclosures that would be required (if material) are:*

1. *The disaggregation of revenue (paragraphs 114–116)*
2. *A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)*

3. *An analysis of the entity's remaining performance obligations (paragraphs 119–121)*
4. *Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)*
5. *A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfill a contract with a customer (paragraph 128).*

Do you agree that an entity should be required to provide each of those disclosures in its interim financial statements? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial statements.

We understand that users of the financial statements would receive some benefit from entities disclosing the information captured in items 1 through 5. However, we also understand that capturing this information, including it in the financial statements, and having it included within the scope of a financial statement review (interim) or audit (annual) would increase the preparer's cost to issue financial statements on an interim or annual basis. We support outreach activities to bring users and preparers of financial statements together to discuss the disclosure requirements included in the revised ED and perhaps arrive at a set of disclosure requirements that strikes a reasonable balance between the benefits provided to users and the costs borne by preparers (and ultimately investors).

To the extent summarized financial data is provided on an interim basis, as discussed in FASB ASC 270-10-50-1, we believe the Boards should consider requiring the interim disclosures only in those situations in which there has been a significant change since the most recently issued annual financial statements. For example, if the movements in the aggregate balance of contract assets and contract liabilities on an interim basis are relatively consistent with the movements in the aggregate balance of contract assets and contract liabilities for the annual period included in the most recently issued annual financial statements, then the reconciliation of those assets and liabilities should not be required in the interim financial statements. However, if there was a significant change in the movements in the aggregate balance of contract assets and contract liabilities in the interim period, then the tabular reconciliation of those assets and liabilities should be required in the interim financial statements.

Question 6: *For the transfer of a nonfinancial asset that is not an output of an entity's ordinary activities (for example, property, plant, and equipment within the scope of Topic 360, IAS 16, or IAS 40), the Boards propose amending other standards to require that an entity apply (a) the proposed guidance on control to determine when to derecognize the asset and (b) the proposed measurement guidance to determine the amount of gain or loss to recognize upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement guidance to account for the transfer of nonfinancial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?*

We agree in concept with the assertion that the gain or loss on the transfer of a nonfinancial asset that is not an output of an entity's ordinary activities should be recognized and measured using the same guidance that is used to recognize and measure revenue on contracts with customers. However, it is difficult to contemplate the effects and repercussions of applying the revenue recognition guidance to the transfer of all nonfinancial assets that are not an output of an entity's ordinary activities. We are concerned that in the absence of implementation guidance addressing such transfers, the proposed requirements will be interpreted and applied by many entities in vastly

different ways. We believe this will particularly be the case with real estate sales as the revised ED would replace the very prescriptive guidance currently contained within FASB ASC 360-20.

For example, consider a situation in which a financial institution (FI) becomes the owner of real estate through repossession in foreclosure proceedings. FI provides financing to a third-party (TP), which enables TP to buy the repossessed real estate. In connection with the financing, TP makes a 5% down payment. TP's credit risk is similar to the credit risk of other borrowers to which FI routinely provides similar financing. We believe the guidance in the revised ED would apply to this situation given the FASB's intention for it to apply to the transfer of a nonfinancial asset that is not an output of an entity's ordinary activities. Areas where we believe further clarification is needed with respect to applying the recognition and measurement guidance in the revised ED to FI's sale of real estate (and other similar scenarios) relate to commercial substance (paragraph 14[a]), commitment to perform (paragraph 14[b]) and significant risks and rewards of ownership (paragraph 37[d]):

- **Commercial substance.** What factors should FI consider in determining whether the collection risks associated with TP rise to a level that draws into question the commercial substance of the contract? Is FI's business decision to finance TP's purchase of the repossessed real estate sufficient evidence in-and-of-itself of the commercial substance of the contract? Is TP's decision to only make an initial down payment of 5% an indication that the arrangement lacks commercial substance? Refer also to our response to Question 2.
- **Commitment to perform.** What factors should FI consider in determining whether TP is committed to perform on its obligation to pay the remaining 95% of the principal due for its purchase of the real estate? Is TP's initial down payment of only 5% an indication that he or she is not fully committed to making the remainder of the payments?
- **Significant risks and rewards of ownership.** What factors should FI consider in determining whether TP has taken on the significant risks and rewards of owning the real estate? Is TP's initial down payment of only 5% an indication that he or she has not assumed the significant risks and rewards of ownership and that FI still retains those risks and rewards? In other words, does TP's initial down payment demonstrate a sufficient commitment from the customer?

We believe the FASB should provide implementation guidance for this and other situations in which the recognition and measurement guidance in the revised ED would be used to account for the transfer of a nonfinancial asset that is not an output of an entity's ordinary activities. Implementation guidance for FI's situation would also be relevant when an entity's ordinary activities include transfers of real estate with similar terms because the same issues related to commercial substance, commitment to perform and risks and rewards of ownership arise in those situations. In other words, implementation guidance on commercial substance, commitment to perform and risks and rewards of ownership would have a much broader audience than just those entities for which a transfer of real estate is not an output of their ordinary activities.

Other Recommendations and Suggestions

Practical expedient for portfolio of contracts or performance obligations (par. 6)

Paragraph 6 provides a practical expedient that allows an entity to apply the guidance in the revised ED to a portfolio of contracts or performance obligations with similar characteristics instead of individual contracts or performance obligations provided that doing so would not result in a material difference. We do not understand the benefit of this practical expedient given that the guidance in the revised ED would need to be applied to the individual contracts or performance obligations to

determine whether the result of doing so is materially different from applying that guidance to a portfolio of contracts or performance obligations. The benefit of providing the practical expedient is significantly diminished by the fact that the entity has to apply the guidance the practical expedient is supposed to be providing relief from in order to determine whether using the practical expedient is appropriate. We believe the FASB should either remove the practical expedient or modify it such that it provides a more substantive benefit (i.e., base the ability to apply the practical expedient on something other than the materiality of the difference between following the guidance in the revised ED and electing the practical expedient).

Scope (par. 11)

In cases where a contract is only partially within the scope of the guidance in the revised ED, paragraph 11 states that an entity shall first apply the separation and measurement requirements of other applicable guidance in the Codification. We believe the guidance in this paragraph should be modified to specifically identify other applicable guidance in the Codification that includes separation and (or) measurement requirements.

Contract modifications (pars. 22 and IG61)

We believe the guidance in paragraph 22 would be clearer if the following changes were made (additions are underlined and deletions are struck-through):

22. For a contract modification that is not a separate contract in accordance with paragraph 21, an entity shall evaluate the remaining goods or services in the modified contract (that is, the promised goods or services not yet transferred at the date of the contract modification) and shall account for the modified contract in whichever of the following ways is applicable:
 - (a) If all of the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification, then an entity shall account for the contract modification as a termination of the original contract and the creation of a new contract. To do so, the entity shall allocate to the remaining separate performance obligations the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay. The amounts allocated to the remaining separate performance obligations shall be accounted for prospectively. ~~In effect, an entity shall account for the contract modification as a termination of the original contract and the creation of a new contract.~~
 - (b) If all of the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification, then the entity shall account for the contract modification as if it were a part of the original contract. To do so, the entity shall update the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity shall recognize the effect of the contract modification as revenue (or as a reduction of revenue) at the date of the contract modification on a cumulative catch-up basis. ~~In effect, the entity shall account for the contract modification as if it were a part of the original contract.~~
 - (c) If some of the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification and some are not distinct and are part of a single performance obligation that is partially satisfied at the date of the contract modification, ~~a combination of items (a) and (b),~~ then the entity shall allocate to the unsatisfied (including partially unsatisfied) separate performance obligations the amount of consideration received from the customer but not yet recognized as revenue plus the amount of any remaining consideration that the customer has promised to pay. For a performance obligation satisfied over time, an entity shall update the transaction price and the measure of progress toward complete satisfaction of the performance obligation. An entity shall not reallocate consideration to, and adjust the amount of revenue recognized for, separate performance obligations that are completely satisfied on or before the date of the contract modification.

Furthermore, we believe the guidance in paragraph 22(c) should be clarified with respect to the accounting effects of updating the transaction price and the measure of progress toward complete satisfaction of a performance obligation satisfied over time. In paragraph 22(b), the accounting effects of updating the transaction price and the measure of progress toward completion are reflected in an adjustment to revenue on a cumulative catch-up basis. It is not clear whether the same accounting effects should result from applying the guidance in paragraph 22(c). In addition, we found the implementation guidance in paragraph IG61 helpful in understanding how to account for fact patterns within the scope of paragraphs 22(a) and 22(b). For that reason, we believe additional implementation guidance should be provided for fact patterns within the scope of paragraph 22(c).

Identifying separate performance obligations (pars. 30 and IG70)

Paragraph 30 provides a practical expedient that allows an entity to account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer. In Example 13 in paragraph IG70, an entity enters into a contract with a client to provide asset management services for one year and receives a quarterly management fee and an annual incentive fee (which is variable). The solution for the example states that even though each increment of service is distinct in accordance with paragraphs 28 and 29, the entity accounts for the contract as a performance obligation to provide investment management services for one year because the services have the same pattern of transfer to the customer. We believe information related to the following questions should be provided in the example: (a) what is an increment of service; (b) why is each increment of service distinct; and (c) what constitutes the same pattern of transfer to the customer? Also, it appears the primary purpose of Example 13 is to illustrate the guidance on constraining the cumulative amount of revenue recognized and not how the practical expedient in paragraph 30 should be applied. As such, we believe the practical expedient aspect of this example should be moved to a separate example solely dedicated to illustrating the guidance in paragraph 30.

A related issue is how separate performance obligations should be identified when there is a multi-year or multi-period contract. For example, consider a situation similar to Example 13, except the contract with the customer spans three years and there is an incentive fee due at the end of each year. In this situation, does the entity have: (a) three one-year performance obligations or (b) one three-year performance obligation? Does the support for concluding there is one three-year performance obligation rest on the entity meeting the conditions in paragraph 30 and electing to apply the practical expedient? We believe additional implementation guidance should be provided to address the identification of separate performance obligations when the entity provides services such as those provided in Example 13 in conjunction with a multi-year or multi-period contract.

Input methods (pars. 46 and IG65)

If certain conditions are present, paragraph 46 indicates the best depiction of the entity's performance when applying an input method to a separate performance obligation that includes goods that the customer obtains control of significantly before receiving services related to those goods may be for the entity to recognize revenue for the transferred goods in an amount equal to the costs of those goods. We find this guidance conceptually inconsistent with other guidance in the revised ED. The reason an input method is necessary is to measure progress toward complete satisfaction of a performance obligation. To get to the point where an input method is being identified, the decision has already been made (based on applying the guidance in the revised ED on identifying and separating performance obligations) that the transferred goods referred to in paragraph 46 are not a separate performance obligation. However, paragraph 46 essentially treats those transferred goods as a separate performance obligation and provides a different model for allocating the transaction price to those goods (i.e., allocate an amount equal to the cost of those goods). In addition, we find

the approach taken to account for the transferred goods in paragraph 46 inconsistent with the guidance on setup activities in paragraph 25, which indicates setup activities do not represent a separate performance obligation. If setup activities do not represent a separate performance obligation, why would the transferred goods referred to in paragraph 46 represent a separate performance obligation?

One basis raised in paragraph BC122 for providing the guidance in paragraph 46 is that it eliminates the problem of what to do with the cost of the transferred goods because it would be inappropriate for the entity to continue to reflect the goods as inventory when the customer has obtained control of the goods. We believe a similar problem was effectively addressed in the revised ED related to product returns. We believe the problem related to the accounting for the costs of the transferred goods referred to in paragraph 46 could be addressed in a similar manner.

Another basis raised in paragraph BC122 for providing the guidance in paragraph 46 is that it solves the dilemma of having to choose between either recognizing a contract-wide profit margin on the transferred goods or a profit margin specific to the transferred goods that is different from the contract-wide profit margin. We do not believe recognizing a zero profit margin solves this dilemma because a zero profit margin is, in fact, establishing a profit margin specific to the transferred goods that is different from the contract-wide profit margin.

For all of these reasons, we believe the guidance in paragraph 46 should be replaced with guidance indicating the cost of the goods referred to in that paragraph should not be included in an input method based on costs (e.g., cost-to-cost method) until the customer receives substantive services related to those goods. If the guidance in paragraph 46 is changed, corresponding changes should be made to Example 8 in paragraph IG65. If the guidance in paragraph 46 is retained, guidance should be provided regarding how the goods referred to in that paragraph should be accounted for if the conditions in that paragraph are not satisfied or if the entity decides that the best depiction of the entity's performance is not to recognize revenue for the transferred goods in an amount equal to the costs of those goods.

Reasonable measures of progress (par. 48)

Paragraph 48 addresses situations in which an entity may not be able to reasonably measure the outcome of a performance obligation, but expects to recover the costs incurred to satisfy it. In those situations, an entity recognizes revenue to the extent of costs incurred until: (a) it is in a position to reasonably measure the outcome of the performance obligation or (b) the performance obligation becomes onerous. We believe paragraph 48 should also address a situation in which the entity can neither reasonably measure the outcome of a performance obligation nor conclude that it expects to recover the costs incurred in satisfying the performance obligation.

Variable consideration (par. 55)

One of the two methods discussed in paragraph 55 for estimating the transaction price when there is variable consideration is the most-likely-amount method. The guidance indicates the most-likely-amount method *may* provide an appropriate estimate of the transaction price if there are only two possible outcomes with respect to the variable consideration. This language implies there may be situations in which it is appropriate to use the expected-value method when there are only two possible outcomes. We could not envision such a situation. If one exists, we believe it should be included in an example in the implementation guidance. If one does not exist, we believe the language in paragraph 55 should be changed to indicate the most-likely-amount method should be used when there are only two possible outcomes with respect to variable consideration.

Furthermore, paragraph 55(b) is unclear as to whether the most-likely-amount method may be appropriate to use in situations in which there are more than two possible outcomes. We believe the first sentence in paragraph 55(b) suggests the most-likely-amount method may be appropriate to use in situations in which there are more than two possible outcomes while the second sentence in paragraph 55(b) suggests that it may be appropriate to only use that method in situations in which there are just two possible outcomes. In addition, we believe Example 20 in paragraph IG76 essentially uses the most-likely-amount method when there are 100 possible outcomes. We believe the language in paragraph 55(b) should be changed to more clearly capture the Boards' intent with respect to the situations in which it may be appropriate to use the most-likely-amount method.

Impairment of contract assets (par. 68)

We believe paragraph 68 indicates the guidance in paragraph 69 (i.e., classifying uncollectible amounts adjacent to revenue) applies to contract assets. However, paragraph 69 only refers to receivables and does not reference contract assets. We believe changes to paragraph 69 should be made to clarify that the guidance therein applies to contract assets.

Allocating the transaction price to separate performance obligations (pars. 73, 75, 76 and IG68)

Paragraph 73 provides guidance on how to estimate a standalone selling price that is not directly observable. While there is discussion of what constitutes an observable price prior to paragraph 73, there is no discussion of what constitutes a directly observable price. As such, we believe guidance should be provided on what constitutes a directly observable price or the language in paragraph 73 should be changed to apply to situations in which there is not an observable standalone selling price.

Paragraph 73(c) provides guidance on when and how to estimate a standalone selling price using the residual approach. The residual approach is described as taking the total transaction price and reducing it by the sum of the observable standalone selling prices of other goods or services promised in the contract. It is unclear to us whether the use of "observable standalone selling prices" in the description of the residual approach means that the residual approach cannot be used in situations where the standalone selling prices of the other goods or services promised in the contract were estimated using an adjusted market assessment approach or an expected cost plus a margin approach. If the residual approach cannot be used in these situations, we believe that should be stated explicitly within paragraph 73(c). If the residual approach can be used in these situations, we believe the residual approach should be described as taking the total transaction price and reducing it by the sum of the standalone selling prices of other goods or services promised in the contract.

Example 11 in paragraph IG68 illustrates how the guidance in paragraph 75 on allocating a discount should be applied. In the example, three products are sold to the customer (Product A, Product B and Product C). The practical expedient in paragraph 30 is relied upon to bundle Product A and Product B into one performance obligation for accounting purposes because they are transferred at the same time. Product C represents another performance obligation. With respect to the allocation of the transaction price to the two performance obligations that exist in Example 11, it is unclear as to why the guidance in paragraph 75 is needed to arrive at the answer provided. We believe the entity should arrive at the answer provided by applying the basic concepts in the revised ED that are applicable to allocating the transaction price. The standalone selling price of the performance obligation that includes Product A and Product B (which is considered a single performance obligation based on the practical expedient in paragraph 30 as Products A and B are transferred at the same time) is \$16 because that is what the entity charges customers when those products are sold as a bundle. The standalone selling price of the performance obligation represented by Product C is \$20. Using the relative standalone selling price model, the amount allocated to the performance obligation that includes Product A and Product B is \$16 ($\$36 \text{ transaction price} \times [\$16 \text{ standalone selling price} / \36

total standalone selling prices]) and the amount allocated to the performance obligation that includes Product C is \$20 ($\$36 \text{ transaction price} * [\$20 \text{ standalone selling price} / \$36 \text{ total standalone selling prices}]$). Based on the fact that the same answer is arrived at by applying the relative standalone selling price model to the two performance obligations identified in this example, we do not believe it illustrates the guidance in paragraph 75. To clearly illustrate how the guidance in paragraph 75 should be applied, we believe Example 11 should be changed so the practical expedient in paragraph 30 is no longer an option (i.e., Product A and Product B do not have the same pattern of transfer to the customer).

Paragraph 76 refers to contingent amounts while paragraphs 53 through 57 and 81 through 85 refer to variable consideration. If there is a difference between the contingent amounts referred to in paragraph 76 and the variable consideration referred to in the other paragraphs, we believe the guidance in paragraph 76 should be clarified to explain what differentiates contingent amounts from variable consideration. If there is not a difference between the contingent amounts referred to in paragraph 76 and the variable consideration referred to in the other paragraphs, we believe the language used in paragraph 76 should be changed to be consistent with the language in the other paragraphs.

Onerous performance obligations (par. 87)

Paragraph 87 indicates that one element of the lowest cost of settling a performance obligation is the direct costs the entity would incur to satisfy the performance obligation by transferring the promised goods or services. We believe that only incremental costs directly related to a performance obligation should be considered when determining the lowest cost of settling a performance obligation. If non-incremental costs are included in this determination, we believe there may be unintended consequences in which the signing of an otherwise profitable contract could result in a day-one onerous performance obligation. For example, an entity may enter into a low margin contract (when considering just the incremental costs to be incurred) in situations in which they currently have fixed labor with excess capacity. In addition, a development stage entity may enter into low margin contracts as it is ramping up its business. When considering other costs like the allocation of direct labor costs that are fixed, the lowest cost of settling a performance obligation may be in excess of the transaction price allocated to the performance obligation, which would result in recognizing an onerous performance obligation. However, if the entity does not sign the low margin contract, those same fixed labor costs would simply be recognized as an expense as incurred. As we believe this result does not reflect the economics of this type of transaction, we believe only the incremental costs should be considered when determining the lowest cost of settling a performance obligation.

Given that the direct costs the entity expects to incur to satisfy the performance obligation are expected to be incurred over a period of greater than one year and that the transaction price allocated to the performance obligation may reflect the time value of money, we believe guidance should be provided with respect to whether the direct cost estimates should be discounted for purposes of determining the lowest cost of settling a performance obligation. In general, we believe the time value of money should be treated consistently in the two amounts used to calculate an onerous performance obligation and related loss. Otherwise, a situation may arise where an onerous performance obligation is recognized solely because the transaction price allocated to the performance obligation reflects the time value of money while the direct costs the entity expects to incur to satisfy the performance obligation do not reflect the time value of money.

Paragraph 87 refers to paragraph 92 for a description of the costs that should be included in estimating the costs that relate directly to satisfying the performance obligation. While the unit of account for paragraph 87 is the performance obligation, the unit of account for paragraph 92 is the contract. We believe guidance specific to each unit of account should be provided because what is

considered a direct cost at the contract level might not be considered (or might not clearly correlate to) a direct cost at the performance obligation level. For example, paragraph 92(c) indicates that direct costs at the contract level might include allocated costs for contract management and supervision. It is not clear whether these costs should be further allocated to the performance obligation level and included in the estimated direct costs of satisfying a performance obligation. Providing separate guidance on what is considered a direct cost at the performance obligation level will eliminate the lack of clarity that arises in applying the contract level guidance in paragraph 92 to the performance obligation level guidance in paragraph 87.

Sale with a right of return (par. IG3)

Paragraph IG3 provides guidance on how to account for the transfer of products with a right of return and for some services that are provided subject to a refund. We believe the guidance should be more specific with respect to the services to which the guidance in paragraph IG3 should be applied. In addition, the supplemental guidance in paragraphs IG4 through IG9 focuses exclusively on accounting for product returns and not refundable service fees. We believe supplemental guidance specific to refundable service fees should be provided.

Customer loyalty program (par. IG79)

We believe the following sentence in Example 24 in paragraph IG79 should be clarified: "The entity expects 9,500 points to be redeemed on the basis of its past experience that it concludes is predictive of the amount of consideration to which it will be entitled." We believe the latter part of this sentence is confusing because the entity is reasonably assured to be entitled to \$100,000 regardless of the number of points expected to be redeemed. While the number of points expected to be redeemed is necessary for purposes of allocating the transaction price to each performance obligation, it is unclear how that number is predictive of the amount of consideration (or transaction price) to which the entity will be entitled.

We would be pleased to respond to any questions the FASB or its staff may have concerning our comments. Please direct any questions to Rick Day (563-888-4017) or Brian H. Marshall (203-312-9329).

Sincerely,



McGladrey & Pullen, LLP