Comments On

Preliminary Views on
Revenue Recognition in
Contracts with Customers

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The author of these comments, Humphrey Nash, is the author and proponent of AFTF: Accounting For The Future, a value based accounting and reporting model. This model is based on the Present Value of Expected Cash Flows (PVECF). More information on the model is available at the website:


The material available on the website should be considered as part of this submission. There are not included because of the volume and availability of those materials (they are on file in the FASB library and may be downloaded or printed from the website) but they are important to understanding the furnished comments, the limitations of current practices and the possibility for future improvements. In the comments that follow, quotes from the Exposure Draft are in the original Times Roman font. My comments use the Arial font. Underlining has sometimes been added to quotes for reference clarity.
Comments on the

SUMMARY AND INVITATION TO COMMENT

S1 Revenue is a crucial part of an entity’s financial statements. Capital providers use an entity’s revenue when analyzing the entity’s financial position and financial performance as a basis for making economic decisions. Revenue is also important to financial statement preparers, auditors, and regulators.

Revenue has been a traditional part of an entity’s financial statement but certainly not a crucial part, unless financial statements have become so traditional, so carved in stone, to preclude alternative financial statement presentations. It is not necessary for revenue (GAAP or otherwise) to be part of a meaningful or useful financial presentation.

Capital providers seldom use an entity’s revenue when analyzing the entity’s financial position and financial performance as a basis for making economic decisions. Most often, stock or bonds investors, analysts, management, and most accountants dealing with capital allocations use future net cash flows or their present value to make such decisions. The recent months (circa year end 2008) of stock market declines has been based not of past revenues but the prospects for future cash flows. I have unfortunately seen companies beat estimates (revenues and net profits) yet tumble with negative forward guidance. A strong case could be made that past revenues are not crucial or even determining to capital allocation decisions.

Revenue is important to financial statement preparers, auditors, and regulators because it is traditionally required. But even in the face of tradition and requirement, expressions other than revenue have become stronger contenders. Cash flow statements and forward looking statements are ascendant. For example, within the life insurance regulatory environment cash flow testing (based on future cash flows) has superseded historic revenues and expenses as the acid test.

If we start with faulty premises we may not optimize financial reporting.

S2 ... In U.S. generally accepted accounting principles (GAAP), revenue recognition guidance comprises more than a hundred standards—many are industry-specific and some can produce conflicting results for economically similar transactions, ...

It is inevitable that inconsistencies and conflicts develop when there is such a multiplicity of industry specific statements. Such statements are not worthy of being called standards. A standard must have some generality and must apply across industries. A statement like “Statement 73: Reporting a Change in Accounting for Railroad Track Structures” is not a standard.
It is inevitable that inconsistencies and conflicts develop when most FASB statements are prospective fixes for an accounting model that is essentially retrospective. The current GAAP model is fundamentally and fatally flawed. It will remain so as long as financial reporting is mired in the past.

S3 This Discussion Paper invites comments on the Boards’ preliminary views on a single, contract-based revenue recognition model. The Boards are developing that model to improve financial reporting by providing clearer guidance on when an entity should recognize revenue, and by reducing the number of standards to which entities have to refer. As a result, the Boards expect that entities will recognize revenue more consistently for similar contracts regardless of the industry in which an entity operates. That consistency should improve the comparability and understandability of revenue for users of financial statements.

This paragraph seems to assume that a contract-based model will emerge, of course after due input and deliberation. At this early reading stage I can’t imagine how such a model would be generally applied. In contrast, the more common practice of recognizing expected cash flows has great generality and is more easily imagined.

S4 Because the Boards are still developing the proposed model, this Discussion Paper does not include all the guidance that would be included in a proposed standard. Instead, this Discussion Paper presents the basic model and its implications in order to seek views from respondents before the Boards publish a proposed standard.

It is unclear whether a standard or the model is being developed. It seems that FASB is putting the cart before the horse by issuing contract-based standards before a general revenue recognition model has been studied. Or has that project been abandoned? If not this effort may be flushed.

Summary of preliminary views

Scope

S10 The proposed model would apply to contracts with customers. A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract. A customer is a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity’s ordinary activities.

It seems (at this stage) that revenue recognition is being equated with enforceable contracts. This narrows the concept of revenue considerably. There may be revenue other that contractual that is more certain than contractual arrangements. I understand the desire for a concrete auditable base for recognition but this audit convenience
doesn’t encompass and even conflicts with economic measures of value. It is these measures that are so desired and useful to end users.

S11 The Boards have not excluded any particular contracts with customers from the proposed model. However, ...

I was concerned that limiting revenue recognition to enforceable contracts was much too narrow an application. But it seems that leases, insurance (of some types) and derivatives are also excluded. These are difficult but important areas. If the model lacks the generality and robustness to encompass these areas it is a further indication of fundamental inadequacy.

S12 In future deliberations, the Boards will consider the implications of the proposed model for entities that recognize revenue or gains in the absence of a contract. For example, some entities recognize revenue or gains from increases in inventory before obtaining a contract with a customer (in accordance with AICPA Statement of Position 85-3, Accounting by Agricultural Producers and Agricultural Cooperatives, and IAS 41, Agriculture). In this project, the Boards do not intend to change the way that those entities measure inventory. However, the Boards will consider whether those entities should be precluded from presenting increases in inventory as revenue and should, instead, present those increases as another component of comprehensive income.

This is confusing. Earlier paragraphs indicated that the model would be contract-based. Excluding inventory value changes from revenue seems to restrict revenue to past income but this conflicts with the ostensible purpose of requiring an enforceable contract basis to enable recognition of future income as revenue. What is the purpose of extending that revenue model beyond its charter and then provide an example of its non-extension? Why distinguish between revenue and non-revenue comprehensive income? The shareholder is interested in all components of value. In fact, future cash flows are necessary and sufficient for shareholder decisions. In fact, revenues as defined (past income) are irrelevant, except to the extent that future cash flows can be extrapolated from them.

S13 The Boards plan to consider whether any contracts with customers should be excluded from the proposed model after reviewing comments on this Discussion Paper.

Perhaps contracted leases, insurance and derivatives? How about legally enforceable (presumably written) contracts with little hope or expectation of complete satisfaction? I think the intent is to base revenues on contract as a means of measuring, controlling and insuring satisfaction or expectation. But it is a poor substitute for using expectation directly. Another goal may be perceived auditing convenience.
Recognition
Contract-based revenue recognition principle

S14 The Boards propose that revenue should be recognized on the basis of increases in an entity’s net position in a contract with a customer.
S15 When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability, or a net nil position depends on the measurement of the remaining rights and obligations in the contract.
S16 In the proposed model, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.

This section clarifies the intent of a contract-based definition of revenue. It appears that revenue is now being based on assets. This asset-based definition of revenues has been lurking in the shadows but apparently now is exposed to the light of day, although still in disguise. This definition partially converts net revenues from a retrospective income measure to a prospective value measure (change). The use of NET assets further redefines the traditional revenue concept. (later note: I was wrong).

The new prospective perspective is most welcome. Less welcome is the limitation of revenue recognition to contract-based assets. It seems that accounting is schizophrenic in that it wants to value the future while retaining a predominately retrospective posture. This is neither fish nor fowl. Fishy turkey comes to mind.

Identification of performance obligations

... The objective of separating performance obligations is to ensure that an entity’s revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

This is confusing. Recognizing revenue over time to faithfully represent that time pattern is not an asset based definition of revenue. I pretty sure that the authors of the discussion paper are not themselves confused, but I'm not yet fully convinced.

Satisfaction of performance obligations

S20 An entity satisfies a performance obligation and, hence, recognizes revenue when it transfers a promised asset (such as a good or a service) to the customer. The Boards propose that an entity has transferred that promised asset when the customer obtains control of it.
S21 In the case of a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the customer’s asset. Typically, that occurs when the customer takes physical possession of the good.
S22 In the case of a service, an entity similarly satisfies a performance obligation when the service is the customer’s asset. That occurs when the customer has received the promised
service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognized as an asset.

S23 Consequently, activities that an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer. For example, in a contract to construct an asset for a customer, an entity satisfies a performance obligation during construction only if assets are transferred to the customer throughout the construction process. That would be the case if the customer controls the partially constructed asset so that it is the customer’s asset as it is being constructed.

Again it seems that revenue recognition is proportional and timed to transaction completion. This seems at odds to an asset based definition of revenue and the earlier phrasings. It was my understanding that enforceable contract-based revenue provided an argument for immediate recognition.

Measurement

S24 To recognize a contract, an entity measures its rights and its performance obligations in the contract. The Boards have not yet expressed a preliminary view on how an entity would measure the rights. However, measurement of the rights would be based on the amount of the transaction price (that is, the promised consideration).

Again the perspective shifts. Now it is not future recognition of revenue timed to specific performance or transactions but “to recognize a contract” which is (or seems to be) an immediate recognition asset-based concept.

S25 The Boards propose that performance obligations initially should be measured at the transaction price—the customer’s promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative standalone selling prices of the goods and services underlying those performance obligations.

What if obligations are related or hedged so that the sum doesn’t equal the whole? What if quantity discounts are involved? What if contingent obligations are involved? Do market prices impinge?

S26 Subsequent measurement of the performance obligations should depict the decrease in the entity’s obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognized is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognizes over the life of the contract is equal to the transaction price.

How would this work for a mortgage contract?
S27 The Boards propose that after contract inception, the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous. A performance obligation is deemed onerous when an entity’s expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation. In that case, the performance obligation is remeasured to the entity’s expected cost of satisfying the performance obligation and the entity would recognize a contract loss.

Changing expectations may produce an immediate loss or writedown but can they also produce a gain? If so, is the gain immediate? Can a hedged loss be offset by expected gains? Accounting may find itself in trouble again if it adopts unsymmetrical treatments (as with fair value).

Potential effects on present practice

S28 For many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the Boards’ proposed model would differ from present practice. For example: (a) use of a contract-based revenue recognition principle. An entity would recognize revenue from increases in its net position in a contract with a customer as a result of satisfying a performance obligation. Increases in other assets such as cash, inventory in the absence of a contract with a customer, and inventory under a contract with a customer (but not yet transferred to the customer) would not trigger revenue recognition. For instance, entities that at present recognize revenue for construction-type contracts would recognize revenue during construction only if the customer controls the item as it is constructed.

Would a mortgagee who takes possession but not control be barred from counting the asset until final payment? If not, what would his value be based on? The value at inception, as suggested or a market value with unrealized appreciation or depreciation?

(b) identification of performance obligations. In present practice, entities sometimes account for similar contractual promises differently. For example, some warranties and other postdelivery services are accounted for as cost accruals rather than as “deliverables” in or “components” of a contract. In the proposed model, entities would account for those obligations as performance obligations and would recognize revenue as they are satisfied.

Suppose a paid for warranty (known and expected to be profitable) is sold. Under the proposed scheme revenue and profit would flow according to satisfaction. Would the present value of profit an asset or a liability?

(d) capitalization of costs. At present, entities sometimes capitalize the costs of obtaining contracts. In the proposed model, costs are capitalized only if they qualify for capitalization in accordance with other standards. For example, commissions paid to a salesperson for obtaining a contract with a customer typically do not create an asset qualifying for recognition in accordance
with other standards. As a result, an entity would recognize such costs as expenses as incurred, which may not be the same period in which revenue is recognized.

Again a dangerous lack of symmetry where revenue recognition is associated with life of contract performance but costs are not. It is not the latter which creates the mismatch?

**Question 1**
Do you agree with the Boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability?

A single recognition principle is not only desirable but critical to a feasible, consistent, relevant and comprehensible accounting and reporting model. Basing revenue and recognition on the balance sheet (assets and liabilities) is also desirable. This can form the basis of a value based financial reporting model. Such a model is what end users want and need.

However introducing the contract into the definition of assets and liabilities is the wrong approach. Granted a contractual basis, especially an enforceable or written contract, may be normally associated with revenues that are more certain (greater expectation of realization and less variable). Granted auditors would prefer to have documented (contractual) arrangements for auditing convenience. But contracts are not absolute guarantees of performance; the contractual obligation may be less certain that that not backed by a contract. Why beat around the bush? It is the expectation which is expected to be more accurate economic representation. The contract is much too narrow to reflect complete economic realities or to produce relevant reporting.

There is no possibility to use the contract as a single characteristic of assets and liabilities. The preceding discussions reveal that insurance, leases, derivatives, inventories, comprehensive income may be treated differently and separately. In addition there are many specialized rules and treatments (see FASB Statements) which could not fit a single treatment.

A contract and judgments as to whether it is enforceable is a legal matter. "An agreement does not need to be in writing to be considered a contract" but such agreements may be difficult to enforce and may involve some uncertainty, especially under stressful conditions. It is futile to hang the accounting hat on a legal peg. Accounting must develop its own directly relevant concepts. It seems that the contract concept is difficult to apply in the common situation where there is no contract to associate with revenue.

If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?
Unless a good portion of existing standards and practices is scrapped it will be impossible to address inconsistencies since existing standards are inconsistent among themselves and inconsistent with the contract-based approach as near as I can fathom.

How would I address such inconsistencies? I have a complete, elegant yet simple solution to this and many other problems that accounting, FASB, the SEC, capital markets, regulators and shareholders have encountered. This solution has been furnished to FASB in great detail in 1998 in the form of the draft proposal Accounting For The Future. In addition there are many periodical additions to this monograph as well as a website containing much explanation and development. Lastly, my ideas have been elucidated in several lengthy comment submissions on FASB exposure drafts. I have done my part. I hope that FASB will take this opportunity to carefully consider my proposals.

Question 2
Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

I must confess that even at this stage I'm uncertain whether immediate recognition of revenue is being considered. At times it seems that a balance sheet approach to revenue is being tossed about. Such an approach would define revenue as an increase in assets. Increases in obligations would be outflows. A contract would be recognized as the net of associated assets and liabilities. This has the potential to create a more relevant value-based reporting model. Other times (most often) it seems that recognition is tied and timed to contract satisfaction. This more traditional approach is incomplete and tends to be conservative.

Despite some uncertainty as to what the proposed principle is, it seems have some limitations. One limitation is that it does not provide decision-useful information for any contract. For one there is a very loose association of contract with expectation. The tightest most enforceable written legal contract is a piece of paper. It may be associated with low expected realization or highly variable realizations. Some contemporary examples include

1. The mortgage based on a well defined contract has proven uncertain. How do we take into revenue the loan in default? How do we value or revenue a portfolio of Adjustable Rate Mortgages? How do we report revenue on a mortgage in default or on a foreclosed property?

2. How do you measure revenue when the company's condition impinges on and discounts its obligation? For example, what are GM automobile warrantees worth to GM? To the auto purchaser?
3. Are bonds or MBSs contracts? If so how do we cope with default, impairment (covenant violations, credit downgrades, impending bankruptcy), market values, pending or likely settlements such as GM bonds.

4. How do we value insurance or reinsurance contracts which seldom require payoff but when they do they can't be satisfied, Examples might be: credit swap derivatives, casualty reinsurance in the face of mega disasters, contracts subject to force majeure, contracts subject to legal or sovereign interference. For example, how should mortgage revenues be recognized in the face of legislatively forced contract modifications or threat thereof. The problem is that recognition may depend cliff-like on likelihood. The obvious solution is to always and continuously use expectations.

5. How about internal or transitory contracts? Do they give rise to revenue by virtue of contract. For example, do transitory overnight interbank loans create revenue? How about intra-company contracts, transactions and transfers?

6. Barter contracts may create problems. For example, services or goods may be exchange or exchangeable for other good or services. The lack of monetary realization may make the measurement of revenue unreliable.

7. Recognizing revenue in proportion to performance may be difficult to do when performance is difficult to measure or undefined. For example, some contracts will only be satisfied upon completion whereas others may involve partial satisfaction. Other contracts with partial satisfaction may be voided by subsequent events. For example, recently my car door latch broke. After obtaining a repair estimate ($80 cost for estimation), I approved the repair (new latch assembly) for an estimated $193. This estimate was abrogated when further work revealed the need for a new actuator at an additional cost of about $300 (parts and labor). Did I have a contract? Yes, but...

8. Most revenue is not associated with a contract. The retail merchant has revenue from customers with no contractual obligation to buy. To use the contract as the “single revenue recognition principle” is ludicrous and this is probably not what was intended. The intent was to apply the principle (whatever it is) to contractual situations. If so, what is the intended general revenue recognition principle? Does the contract principle (whatever it is) agree or conflict with the general principle?

9. The attempt to separately identify and quantify all the components of income (contractual or not) is doomed. It is unlikely that all such components can be identified in an exhaustive and non-duplicative manner. Even if this is accomplished, what do we have? We have revenues that represent … revenues. We do not have a measure of the positive economic progress that is of interest to shareholders and other targets of financial reports. For this we need value-based measure from the entity perspective.
10. Contracts may depend on values which may be difficult to assess. For example, FASB's ill-fated Fair Value "principle" which depends on market values not only ceased to operate reasonably but may have precipitated or aggravated the banking crisis. Depending on undependable measures is hazardous. Parenthetically, I argued vigorously and repeatedly to FASB against "Fair Value" citing, among other reasons, the danger of self-fulfilling and self-defeating results. My arguments fell on deaf ears.

11. One major problem with accounting standards is that they require too much of accounting and the accountant or auditor. Financial reporting rules are themselves extremely complex, not transparent, inconsistent, arbitrary, hidebound, undisciplined, and purposeless. This is compounded by requiring that the auditor understand and master complex industries which are often more than a match to managements and their large support staffs. There is no way the auditor can authoritatively opine with his limited knowledge of the industry, the company, internal developments, management intentions, market or economic outlooks. If we now introduce legal constructs, (such as contract, enforceability, performance under contract, multiple parties, unwritten agreements), complexity grows.

12. Revenue measurement problems may be compounded with long term contracts which don't take the cost of capital, inflation or currency changes into consideration. Those contracts which do take into account a changing monetary unit may be even more problematic.

13. Management contracts with the future would probably be excluded. Management may intend and state its intention to maintain the dividend. Is this a contract or agreement between management and shareholder? Management may decide to expand its territory of operation and this may have major significance to the shareholder. Are such decisions recognizable? What if a contract is involved?

14. An alternative for measuring contract-based revenues (and indeed all "revenues" in a relevant, complete and non-duplicative manner) is to use the Present Value of Expected Cash Flows (PVECF). Only such a measure can be expected to provide relevant economic measures. See the AFTF model (and writings and submissions) for complete details.

**Question 3**
Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Presumably the following is the definition being referred to:
A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract.

No, I don’t agree with this definition. For one it is not symmetric, a fundamental and critical element. Symmetry is important from a legal perspective but also from an accounting perspective. A contract creates RIGHTS and obligations.

From an accounting perspective this duality is fundamental being reflected in double entry bookkeeping, the balance sheet, reconciliation of income and balance sheet, income and outflow, capital inflows and outflows, etc. It is also important to uphold the neutrality principle.

There is also some question of enforceability for contracts. For example, is revenue based on a written contract an asset? How about liabilities based on an unwritten contract? Are contract assets and liabilities treated symmetrically? If not, how do we cope with internal contracts (completely hedged)?

A more fundamental question is why the board feels impelled to define a contract. This is not an accounting concept. More importantly, starting down the road of “a single, contract-based revenue recognition model” may be an unnecessary and time-consuming detour. I trust the contract is not being considered as a guide to general revenue recognition and that the model (whatever it is) applies only to contract based situations. If this is the case then a contract-based model seems appropriate, although somewhat hollow.

Asset (such as a good or a service)

3.8 A performance obligation represents an entity’s promise to transfer an asset to the customer. The Boards define an asset as follows: Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Concepts Statement 6, paragraph 25] An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [IASB’s Framework for the Preparation and Presentation of Financial Statements, paragraph 49(a)]

Both the FASB and IASB definitions are vague enough to permit an asset to be defined in terms of present values of expected cash inflows. An expected cash flow is the compound of an expected event (“probable ... benefit” in FASB-speak and “expected ... flow” in IASB-speak) and an expected amount (“economic benefit”). This is precisely expected cash flow (or expected cash equivalent). Similarly, liabilities may be defined as the present value of cash outflows. If we use assets and liabilities in this way we arrive at a value-based reporting scaled to and disciplined by the capital markets. See AFTF for details. If we do this there is no need to treat contract-based revenue separately or differently.
While I'm on my high horse I would like to quibble with the newly proposed (Conceptual Deliberations) definition of asset.

An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.

Intangibles are major resources (perhaps dominant resources) which are expected to produce future cash flow. I'm not proposing to identify or measure such intangibles. However, the resulting cash flows are easily quantified as expected values. This can be done in a reliable manner, as AFTF clearly outlines. The above definition could be phrased

An asset of an entity is a present resource arising from expected future economic benefits to that entity.

Note that the phrase “that others do not have” is scrapped. If we are dealing only with a physical items perhaps this phrase might be an appropriate condition since such items generally can't be divided without impairing their resource value. However we live in a world of information, technology, patents, grants, privileges, licenses, access rights, market research, and other divisible assets. For example, a company may purchase administrative or accounting software “that others do have”. Such assets are central in today's knowledge economies.

There is a lingering and misplaced desire to anchor values (assets or liabilities) to an identifiable causative “past” (traditional auditing stance) but identification and causation may be so complex, indirect, and tenuous as to be useless as an audit anchor. A future economic benefit to a drug company may be the result of decades of research, clinical trials, advertising and promotion. It is useless to identify the event or causes. It is also somewhat moot to insist on causation since effects always have some cause. It is sufficient to identify and measure the effects (PVECF).

Much of the economic value of many, if not most, companies resides in intangibles or goods such as market share, patents, brand, organization, technology, human resources, marketing prowess, economies of scale, monopoly, reputation, diversification, vertical integration, established relationships, etc. Such intangibles have ill defined or tenuous event or transaction links yet they give rise to substantial economic benefits. Intangibles are real assets (in fact dominant) that manifest themselves in the future; they have substantial present economic value. These can be only be only be ignored by accounting at the cost of relevance. Accounting and financial reporting may be sand rather than oil in the engine of our economy.
3.12 This example highlights that a good does not have to be promised explicitly in a contract to give rise to a performance obligation. If an entity must transfer a good to the customer to fulfill a contractual promise, then promising that good gives rise to a performance obligation.

This last sentence doesn’t seem to relate to the premise or example. Perhaps it should read: “…then implicitly promising that good gives rise to a performance obligation.”

3.13 A service also can be an asset promised by an entity in a contract with a customer. … Although services to be received in the future might not meet the definition of an asset, services are assets when received.

Promised services can be assumed to probable or expected. “Their use may create or add value …” seems to be an economic benefit to the receiver of services. Hence promised services may be an asset. I’m not sure why services to be received in the future might not meet the definition of an asset. They are economic resources that are capable of producing cash inflows or reducing cash outflows. If they were not promised (contracted for) they would have to be purchased. I’m not sure why services are momentary assets when received. They seem to be better classified as revenues. The notion of an assets emerging spontaneously without cause and evaporating without effects is perverse.

Promised services exist or are present by virtue of promise. Such services are an economic obligation to the provider of services (obligor). Hence promised services are a liability.

Two streams of equally likely identical economic benefits will be treated differently on the balance sheet when provided versus received. This may be conservative but hides useful information. This cannot support optimal decisions. It also offends the duality principle and my sensibilities.

I’m not sure why future good are distinguished from future services in their accounting treatment since they are both economic resources affecting future cash flows. But it is neither goods nor services that is the essence of economic value but the resulting cash flows. Those are much easier to cope with than trying to identify, enumerate, quantify and account for all goods and services the company experiences.

3.24 Hence, if an entity promises to transfer a bundle of goods and services to the customer at the same time, then the entity can account for those promised assets as a single performance obligation. In other words, an entity needs to separate a contract’s promises into separate performance obligations only when the customer receives the promised assets at different times.

There may be reasons to separate assets that happened to be delivered at the same time, for example, assets transferred from different divisions or of a different nature. Of course these might not be considered a “bundle”. The second sentence is a non-
The fact that there is no need to separate simultaneous performance does not mean “in other words” that non-simultaneous performance must be separate assets. A bundle of related performance obligations may be appropriately and conveniently considered a single asset (or liability). It is only the assumed necessity for spreading revenues that requires separating performance obligations.

3.25 The objective of identifying separate performance obligations is to represent faithfully the pattern of the transfer of goods and services to the customer. In assessing whether a performance obligation should be accounted for separately, an entity should consider whether separation is needed to reflect faithfully the changes in the performance obligations over the life of the contract.

It is far more convenient to revalue when needed than to separately value. Of course the timing and expected changes over time must be reflected in any initial or subsequent valuation.

TuneCo is a manufacturer of music players and is an online music retailer. As part of a seasonal promotion, TuneCo gives each customer a CU40 gift card with the purchase of a music player. The customer can redeem the gift card on TuneCo’s website by downloading music. SongCo, a TuneCo competitor, also manufactures music players and retails music online. As part of a seasonal promotion, SongCo gives each customer a 40 percent discount on its online music (for purchases up to CU100) with the purchase of a music player.

It is instructive to consider the TuneCo and SongCo examples. First, we observe that accounting should serve its stated purpose to convey decision-useful information. This information must be at least related to the economic values and progress being reported on. For example, a gift card program expected to lose money should be a liability and a program expected to produce gains should be an asset, at least in the generally understood sense.

The gift card could be of known negative value to be used as an incentive to market the player. It could be expected to be of positive value but ultimately prove costly. It could be expected to be profitable by itself and indeed might subsidize the player (much like cheap color printers that make profits from ink cartridges). At first blush it would seem that the CU40 card would cost more than the 40% discount since it has a high probability of exercise, being free. The 40% discount might not be used or only partially used since further cash outlay is required. The 40% discount might have a greater chance of utilization since the discount provides the opportunity to buy CU100 worth of discounted music. The 40% discount program might be more appropriate to SongCo’s situation than to TuneCo. The reverse could be true.

The point of all this conjecture is that the accountant (and accounting in general) is ill equipped to assess the economic benefits of the seasonal music player and provider company promotions. Accountants are not responsible for market research, product
development, pricing, strategic planning, tactical planning, contingency planning, allocating capital, assuming risk, implementing or managing projects, measuring progress, changing course, within specialized industries. It is difficult enough for experienced management with all the company resources to make quantitative judgments. This is not and should not be an accounting responsibility. Accounting standards should be aimed at general principles of accounting and reporting. Only within such general principles can relevance and a measure of Truth emerge.

This brings up a philosophical yet practical point. Accounting should not be based on industry specific prescriptions, auditing convenience or absolute accuracy. These are not holy grails. For example, the auditor might assert that the accounting net worth of a company is CU52,137,355,914. Ignoring the fact that net worth may be a small fraction or large multiple of the capital market or economic value of that company, what does the figure mean? Its real significance depends on many things. It must be related to such things as the number of shares outstanding, the type of currency and its point in time, the capital market price of those shares, the prior period net worth of the company, prior period expected net worth, the expectation for the future net worth, the risk profile for the company, the size of its assets and liabilities, the company’s use of its assets, the relationship of its accounting assets (net worth) to total assets, etc. The significant items are not absolute measures like CU52,137,355,914 but rather the foregoing and similar relationships and their measures. A dividend yield, for example, conveys an essential Truth, a decision-useful measure that traditional absolute accounting measures generally fail to provide. The traditional income statement may report total dividends paid of $43,122,754.21. This fact may comply with accounting rules, be accurate to the penny and conveniently auditable. So what? Accounting does not exist for itself. It must have meaning and serve an external purpose.

The two gift card programs (tuneCo and SongCo) might be essentially equivalent from an economic standpoint yet be treated differently, not the hallmark of a disciplined accounting model. Similarly, it is undisciplined for an accounting system to permit options or choices as in the case of RetailCo. Basing accounting on differing treatments is hazardous and unnecessary. Using economic values based on expectations produces identical results no matter the perspective. As pointed out in the RetailCo example, using the uncompleted sale approach matches the return cost approach when probabilities are applied. The PVECF approach (as espoused by AFTF) is unequivocal.

Summary

3.43 In the Boards’ preliminary view, an entity’s performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit.

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1 “Inexact measures of contemporaneous economic values are more useful than fastidious historic records of past exchanges” AIMR: Financial Reporting in the 1990’s and Beyond.
I’m not sure of the intent of the contract-based revenue recognition model. When it includes implicit contracts and unwritten contracts it seems the intent is to somehow base revenue recognition generally on a contract-based model (the nature of which remains a mystery). At times this model seems to tie recognition to contract fulfillment but depending on the perspective this can be immediate, proportional or delayed recognition. This is not a model but rather a non-model. Perhaps this is the intent to explore possibilities. If FASB is truly open to new ideas, AFTF provide a relevant, feasible, disciplined and unequivocal recognition model.

3.44 When an entity promises to provide a good, it is promising to transfer an asset to the customer. When an entity promises to provide a service, it similarly is promising to transfer an asset even though the customer may consume that asset immediately.

How does immediate consumption enter into the entity’s accounting? It enters only the recipient’s consideration.

3.45 An entity accounts for performance obligations separately if the promised assets (goods or services) are transferred to the customer at different times. The objective of separating performance obligations is to ensure that an entity’s revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

Do discounted values faithfully represent the time pattern of transfer? If such values represent an economic value or market value are they then a faithful representation?

Questions for respondents

Question 4
Do you think the Boards’ proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract?

No. The only definition I find is “...an entity’s performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit.”

In the words of Sam Goldwyn: “A verbal contract isn’t worth the paper it’s written on.” Unwritten or implicit promises are a shaky foundation for revenue recognition. Unfortunately many obligations are not contract-based so I don’t see the point. The definition seems circular in that a performance obligation is a promise and a promise is a performance obligation. Admittedly definitions can be useful even if somewhat circular but some definitions are more circular than others.
Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

If a question can be answered with a question, I would ask: how does the proposed definition of a performance obligation improve upon current interpretation and practice? It may be weakened (due to ambiguity) if tied to unwritten contracts or the option of implicit promise recognition.

The proposed definition may inappropriately identify, omit or include performance obligations if:

1. The contract is very complex
2. The contract has implicit promises
3. The deliverables are improbable
4. The deliverables are un-measurable
5. There is no contract
6. The deliverables are hedged or reinsured
7. The contract creates a moral hazard
8. They exacerbate dislocations
9. They tend to exclude non-contractual obligations
10. The obligations or associated liabilities are only discharged upon entire completion or even later events.
11. Legal judgments subject to appeal
12. Unfunded liabilities
13. Liabilities discounted for credit unworthiness
14. Contractual liabilities subject to legal or legislative modification or abrogation
15. Transferable or salable liabilities
16. Internal contracts
17. Barter contracts
18. Written contract where there is a lack or understanding or meeting of the minds
19. The contract deals with assets that are neither goods nor services, such as, rights, access or non-compete provisions
20. Contracts with indeterminate time frames such as contracts that are delayed or open ended. For example, a burial contract or a disability income contract.

**Question 5**

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer?

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2 For example, credit default swaps if recognized per contract or market value may sink the guarantor
3 For example, the installation of a computerized airport baggage handling seems to proceed as expected and trial runs are successful but full scale implementation is a nightmare and the system is scrapped.
No. Obviously timing and frequency affect things. But some periodic timing may be assumed (daily, annual) with some expected outcome for each period. A measure can be assigned (cash flow or cash flow equivalent) which can then be discounted to a present value (PVECF approach). In this way a single economic value is assigned to the entire contract. Changes in this economic value (asset or liability) can define revenue in a natural way. This is part of the AFTF technology.

Only if revenue is based on performance under the contract would the suggested approach be required. But if the basic question of revenue recognition is being openly considered one should not conclude separation is needed based on the assumption that revenue must be recognized based on performance. This is putting the cart before the cart.

Why or why not?

At the level of significant financial reporting almost complete aggregation is a must. There is a level of aggregation or scale that gives meaning to the economic information. A company may have several divisions and within several departments. Each department may have its own accounting. Such accounting may involve, among other things, many contracts each assigned an asset or liability measure. There is no accounting significance to the myriad individual performance obligations. When playing baseball we don’t deal with the molecules, or atoms or electrons that make up the baseball. It makes no sense for the pitcher or catcher to know the molecular structure of the baseball. It makes no sense for accounting to deliberately separate a contract into its components. It makes more sense to value the contract or group of contracts.

Granted the components make up the whole but it is the aggregation and value of the whole contract which is the useful scale and goal of accounting. If we are evaluating a contract we must somehow assess the economic value present in that contract. An ideal measure of that value is PVECF. However, it is not individual contract valuations which is the financial reporting scale. It is necessary and sufficient to represent the entire company (all its divisions, departments, projects, contracts, performance obligations, etc). It is necessary from two standpoints. First, to be comprehensible and meaningful accounting information must simple; it must be processed, refined and put into some (relational) context. Second, the sum of the accounting parts seldom adds up to the economic whole. It is better to account for the whole using economic measures. It is sufficient since economic measures for the company as a complete whole provide shareholders with useful decision criteria.

Basing accounting (assets, liabilities, revenues, etc.) on legal concepts such as contracts and contract fulfillment is passing the buck. It also fails to represent economic values since legal obligations may not correspond to economic measures. For example, bonds are ironclad legal contractual obligations and remain so even if their economic or market value plunges. Expectations form a more relevant accounting yardstick than do legal concepts. Expectations are a long-standing accounting concept, paradoxically accorded little respect in its own house.
If not, what principle would you specify for separating performance obligations?

Future performance obligations have a magnitude, a probability and a present economic value (PVECF). These are necessary and sufficient to capture and measure their economic value. There is no need for performance based revenue recognition. It doesn't work anyway. It is unnecessary and insufficient. In fact, traditional revenue recognition is unnecessary, insufficient and dangerous. AFTF works quite well without a revenue concept.

**Question 6**
Do you think that an entity’s obligation to accept a returned good and refund the customer’s consideration is a performance obligation? Why or why not?

The entity’s obligation is an obligation. Is it a performance obligation (which can be related to delayed revenue recognition)? I would say no. It is a monetary obligation (with some expected future value and some present discounted value). Delivery of goods or services is more akin to performance obligations but even in those cases monetary measures must be used. Perhaps delivery of money (refund) may be considered a performance which is then measured monetarily. Why introduce the spurious non-monetary performance concept when the accounting measure must always revert to money?

There may also be circumstances where the obligation concept is turned on its head. For example goods sold at a discount, goods that appreciate, or non-monetary refunds (credit towards merchandise).

**Question 7**
Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and “free” goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Here we run headlong into a conundrum. Sales incentives are not (generally) misguided giveaways or expected money losers. They have a purpose: increasing current or future sales and profit. An asset rather than a liability is created. Granted this asset is based on expectations which may be exceeded or shorted depending on future experience. It could be argued that an uncertain asset is not an asset. But two points can be made. First, there are no absolute certainties and to insist upon it excludes everything. The criterion must be reasonable certainty. Second, we must use the proper scale. The individual sale is not a basis for meaningful judgment. A sales incentive program is also too narrow a focus, although for the program meeting expectations is more likely. If we use the whole company scale and blend in all sales campaigns, sales incentives, advertising, solicitations, rebates, financing or payment
options, etc., reasonable certainty emerges. It could be said that company level
certainty trickles down to the uncertain individual outcome, i.e., the law of large numbers
make uncertain individual probabilities and outcomes useful when aggregated.

Getting back to the question: are sales incentives performance obligations? It seems
pervasive that an expected good (asset) might be classified as a net performance
obligation. I think FASB is barking up the wrong tree, perhaps because it can’t see the
forest for the tree. Why focus so narrowly (contract-based performance and revenue
recognition) when recognition hasn’t even asked more fundamental questions like: what
should be recognized and why? At least AFTF has asked (and answered) such
questions.

CHAPTER 4: SATISFACTION OF PERFORMANCE OBLIGATIONS

Introduction

4.1 This chapter explains when an entity transfers assets to a customer and, hence, when the
entity satisfies performance obligations. The satisfaction of a performance obligation increases
an entity’s net position in a contract. Accordingly, this chapter discusses when revenue is
recognized.

As is the case in so many exposure documents the door to alternatives is ostensibly
open but the bulk of the document clearly indicates a path already chosen. In this case
the timing of revenue recognition is tied to contract performance. This approach of
asking open questions, answering the question and justifying the answer is
disingenuous. More importantly it damages standard setting, accounting, financial
reporting, capital efficiency, and the economy.

To provide an example, fair value accounting which includes mark-to-market was
exposed for comment roughly ten years ago. At that time, it was my opinion that market
values were inappropriate and dangerous. Among other things, I argued that using
market values (liquidation values) might create insolvencies. The current banking and
credit crisis has been exacerbated, perhaps created, by requiring liquidation values to
be used. I presented my arguments, early, repeatedly and forcefully. These arguments
were carefully reasoned and I believe correct. I have never seen any mention of my
points in FASB literature or exposure documents (except my submissions), as if my
comments were never read.

But the issue goes beyond fair value. I have presented FASB with a principles-based
model of accounting which is simpler, more relevant, and more disciplined than the
current GAAP model. This is important since the current GAAP model is massively
complex and detailed, lacks relevance to today’s industry and capital markets, and is
infested with ambiguity, inconsistency and license.
4.5 In accordance with the Boards' existing definitions of an asset (paragraph 3.8), the customer has the promised asset when it controls the resource underlying that promised asset. Accordingly, to determine when a good is transferred to a customer, an entity assesses whether the customer controls the good so that the good is the customer's asset. Typically, the customer controls the good when it takes physical possession of the good.

This last sentence is typical of the sophisticated language employed by FASB to further its often hidden agenda. I agree that the customer controls a good or service when it takes possession. That's not the appropriate question or answer. The question should be: when does the customer first control the good or service? That occurs when the contract or promise is made, at that point the provider is merely a custodian. This most often occurs before any performance under the contract. This distinction is important since in a complex financial environment actual possession may be rare. This distinction is important since it at least admits the possibility of immediate recognition (the PVECF/AFTF approach).

Both the liability and the asset created by contract should be treated consistently and both should be based on the expectation. To require the liability but prohibit the asset is biased.

4.7 Similarly, to determine when a service is transferred to a customer, an entity assesses whether the customer has received the promised service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognized as an asset (paragraph 3.13).

If a service enhances an existing asset it may be recognized as an asset. Is the service measure the existing asset enhancement? Suppose the immediately consumed asset has a purchase price or a market value, is it then an asset? Does a promise to provide a consumable service constitute a liability? For example, I may have qualified for a free $200 massage coupon from China Girls Unlimited. The going street value of this coupon may be $150. Is this an asset?

4.8 In essence, an entity satisfies performance obligations, and recognizes revenue, when the customer receives the promised goods and services. Consequently, in the proposed model revenue would reflect the transfer of promised goods and services to customers, and not the activities of the entity in producing those goods and services. Activities that an entity undertakes in fulfilling a contract result in revenue recognition at the time of those activities only if they simultaneously transfer assets to the customer and, hence, satisfy a performance obligation.

I agree that in essence, an entity satisfies performance obligations when the customer receives the promised goods and services. But the seemingly innocuous addition of the
short phrase "and recognizes revenue," jumps to a conclusion, and, in my view, the wrong one. This is an important issue that should be hidden, assumed or glossed over.

4.9 Recognizing revenue when assets are transferred to a customer is consistent with many existing standards (although the terminology may differ). However, identifying that transfer on the basis of control of an asset may differ from standards that identify the transfer on the basis of the risks and rewards of ownership.

Not if the contract passes control.

4.16 ... It is not the likelihood of return that determines which entity has the asset (indeed, the likelihood of a return may be the same under either scenario). Rather, the decision is based on which entity controls the tool.

FASB almost got it right here. The two scenarios have similar if not identical likelihoods and from an economic standpoint they would be similar if not identical. Why does FASB strain to make a legalistic "control" distinction since doing so contradicts economic logic? Adherence to traditional structures and rules will continue to impair accounting relevance. Accounting must develop its own guiding principles not appeal to legal distinctions only tangentially related to the purpose of accounting.

I tend to agree that the notion of risk and rewards is difficult to apply. So is the notion of control. Using expectations is easy to apply and produces universal (unequivocal and comparable) values. But even if we concede that control determines revenue FASB cannot argue for a legal contract-based approach to revenue recognition while denying that control passes when the contract is signed. At least not in the same sentence. FASB can't eat its cake and have it too.

4.19 In addition, in the Boards' view, if in one legal jurisdiction an asset has not been transferred to the customer whereas in another legal jurisdiction an asset in a similar contract has been transferred, then those differences are substantive (they are real economic differences between two contracts).

There are certainly real legal differences but it is a logical grand jette to conclude that there are necessarily any economic differences in the similar contracts. Since the logic is suspect the conclusion is suspect. I would say that differing legal definitions of transference take a back set to expectations, which the word similar implies are similar if not identical. Wrong tree.

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4 One might argue that management expectations are not universal. With AFTF such expectations are forward looking statements and represent what the capital markets crave (guidance). Furthermore, with AFTF they are constrained to relevant capital market values and strongly disciplined.
4.19 … Therefore, in those cases (differing legal transference) the Boards think that the two contracts should be accounted for differently in order to provide relevant, comparable information to users of financial statements.

Again FASB is trying to back into revenue recognition dependent on transference or performance. No matter how many times FASB repeats its mantra it can't overcome the fundamental problem of a complex, illogical, inconsistent and purposeless approach to revenue recognition.

**How do customer acceptance, customer intent, and customer payment affect the satisfaction of performance obligations?**

FASB is getting bogged down in legalities … unnecessarily. A company providing contractual warranties (and/or other contingent benefits) does so with some idea (probabilistic expectation) of warranty exercise. If the expectation is reasonable for aggregated sales and if the expectation creates an asset or liability upon sale, it isn’t necessary to examine potential individual contract legal complexities. In fact, it’s misguided to do so since any answer differing from expectations is expected to be wrong.

Perhaps more important is that basing accounting on ambiguous legal complexities or technicalities will inevitable result in accounting options. The company or its accountants and auditors will be able to interpret or manipulate the legalities producing instability or permitting misrepresentation. For example, permitting “customer intent” to directly affect accounting judgments is dangerous. Accounting must be disciplined not a free-for-all.

4.48 … an entity must consider factors such as the contract terms and the operation of law to determine when the customer receives an asset. The decision of which party controls the asset (that is, the work in progress) as it is being constructed indicates whether a promise is for a good or for a service and, consequently, when revenue is recognized from satisfying a performance obligation.

Contracts for goods and services may have the same economic value (PVECF) and timing yet they might be treated differently. Under AFTF they would be treated identically. Both would be valued and recognized at contract signing so that downstream revenue recognition is not important. If contract doesn’t transfer control then the meaning of contract is eviscerated and contract-based distinctions become a shaky foundation for accounting.

4.58 In the above painting example, on the basis of the facts given, it is unclear whether the customer controls the paint when delivered on June 30. In the absence of a clear indication to the contrary, the presumption would be that the paint is not transferred to the customer until the paint
is used in satisfying the painting service performance obligation (that is, when the paint is on the
customer’s walls). Similarly, that presumption would apply to a good that is used in providing
another good and to an entity’s activities that precede the delivery of a good.

Is the “paint presumption” going to be codified as a new FASB Statement?

Summary

4.59 An entity satisfies a performance obligation and, hence, recognizes revenue when it
transfers a promised asset (such as a good or a service) to the customer. The Boards propose that
an entity has transferred that promised asset when the customer obtains control of it.

The word “hence” implies a logical consequence. Performance under a contract and
revenue recognition are not logically linked. Linking control and recognition to contract
signing is a much simpler and more relevant concept. It is also more consistent in that
assets and liabilities, goods and services are treated equally.

4.57 That presumption would be rebutted if other indications such as the terms of the contract or
the operation of law clearly indicate that the asset is transferred to the customer at a different
time.

Don’t “the terms of the contract or the operation of law clearly indicate that the asset is
transferred to the customer” when the contract is signed?

4.60 In the case of a good, an entity satisfies a performance obligation when the customer obtains
control of the good so that the good is the customer’s asset. Typically, that occurs when the
customer takes physical possession of the good.

The general setting and title of this DP is “Contracts with Customers”. The customer
obtains asset control when a contract is signed (likewise the seller incurs a liability).
When a customer takes possession from the seller/custodian does not interfere with the
asset, although it may affect when the seller satisfies his obligation (eliminates his
liability).

4.61 In the case of a service, an entity similarly satisfies a performance obligation when the
service is the customer’s asset. That occurs when the customer has received the promised
service. In some cases, that service enhances an existing asset of the customer. In other cases,
that service is consumed immediately and would not be recognized as an asset.

It seems purposeless to distinguish between enhancing and consumable assets.
Services to be consumed have a market value (they certainly have a purchase price).
Are they ever assets? There also might be free services, such as information or other intangibles, which enhance an existing asset. Are these services assets?

4.63 The Boards’ proposed model presumes that an asset that is used by an entity in satisfying another performance obligation in the contract is not transferred to the customer until the asset is used in satisfying that other performance obligation. That presumption would be rebutted if other indications such as the terms of the contract or the operation of law clearly indicate that the asset is transferred to the customer at a different time.

Does not a contract clearly mean that the asset is transferred at signing by contract terms and by the operation of law? The presumption seems rebutted. It also seems to create complexities and remove accounting from economic measures and from relevance.

Questions for respondents

Question 8
Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

What a loaded question!

Yes, I agree that an entity transfers an asset to a customer when the customer controls the promised good. This happens by contract when the contract is signed, in my view.

But this is NOT when the entity “satisfies a performance obligation”. Sneaking this phrase in parenthetically is revealing.

"or when the customer receives the promised service" is not a parallel construction to "when the customer controls the promised good". It says something different and implies that control and performance are equivalent.

Alternative: a promised (contractual) good or service is transferred as an asset (or liability) when the contract is put into effect (signed). Its measure is the present value of expected economic benefits (or costs).

Question 9
The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.
Yes. For almost every contract the proposal would not provide decision-useful information. Management, analysts, shareholders, even accountants supporting capital allocation decisions use PVECF. PVECF is an economic measure of value and such values are necessary and sufficient for informed decisions. The complex legal contract-based approach is unnecessary and insufficient.

Since almost all contracts are examples or non-usefulness, it is easier to provide an example of usefulness. The proposal would be useful for contracts that are immediately satisfied. The alternative works in this special case too.

CHAPTER 5: MEASUREMENT OF PERFORMANCE OBLIGATIONS

Introduction

5.3 ... Therefore, measuring a net contract position requires the measurement of both rights and obligations.

The net position is the bottom line and, to get it right, rights and obligation must be measured consistently. It may also need to reflect the time value of money and any uncertainties in the amount and timing of consideration, goods or services given or provided.

Objective of measuring performance obligations

5.9 In the Boards’ view, that amount includes three main components:

(a) expected costs—

It should be made clear that expected costs are implicitly discounted for probability. For example a $100,000 life insurance policy will pay $100,000 upon death at age 80 and $100,000 upon death at age 99. But the expected cost for death at age 99 is very small compared to the expected cost for death at age 80.

(b) time value of money—

It should be made clear that the cost of money involves more than a risk free rate. For reporting economic values to shareholders the shareholder’s cost of capital is the useful time value of money.

(c) margin—
Depicting the entity’s contractual performance

5.13 A revenue recognition model that is founded on measuring contract assets and contract liabilities to determine an entity’s contractual performance is not intended to imply that the statement of financial position is more important than the statement of comprehensive income. The objective of measuring performance obligations gives equal importance to both statements. However, in the Boards’ view, deriving revenue and profit or loss from measurements of the contract asset and the contract liability provides a more consistent and coherent framework to determine an entity’s performance than existing revenue recognition models.

I agree with this last statement which is in keeping with a balance sheet approach to the income statement. But there is a fundamental problem with the traditional income statement and balance sheet, namely, they don’t balance. The income statement is retrospective whereas the balance sheet is prospective. It would be the greatest coincidence if changes in the prospective balance sheet matched the retrospective net income. Of course they do balance, in a sense. They are artificially forced to balance which is to say they don’t really balance. This may seem a vapid observation until it is pointed out that the AFTF value-based model defines income as the balance sheet change, i.e., the income statement and balance sheet naturally balance. The AFTF change in value truly represents the economic progress of the company. In fact, the AFTF income statement and balance sheet are the same statement (Statement of Values).

Another fundamental difference between the proposed FASB approach and the value-based AFTF approach (using PVECF) is that AFTF employs immediate recognition whereas revenues under the FASB approach are delayed. The AFTF approach is in line with the interpretation of control passing when the contract is signed and in line with the economic measures useful to end-users.

Initial measurement of performance obligations

5.14 With the objective of measuring performance obligations in mind, the Boards considered the following approaches to measuring performance obligations at contract inception: (a) current exit price approach (b) original transaction price approach.

Did the board not even consider an ongoing entity approach? Business contracts are designed (and expected) to be profitable. When an entity obtains contracts it enhances its future income and its present economic value. Should the economic value increase not be counted or reported? Does this help management or the capital markets make informed capital allocation decisions? I think not.
One problem with the current exit price approach is that it ignores the ongoing nature of the entity and its capacity to profitably satisfy the contract. Instead it values the contract at what would be required to have someone else fulfill the contract. This is often done under difficult conditions or duress, i.e., at forced liquidation cost. If the goal is to preserve the entity as an ongoing and profitable enterprise one should not measure liquidation values. This has been done (with forced “fair values”) with mortgage backed securities creating or exacerbating today’s banking and credit crisis. Does FASB want a repeat? Interestingly such a consideration is not even on FASB’s radar. Indeed, FASB seems to be concerned that exit prices will present too rosy a picture (immediate recognition)!

Immediate recognition presents no problem from an economic standpoint or the AFTF standpoint. Even from a legal contract perspective there is no problem if we simply interpret the contract as passing asset or liability control.

Another problem with exit prices is that they are not generally available or are available at inactive (onerous) market prices. The conditions that might force such liquidation of obligations may be adversely correlated with the exit price, due to social or economic dislocations, supply and demand, fear and greed, etc.

I agree with FASB that exit prices are not a good choice but not for FASB’s reasons.

Complexity

5.21 A current exit price would rarely be observable for the remaining performance obligations in a contract with a customer. Consequently, measuring performance obligations at a current exit price would typically require the use of estimates. The Boards note that estimating the current exit price for the remaining performance obligations at contract inception would be complex and that the resulting measurement might be difficult to verify. The Boards think that any improvements to the decision usefulness of the financial information from using a current exit price generally would not be sufficient to justify the resulting costs.

Why the sudden aversion to estimates? The bulk of assets and liabilities are estimates of the future.

5.22 Also, the Boards acknowledge that many think it is counterintuitive to have a measurement approach based on transferring obligations to a third party when, in most cases, the entity neither intends nor has the ability to transfer them. Many think the measurement approach should reflect that the entity intends to satisfy its performance obligations by providing the goods and services promised in the contract.

5 5.18 ... Accordingly, the measurement of the rights at contract inception typically would be greater than the measurement of the remaining performance obligations—thus leading to the recognition of a contract asset and revenue.
Not counterintuitive, inappropriate.

Risk of error

5.23 As paragraph 5.18 notes, measuring a performance obligation at a current exit price means that a contract asset and revenue could be recognized at contract inception. If an entity fails to identify a performance obligation at contract inception, then that error would result in an entity recognizing too much revenue at contract inception. The entity’s net contract position would remain misstated until the omitted performance obligation is satisfied. Furthermore, if an entity either underestimates or overestimates the measurement of a performance obligation, that error would be included in profit or loss at contract inception.

The other side of the coin is the risk of doing nothing to represent the economic reality. It appears that FASB is willing to be precisely wrong rather than equivocally right.6

5.24 Therefore, the Boards were concerned with a current exit price approach because it might be difficult for an entity to establish whether revenue (and profit or loss) recognized at contract inception is the result of an error rather than from an increase in the entity’s net contract position.

Rather than allow management to try reporting economic values, FASB will simply forbid the reporting of economic values. I don’t agree with exit prices, since they involve liquidation prices, but the arguments used here are absurd.

Original transaction price approach

5.25 Another approach for measuring performance obligations is to measure them at the original transaction price, that is, the consideration the customer promises in exchange for the promised goods and services.

Pattern of revenue recognition

5.28 If at contract inception an entity measures its performance obligations at the transaction price (that is, at the same amount as the measurement of the rights), then neither a contract asset nor revenue is recognized at contract inception.

It seems peculiar for "contract-based revenue recognition" to essentially ignore the economic value of an agreed enforceable contract. Would the transaction price be appropriate if the margins were negative, i.e., the contract had negative value? The answer is surely not. The negative asset (liability) would have to take into account the expected deficiency no matter the "risk of error" or "complexity". Again we are

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6 “... analysts prefer information that is equivocally right rather than precisely wrong. AIMR: Financial Reporting in the 1990s and Beyond, 1993.
confronted with a lack of symmetry and a deliberate suppression of information. It never does harm to provide complete information. It always hurts capital efficiency to hide information no matter how well intentioned (for example conservatism).\(^7\)

5.29 Others think that an asset is likely to exist at contract inception and, therefore, revenue could arise (in principle) in the Boards' proposed revenue recognition model. However, some of them are not comfortable recognizing that contract asset and revenue at contract inception because of the complexity and risk of error associated with a current exit price approach.

I don't like exit prices (not because of "risk of error") but I do like immediate recognition at contract inception. I may not be alone.

FASB has a hard time maintaining the old model while trying to reflect economic reality. One solution would be to base accounting and reporting directly on economic realities (as AFTF does). The solution adopted is to superimpose special rules (FASB Statements) on the old model. This creates complexity and inconsistencies which may sink FASB and the SEC, and damage accounting and the economy. Paragraph 5.31 cites or hints at an example of superimposition. Immediate recognition is forbidden unless the reality of expense incurred is so great that the associated benefit can not be meaningfully ignored. This is phrased or disguised as deferrable expense but it is immediate recognition. So even the conservative principle of not recognizing future expected income must give way. This might suggest a fundamental weakness.

**Concerns with a transaction price approach at contract inception**

5.34 The Boards acknowledge that using the transaction price can sometimes misrepresent the entity's obligation to transfer goods and services to a customer.

It will almost always do this since most contracts have margins (expected profit). What is being sacrificed is the net economic value of the contract, hardly appropriate in accounting for the contract or in reporting to management or shareholders.

5.35 ...some think the transaction price typically overstates an entity's performance obligations at contract inception. However, they think this disadvantage is preferable to the disadvantages of the current exit price approach.

I agree "the transaction price typically overstates an entity's performance obligations at contract inception." I don't agree with the proposed lesser of two evils solution. There are other choices beside two disadvantageous approaches. The AFTF (PVECF)

\(^7\) If FASB wants a principles-based model then asset/liability symmetry might be considered. More generally AFTF is only based on principles and those principles explicated or implicit in AFTF might prove enlightening.
approach has few theoretical disadvantages or practical disadvantages. I don’t see disadvantages to immediate recognition of value.

5.36 ... the Boards propose that the measurement of the performance obligation should be increased to an amount greater than the transaction price with the corresponding entry recognized as a contract loss.

Lack of symmetry? Complexity? Risk of error?

Subsequent measurement of performance obligations

5.37 ... Therefore, the initial measurement of the performance obligations in a contract must be updated if it is to continue to provide a useful depiction of the entity’s obligations to provide goods and services in accordance with the contract.

To say nothing about economic measures.

5.38 To capture all of those changes affecting an entity’s performance obligations, the entity would need to measure them at each financial statement date using the same basis as for their initial measurement.

FASB has painted itself into a corner. The transaction prices at inception approach is not appropriate (not that it ever was) if circumstances change.

5.39 ... That is either because the values of the goods and services promised in those contracts are not inherently volatile or because those contracts are of short duration, which itself minimizes the risk of volatility.

Don’t these reasons reduces “complexity” and “risk of error” and suggest immediate recognition?

5.41-5.43 ...

These sections introduce the subject of accounting allocations (time shifting) and now is the time to discuss these from an important general perspective. Time shifting of cash flows is logically impossible so accounting has defined such things as revenues and expenses. The problem with such definitions is that they are artificial, arbitrary, ambiguous and undisciplined. In contrast, cash flows are subject to the discipline of the ledger and balancing. They represent, in fact are, real measurable values.
The FASB approach to revenue recognition in a sense is unassailable since revenues are defined as that which is recognized and recognition is the measurement of revenues. But such circularity is hollow and, more importantly, not useful. Accounting does not exist in a vacuum; it must serve an external purpose. Only by heading toward the beacon of purpose can a useful accounting and reporting model be approached. Consider two types of allocations.

First, incurred or paid expenses are often allocated or deferred, for example, deferred acquisition expenses. It seems peculiar and perverse to not immediately recognize such expenses since money has been paid out and no longer exists. In fact, this is not what is done. No such expenses are deferred unless they are recoverable, i.e., there exists a stream of expected income to offset the expense. Furthermore only such expenses that are fully recoverable from expected income are deferred. This is identical to immediate conditional recognition of the income stream (up to the limit of expenses). In this way no future net income is recognized even though the contract or endeavor may be quite profitable. This hides information and is not useful for shareholder or management decisions. In fact, investment and economic progress is hindered by such an unbalanced and dismal perspective.

Second, incurred and received incomes are often allocated or deferred, for example, money received in advance on a service contract. It seems peculiar and perverse to not immediately recognize such income since money has been received. In fact, this is not what is done. No such income is deferred unless there is a corresponding future expense associated with it. To make sure that no income is recognized the future expenses are set equal to the income received (transaction price at contract inception). This is identical to immediate conditional recognition of the expenses (at least equal to income). This hides information and is not useful for shareholder or management decisions. In fact, investment and economic progress is hindered by such an unbalanced and dismal perspective.

The goal of allocations is to match income and expenses but such matching is unbalanced and biased against the future. It is also not the only way of matching. Immediate recognition of all expenses and income is another way, in fact the dominant way of making financial decisions. Immediate recognition promotes transparency, relevance, timeliness and candor. Financial reports should immediately recognize and immediately (within reason) report changing expectations.

Accounting would do itself and the world a favor if it matched the methods and needs of its audience.

**Allocating the transaction price to separate performance obligations**

The Boards' preliminary view is that the transaction price should be allocated to each performance obligation in proportion to the standalone selling price of the promised
good or service underlying that performance obligation. It is peculiar that FASB is suggesting exit prices after rejecting them for initial recognition. In addition determining standalone exit prices seems burdensome. I think such standalone prices may not be observable or may add up to much more than the initial transaction price. Estimating such standalone prices makes a mockery of FASB’s objections to valuations as being “complex” or subject to “risk of error”.

Estimating standalone selling prices

5.47 The Boards acknowledge that estimating a standalone selling price for a promised good or service can be difficult. ... Failing to account for the satisfaction of a performance obligation would impair the depiction of an entity’s financial position and performance in a contract with a customer.

I disagree with the underlined part. It is immediate recognition which provides the best depiction of an entity’s financial position. It is reporting delay and allocations which impair.

I object to FASB willy-nilly lumping things together, jumping to conclusions, loaded questions, unjustified assumptions, setting up straw men, providing limited or incomplete choice, exposure drafts with predetermined conclusions, not presenting alternative models. This behavior is not productive and, frankly, intellectually dishonest. This is a harsh assessment but I can’t continue to be polite when the stakes are so high. FASB must examine its purpose, its behavior and the purpose of accounting and financial reporting.

5.48...

(a) expected cost plus a margin approach—an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity typically requires on other similar goods and services.

What is the rationale for adding a margin? ...

Just as I thought.

Remeasurement of performance obligations

When those changes are significant, an entity may need to recognize them by updating the initial measurement of the performance obligations.
This sound like immediate recognition. I hope this is not accomplished by permitting misrepresentative "prior period restatements".

**Remeasure when deemed onerous**

This section is another example of accounting bias. Where is the remeasure when favorably changed circumstances arise. I presume complete obligation extinguishment would create a windfall profit but not anything less than that. An example of an irrational accounting discontinuity or cliff.

5.60 ... (b) the remeasurement basis, that is, how should a performance obligation be remeasured if deemed onerous?

I suspect that immediate recognition of all deficiencies would be specified.

**When should a performance obligation be deemed onerous?**

5.61 ... when the expected costs to satisfy that performance obligation exceed its carrying amount (that is, a cost trigger). ... When the loss becomes probable, the contract is remeasured and the loss is recognized.

Why does FASB ultimately appeal to expected value and immediate recognition yet refuse to consider such a model directly. This band-aid approach to standard setting creates massive complexity and constant confusion. FASB may collapse under the weight of its own constructions, unfortunately dragging financial reporting and the economy down with it.

**Summary of options for an onerous test**

5.82 The Boards’ preliminary view is in favor of the cost test.

Isn’t this expected cost approach at variance with the "transaction price at contact inception" approach?

**Concerns about remeasuring performance obligations only when deemed onerous**

5.84 For most contracts with customers, the Boards think that an allocated transaction price approach results in decision-useful information to users of an entity’s financial statements.

Immediate recognition would be most decision-useful. Delayed recognition less so.
5.86 ... (b) It is a one-way test. Adverse changes that do not cause a contract to become onerous are ignored along with all favorable changes (except those favorable changes that prevent the contract from becoming onerous). That is inconsistent with the concept of neutrality in the Boards’ conceptual frameworks.

Why is the neutrality concept a concern for remeasurement and not when the contract is originated?

(c) It is inconsistent with IAS 37. IAS 37 requires the use of current cash flow estimates at each financial statement date. The Boards note that some transactions are likely to be moved from the scope of IAS 37 into the revenue recognition standard (for example, warranty and refund obligations).

Why not put financial reporting on a cash flow basis (as AFTF suggests) and dispense with unnatural accounting definitions and accounting treatments of revenue and expenses?\(^8\)

Addressing concerns about remeasuring performance obligations only when deemed onerous

Scope of the revenue recognition standard

The potential need to exclude derivatives, insurance contracts, long term contracts with volatile prices, contingent contracts, big ticket contracts (and probably many other contracts) from the revenue recognition standard severely restricts its scope. There will always be questions about its applicability. In fact, there is some question as to whether, because of its limited scope and lack of robustness, it should even be called a standard. It is also very complex and legalistic. Is it even worthwhile?

5.88 ... 
If those contracts are initially and subsequently measured at fair value, then any changes in circumstances that affect their fair value are recognized in the period in which they arise. The Boards could exclude those obligations from the scope of a revenue recognition standard.

Although I agree with the immediate recognition aspect of the fair value concept that concept is dangerously flawed (as I have long and repeated contended)\(^9\). What a tangled web has been woven!

5.89 Some insurance contracts are another example of performance obligations for which the allocated transaction price approach may not provide decision-useful information.

\(^8\) If you chase two rabbits both will escape.
\(^9\) See my website or submissions to FASB for details.
Both statutory and GAAP insurance accounting have given way to cash flow testing (PVECF technology).

**Disclosure**

5.91 As part of a revenue recognition standard, the Boards intend to use disclosures to enhance the decision-useful information about an entity’s contracts with customers.

Why not disclose current economic values and be done with it?

5.92 ... They think that re-measurement of performance obligations may not be necessary if disclosure requirements provide sufficient information to users of an entity’s financial statements about the changes in circumstances affecting those performance obligations.

End users of financial reports want useful processed quantitative information not data or background information. They want information that is understandable, meaningful, comparable and Truthful; Truthful not in the sense of accuracy or neutrality, but in the sense of conveying and clarifying quantitative relationships (see the philosophical point discussed above for Section 3.25).

5.94 Others, however, note that the Boards’ conceptual frameworks state that disclosure is not a substitute for adequate recognition and measurement.

**Another measurement approach for some performance obligations**

5.95 ... In such an approach, the performance obligations would be measured (in either direction) at each financial statement date rather than only by exception when deemed onerous.

Right on.

5.96 Those supporting another measurement approach note that the scope of a revenue recognition standard would be very broad, covering the most simple transactions to the most complex. Hence, they think that more than one measurement approach would be required unless a single measurement approach is adopted that can handle the most complex transactions.

PVECF is robust and adapts to all situations.

5.97 If the Boards were to specify another measurement approach for some performance obligations, they would need to specify which types of performance obligations should be subject to that other approach. It would be difficult to draw the line between two measurement
approaches—any line is bound to be somewhat arbitrary and inconsistent with a principle-based approach.

I agree that another approach is difficult to demarcate. PVECF is a single approach which is principles-based unlike the bulk of FASB/GAAP accounting which is based on various detailed, often inconsistent or conflicting rules.

5.98 ...

Insurance contracts are a square peg for which FASB has a round and triangular holes.

Summary

5.102 The measurement of a performance obligation should depict decision-useful information about an entity’s obligations to provide goods and services to a customer, and the entity’s contractual performance in the reporting period.

This misses the mark. The subject of this discussion paper is revenue recognition in contracts, not specifically the measurement of a performance obligation and the allocation of revenue based on performance. This type and level of data is not decision-useful information. The economic or PVECF value of the contract or groups of contracts is a better type and scale for financial reports.

5.103 The Boards propose that performance obligations initially should be measured at the transaction price

I can’t decide which is the more inappropriate: exit prices or transaction prices.

5.104 ... Consequently, the total amount of revenue that an entity recognizes over the life of the contract is equal to the transaction price.

Does this apply equally to pre and post payment?

5.105 ... In that (onerous) case, the performance obligation is remeasured to the entity’s expected cost of satisfying the performance obligation and the entity would recognize a contract loss.

An immediate loss?

Questions for respondents
Question 10
In the Boards’ proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.
(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

No. If the goal is decision-useful financial information, the value of the contract(s) should be communicated. Transaction prices assume that such contracts are initially valueless and then corrects over time. This type of accounting is not useful for capital allocation decisions whether by management or shareholders. Hiding information (even when conservative) violates the Board’s concept of neutrality.

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity’s expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

Yes. But expected cost should be also applied to initial measurement and for contracts which are the opposite of onerous (i.e., profitable) which is the more common situation.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

Almost all contracts have an economic value, generally positive. When the contract is signed the company and counterparty are committed. That contract, if it has meaning and is enforceable, must be immediately recognized legally and financially. I would even go so far as to say that the performance under the contract is satisfied when signed. Admittedly there is a promise but how is that different from the bank promising to give back your deposit at some future time (which has immediate recognition).

But it is not necessary to appeal to the contract for recognition. In fact, I think the contract link is the wrong approach. The principle I espouse is that financial report should recognize expectations, i.e., as soon as management’s expectations (PVECF) change the economic measure of such change should be reported (with periodic reporting or significance limits).

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Yes, they should be revalued periodically. Any change in value should be immediately reported (again subject to significance and reasonable periodicity). But this should be
at the proper company scale and generally not for individual contracts since some may perform better and some worse; it is the overall values which should trigger disclosure. A very large or dominant contract might require its own trigger. Individual performance obligations within a single contract generally are insignificant. The smallest scale of measurement should be the individual contract. I doubt that performance obligations will ever form a complete or representative picture.

I would not use performance under a contract. I would not use contracts per se since they form an ill defined and small portion (see exceptions already discussed) of the total economic picture. In fact I would not use any accounting summary of assets or revenues since they are massively incomplete. Much if not most of today's company values are wrapped up in intangibles (think Google, Intel, financial services). Our economy is increasing service, technology and information based. Intangibles are "accounting intangibles" that are difficult to identify and measure but nevertheless create future cash flows. Such intangibles may be corporate structures, patents, human capital, information systems, etc. I would use expected future cash flows as the basis for assets and liabilities and measure the economic progress as their net change. AFTF outlines how this may be accomplished in a simple, relevant and disciplined manner. Please see my website for complete details.

Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.

I've noticed that the word "profit" has been religiously avoided. But most contracts are, by design, profitable. Not only has the word profit been avoided but there has been an active attempt to disguise it. For example, the above paragraph cites "costs of obtaining the contract" which I presume includes the cost of capital, thereby eliminating the shareholder cost of capital. This is fine from an "accounting perspective" but shareholders and others want to know their expected returns and current value. Using the transaction price values the contract at zero.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity’s performance obligations? Why or why not?

No. For one that cost is generally incurred in advance where obligations are future liabilities. Second, there may be many such costs incurred on an ongoing basis for potential contracts. Should the successful contract(s) fund ongoing cost of business?
Third, in the case of a large single occasional contract, acquisition costs are often deferred. Isn’t this the opposite of inclusion as an obligation? Fourth, it seems contradictory to carefully define performance under a contract and then throw in something which is separate in nature and timing to performance or satisfying the customer.

(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity’s financial position and financial performance? Please provide examples and explain why.

I think recognizing cost as they occur (if not before) is fine. Recognizing them later is non-recognition.

AFTF is prospective and recognizes expected cash flows (when they occur) and measures them as present values. The result of these two steps is the recognition of value. Past cash flows nevertheless are very important in the AFTF model.

**Question 12**
Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity’s standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Too complex. End result is dubious.

I would not use transaction price. This is an abrogation of accounting responsibility. It may be convenient and easy but it accomplishes nothing.

**Question 13**
Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Yes I agree that, failing established prices, estimates should be used. But I don’t agree with the transaction price assumption. Standalone transaction prices (market or estimate) are liquidation prices (like mark-to-market) and we know where that road leads.

Transaction price obliterates expected contract profit. Hence the net result of a signed contract is non-recognition. This is “opposite world”.
CHAPTER 6: POTENTIAL EFFECTS ON PRESENT PRACTICE

Introduction

6.2 To some, it may seem premature to discuss the effects of the proposed model when that model is still subject to change in light of responses to this Discussion Paper and the Boards’ future discussions.

Not the first time exposure drafts or discussion papers have indicated a path already chosen.

6.3 For many contracts with customers, the proposed model would not change the way an entity recognizes revenue. For example, the proposed model would not change how revenue is recognized for typical retail transactions in which the entity and the customer fulfill their respective promises at the point of sale.

Timing in this case is trivial and revenue is recognized immediately. This reflects the economic benefit to the company.

6.5 The Boards invite comments not only on the areas listed above, but also on any other area of present practice for which respondents think that implementing the Boards’ proposed model would affect an entity’s revenue.

It is unclear whether contract/performance based recognition is intended to be a general revenue recognition model. We have seen many examples where it lacks applicability. But it also lacks applicability to non-contractual situations, for example retail sales. It doesn’t adequately account for most profitable contracts. More importantly it does nothing to capture important, perhaps dominant, economic values resulting from accounting intangibles. If contract/performance based recognition is intended to be a general revenue recognition model then it will affect other areas of revenue recognition and consign GAAP and FASB to its appropriate location.

Use of a contract-based revenue recognition principle

6.7 That principle, which the Boards think can be applied consistently to all contracts with customers, is the core of the Boards’ proposed model for a revenue recognition standard.

How can FASB make this claim in light of all the cited exceptions and conflicts?

So now the truth comes out: “That principle … is the core of the Boards’ proposed model for a revenue recognition standard. What a disaster! How in the hell did this
contract-based detour subsume FASB commendable intention to examine general revenue recognition from the ground up, perhaps even based on basic principles?

6.8 ... recognized at time of sale (usually meaning delivery).

Is this a common usage, a legal usage or could it be an “accounting usage”?

6.9 Similarly, IAS 18 implies that an entity should recognize revenue from the sale of a good when a performance obligation is satisfied because an entity recognizes that revenue only when it has transferred to the customer the risks and rewards of ownership and control of the good.

Doesn’t the contract transfer ownership and control?

6.10 Some standards, however, are inconsistent with the Boards’ proposed revenue recognition principle and might be affected significantly. For example, sometimes revenue is recognized on the basis of increases in assets, such as cash, inventory in the absence of a contract, and inventory under a contract, rather than an entity’s contract with a customer.

Does this not suggest an alternative approach? This approach should be more than an afterthought.

Potential effect on cash-based revenue recognition

6.11 In some cases revenue is recognized from an increase in cash rather than from an increase in an entity’s net position in a contract with a customer.

In some cases? Are not cash (non-contractual transactions) sales dominant? Why introduce the entity’s net position in a contract now when it has been buried in all previous discussion?

6.12 Present practice sometimes uses the collectibility of payment as a criterion for revenue recognition. Hence, if collectibility is not reasonably assured, revenue recognition is determined by the increase in cash rather than by an increase in the entity’s net contract position.

Expected values provide reasonable assurance. Expected values are designed to work with groups of items over time. These values are already discounted for collectibility and the grouping of contracts or transactions over time provides reasonable assurance. In any event, it is the best we can do and more than adequate for financial reporting, especially within a disciplined model like AFTF. In contrast, GAAP is reasonably expected to be inadequate.
6.14 ... The Boards have not yet discussed that issue (collectibility) and its potential effect on the amount of the contract's transaction price that is allocated to performance obligations.

This creates a problem. There is no problem in the AFTF approach. Either payment is thought to be collectible in which case assuming collection is appropriate or there are doubts about collectibility in which case those doubts can be translated into expected payments. In aggregate such expectations are reasonable and as representative as financial reporting ever gets.

**Potential effect on accounting for inventory in the absence of a contract**

6.15 Recognizing revenue in those instances is consistent with the Boards’ existing definitions of revenue and the recognition principles in their conceptual frameworks.

But it is inconsistent with contract performance based recognition.

This brings up a recurring issue in the current accounting model. The current GAAP model is fundamentally flawed and does not communicate decision-useful economic information. This failing is often so critical that accounting practice must use alternative methods. Even FASB acknowledges fundamental flaws and publishes Statements that bridge the gap between GAAP and economic reality. Most FASB Statements are attempts to reconcile the basic retrospective cost model with prospective (balance sheet) economic values. I concede that most fundamental concepts and principles are sound, if incomplete, but GAAP is a most unfortunate implementation. AFTF is better implementation.

6.16 Therefore, the Boards need to consider whether those entities should be precluded from presenting increases in the value of inventory as revenue and should, instead, present those increases as another component of comprehensive income.

Again we see a fundamental weakness in the revenue concept. If something does fit the revenue concept, dump it in non-revenues (whatever that means). AFTF doesn't have to artificially reconcile the past (income statement) with the future (balance sheet). AFTF is prospective and utilizes a Statement of Values which automatically and naturally balances the economic progress (the period change in values or value added) and outlook (PVECF) of the company.

**Potential effect on accounting for inventory under contract**

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10 Better in the sense of simpler, more relevant, more disciplined, more transparent, more comparable, more consistent and more widely applicable. AFTF would be good for shareholders, capital markets, management, accountants and FASB.
It seems peculiar that revenue from inventory writeups might be permitted yet forbidden under contracts where control legally passes with the contract. A model that frequently doesn’t apply or has exceptions seems weak. Where is the general principle?

**Identification of performance obligations**

The Boards think this pattern of revenue recognition better represents the transfer of assets to the customer and, therefore, results in more relevant information to users of financial statements.

Why is delayed recognition more relevant than immediate recognition? It seems that when a contract, expected to be profitable, is obtained and signed economic value has been enhanced. This is desired and useful information. Non-disclosure or delayed disclosure (using the transaction price assumption) hides or destroys information. This is less relevant and non-neutral. Better to measure “at an entity’s expected cost of satisfying the performance obligation.”

**Sales incentives**

No comment

**Use of estimates**

6.36 In the Boards’ proposed model, the transfer of assets to a customer determines when revenue would be recognized, but the amount of revenue recognized under the Boards’ proposed model would often depend on an entity’s use of estimated selling prices. ... Revenue recognition standards in IFRSs do not prohibit the use of estimates when allocating the transaction price to identified components of the contract.

Can estimates be used to immediately recognize expected losses for onerous contracts? Same question for expected profitable contracts.

6.38 ... 

In one sense, observed or estimated prices, if available, are incontrovertible evidence. They are incontrovertible evidence of ... ta da ... market prices. Are such prices representative of an entity’s assets or liabilities. Generally not. Only in the case of forced liquidation are market prices appropriate. This is the problem with mark-to-market. See the Essay “Fair Value Accounting” or comment letters to FASB for a detail discussion.
immediately transfers that profit to another company and may even create artificial losses. Not a good basis for reporting the company’s economic status or progress.

6.40 ... The Boards’ proposed model would not allow the residual method, whereas Issue 00-21 requires it in specified cases.

This is only one of several changes from current practice. What does this say about the robustness of the GAAP model?

6.42 ... standards that implement measurement reliability thresholds (such as VSOE in SOP 97-2) and limit the use of estimates often create units of account and patterns of revenue recognition that the Boards think do not faithfully represent the economic position and performance of the entity in the contract.

AFTF extends this thinking to its logical conclusion: unless estimates are used the economic position and performance of the entity cannot be faithfully represented. This follows from the fact that the economic position (and the balance sheet progress) are purely prospective. The only means of capturing the future is with estimates (PVECF). In the case of AFTF these estimates are highly disciplined and auditable!

**Capitalization of costs**

6.43 ... consequently, costs would be recognized as expenses when incurred unless they were eligible for capitalization in accordance with other standards.

Does the Board not see that this fragmented approach to standards as a fundamental flaw? There must be some guiding principle not circumstantial exceptions and choice. AFTF does not permit such complexity and license. AFTF is based on principles and only principles, e.g., there are no industry or situation specific rules or exceptions.

6.44 In other instances, an entity recognizes the costs of obtaining a contract as expenses when incurred, but revenue is also recognized to offset them. As noted earlier, the Boards’ preliminary view is that revenue is recognized only when a performance obligation is satisfied. Hence, revenue would neither be recognized at contract inception nor offset any costs of obtaining a contract.

Is this a trial balloon? If so it’s made of lead.

6.45 A common example of that potential effect is sales commissions and other marketing expenses associated with obtaining a contract. If those costs are not eligible for capitalization in accordance with other standards, they would be recognized as expenses as incurred. Because no
revenue would be recognized at contract inception (unless a performance obligation is satisfied), that may lead to the recognition of a loss when a contract is obtained.

So a profitable contract could even have negative recognized value. Another visit to backwards world.

6.46 Some note that an allocated transaction price approach could be modified…

Is there no end to this tangled web?

Consequently, although some revenue would be recognized at contract inception, no profit would be recognized at that time.

At least there is some consistency here, however misplaced.

Summary

6.47 For many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the Boards’ proposed model would differ from present practice.

A contract-based revenue recognition model is not needed for and hardly applies to retail transactions. Unfortunately where it does apply it either conflicts with established practice or produces the wrong result. Although I don’t necessarily support established practice, much practice and FASB Statements are intended to recognize and represent economic reality. There are underlying principles, however implicit or poorly satisfied. To scrap these is throwing out the baby with the bath water.

APPENDIX A: EXAMPLES

No comment.

APPENDIX B: SUBSEQUENT MEASUREMENT ALTERNATIVES

B1 As Chapter 5 mentions, some prefer an approach of measuring an entity’s performance obligations at each financial statement date rather than only when the entity deems a performance obligation onerous. In other words, they favor an explicit measurement approach rather than an allocated transaction price approach that remeasures only when a performance obligation is deemed onerous by exception.
Who are these “some”? Are they Board members? Do they favor explicit measurement at contract inception? Do they favor immediate recognition “both favorable and unfavorable”? Is the “entity’s net position” an economic value (PVECF)?

**Current exit price approach**

Isn’t the exit price approach in line with the “fair value” concept? Both are potential disasters. I only raise the question to emphasize the crazy conflicts and contradictions that infest GAAP.

... Although the Boards rejected that approach as the general approach for measuring performance obligations, they could require its use for measuring some performance obligations, both initially and subsequently.

Tangled web.

B5 ...

Exit prices may not be observable or may be hard to estimate, as noted. But they also may be unreasonable due to illiquid or panicked markets. This is the fate that befell mortgage backed securities where the market for MBSs essentially evaporated causing accounting bankruptcies for those banks marking to market prices.

**Transaction price approach**

This approach essentially artificially sets the margin to zero. Profitable contracts are not recognized when initiated. This is economic non-recognition!

**Building block approach**

B13 Consider the three components or building blocks of a transaction price described in paragraph 5.9. Those components are the entity’s expected costs, the time value of money, and margin. For simplicity, this appendix ignores the time value of money.

This could be used at inception. It is the PVECF/AFTF approach, except that the margin or profit is immediately recognized and reported.

B16 ...
The margin would be locked in (not recognized) if positive but would be immediately recognized if negative (onerous contract). Violates neutrality principle.

APPENDIX C: TOPICS NOT COVERED IN THIS DISCUSSION PAPER

Scope of a general revenue recognition standard

This hints of a general standard but the description reads:

The Boards will decide whether any particular types of transactions should be excluded from the scope of the standard.

This revealing refers to the standard. In fact this is hinted at earlier in the DP. “That principle, which the Boards think can be applied consistently to all contracts with customers, is the core of the Boards’ proposed model for a revenue recognition standard.”

Among the issues the Boards will consider are:
• time value of money
• uncertainty (including credit risk and contingent consideration)
• noncash consideration.

Uncertainty and the time value of money are generally not handled in a coordinated or meaningful manner. AFTF develops a historical cost of capital approach which deals with all interest components (risk, uncertainty, inflation, time value of money, etc.) for the company and conditions under consideration.

Transition and effective date

The Boards will consider the effective date of the general revenue recognition standard and the transition guidance required.

Final Comments

This DP has been focused on contract-based revenue recognition: its scope, limitations, exceptions, internal inconsistencies, methods of application, illustrative examples, and, conflicts with practice or with Statements or with other pronouncements. I doubt that the model discussed will be successful even within the confines of contracts. To use this narrow shaky foundation as the core for the edifice of a general revenue recognition standard is irresponsible.
FASB must first consider the purpose of financial reporting. It must meet the needs and desires of management, shareholders, analysts, regulators. It must determine what information and what form of information is most decision-useful. FASB must construct principles that satisfy its ultimate audience (not accountants, auditors, the AICPA, or traditional practice and views). FASB must be open to new ideas and change.

I have contributed to FASB many new ideas in the form of the draft proposal: *Accounting For The Future* which is a new complete accounting and reporting model. It has been supplemented by a news letter and many essays delving into many aspects of AFTF. In addition many detailed submissions have been provided FASB to help them with their exposure drafts and discussion papers. I have never seen a single idea of mine enter into FASB thinking or arguments. I can only conclude that FASB has not read my ideas, proposals or comments.

There are few voices which represent the shareholder. Those voices which are raised seem to be ignored. FASB has failed its mission. Something needs to be done.

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12 Attached to the end of these comments is an essay furnished to FASB in several forms 10 years ago which presented sound arguments about the inappropriateness of the “fair value” concept. I have never seen any presentation of my arguments is subsequent FASB deliberations or publications.

13 Once one confers on a select and denominated group ultimate epistemological authority on core questions arising from the problem of knowledge, the nearly inevitable result is philosophical paralysis, and what is more likely to happen is positions will become hardened, and the only thing left for scholarship is to interpret the words of the wise; so the entire debate is now not a debate about the nature of truth, but about how a text or holy maxim is to be understood.

The Great Ideas of Philosophy: Daniel N. Robinson
Fair Value
by Humphrey Nash

Abstract

*Fair value is the attribute that will guide the use of present values in future accounting developments and pronouncements. The use of present values is most welcome; the use of fair value is not. This article explains why and sounds the alarm.*

Introduction

In recent years the Financial Accounting Standards Board (FASB) has researched, developed, and promoted the use of Present Value of Expected Cash Flows (PVECF) as a measure of economic value. FASB has done a commendable job of introducing the concept of expected cash flow based on probability-weighted outcomes. FASB has also illuminated the concept of present value as a sum of interest discounted expected cash flows.

In order for a measure to be relevant it must represent some observable attribute. For PVECF the attribute recently proposed is fair value. This attribute is what PVECF is intended to represent and hence fair value provides theoretical guidance in calculating PVECF or judging whether or not PVECF is appropriately representative.

The adoption of a PVECF attribute is critical to the future of accounting, accountants, and accounting organizations. It is vital to get it right.

In its exposure draft *Using Cash Information and Present Value in Accounting Measurements*, FASB has defined Fair Value to be,

"The amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

If there is an active market for the asset (or liability) then the observed market price is a fair value and a PVECF measure should approximate or be that price. If no active market exists then a similar PVECF should be employed to input an appropriate market price. If PVECF meets this goal it is then said to have satisfied the fair value attribute.

The definition of fair value seems reasonable and it is difficult, perhaps un-American, to challenge a term like "fair value". In fact, I like the term and I support both the concept of fairness and the concept of value. The only thing I have a problem with is the interpretation of the definition.
What Fair Value Is Not

Fair value is one of several competing attributes of PVECF. FASB cites two others in its exposure draft, namely, entity-specific value (similar to value in use) and cost accumulation value (a terrible term). FASB distinguishes these two attributes from one another and from the fair value. Without going into detail, I believe that entity-specific and cost accumulation are, in practice, identical concepts.

The table below is taken from the FASB exposure draft and compares fair value with cost accumulation.

<table>
<thead>
<tr>
<th>Fair Value</th>
<th>Cost Accumulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected cash flow approach</td>
<td>Same</td>
</tr>
<tr>
<td>The entity’s labor costs, which management believes are consistent with those that others would incur</td>
<td>The entity’s labor costs, regardless of whether others would incur similar costs</td>
</tr>
<tr>
<td>Allocation of overhead and equipment charges</td>
<td>No allocation of fixed charges</td>
</tr>
<tr>
<td>Contractor’s markup</td>
<td>No markup</td>
</tr>
<tr>
<td>Market price of items manufactured by the entity</td>
<td>The entity’s cost to produce those items</td>
</tr>
<tr>
<td>Value of salvaged equipment</td>
<td>Same</td>
</tr>
<tr>
<td>Expected cost of subsurface crash based on 1-in-10 probability and estimated cost of $100,000</td>
<td>Same</td>
</tr>
<tr>
<td>Market risk premium</td>
<td>None</td>
</tr>
<tr>
<td>Adjustment to reflect the entity’s credit standing</td>
<td>Discount rate based on the entity’s embedded cost of liabilities</td>
</tr>
</tbody>
</table>
The choice of attribute has created some controversy among the FASB board members. At least two members (the Dissenters) strongly favor the cost accumulation attribute and their views are well represented within the exposure draft. Despite the lack of agreement, FASB has tentatively chosen fair value.

"In future standard-setting deliberations, the Board expects to adopt fair value as the measurement attribute when applying present value techniques in the initial and fresh-start measurement of assets and liabilities."

The Dissenters have no quarrel with PVECF, which they seem to like, only with fair value as an attribute of PVECF. It is stated that they support fair value under certain circumstances, but I think that statement is a mischaracterization, in that it appears they support fair value only when it coincides with cost accumulation, for example, in the case of an actively traded financial instrument held short-term. In general the Dissenters

"... agree with that description of fair value and with the notion that fair value is an estimate of a current price, even though current settlement may not be possible. However, they do not consider market-based assumptions to be relevant if the entity does not intend to acquire a non-financial asset or settle a non-financial liability in a current transaction."

They further hold that,

"Using fair value to measure non-financial assets and liabilities has troublesome recognition implications. " (for example, recognizing non-existent liabilities)

Using fair value to measure non-financial assets and liabilities also “produces income statements that are confusing and less useful than those produced by a cost-accumulation approach.”

The crux of the controversy boils down to a simple observation: fair value is not value-based. It is price based and would be better labeled “fair price”. This follows directly from the definition; "fair price" is the amount at which that asset can be bought in a current transaction between willing parties.

Is there a difference between price and value? It depends. In the case of an actively traded financial instrument held short-term, there is no difference. In the case of the seller of an asset there is no difference. For the buyer of an asset to be held or used, there is a difference, often quite large.

Why is there a difference? The answer is that the buyer of an asset has an economic or comparative advantage in using that asset. The asset is worth more to the entity than the price; this motivates the purchase in the first place. The value to the buyer of a rational purchase exceeds the price or cost. If the measurement of value is the goal then fair value as, an attribute of PVECF, should not be used.

Should value be the goal? If we want to make rational economic decisions, we must measure value. If we want to exploit comparative advantage, we must measure value. If we want accounting to be more forward looking, we must measure value. If we want to use PVECF, we must measure value.

Fair value is a price-based concept. It continues the historical cost perspective of traditional accounting. This retrospective view is at odds with the prospective view of PVECF. To assign a retrospective attribute to a prospective measure is inconsistent and self-defeating.
An Alternative View

The Dissenters have provided an alternative to fair value. This alternative, to its credit, is value oriented. But cost accumulation is incomplete or, at least, not explicitly complete. "To provide relevant information in financial reporting, present value must represent some observable measurement attribute of assets or liabilities." Fair value represents observed price (PVECF to the seller), but has no connection to PVECF to the buyer. Fair value observes, but observes the wrong thing. What is the observable attribute of the cost accumulation approach? What value does it represent? What value should it represent?

A clue to what it is, or should be, can be found in the basic purpose of accounting and financial reporting. Accounting and financial reporting is intended to be relevant to shareholders and their representatives (management, analysts and portfolio managers). The value they are concerned with is shareholder value. This value is readily observable in the capital markets. PVECF should have shareholder value as the observable attribute.

Prospective Accounting

The draft proposal Accounting For The Future (AFTF) outlines a prospective accounting model based on shareholder value as the observable attribute of PVECF. AFTF provides a relevant attribute, but also provides specific disciplined technology to ensure that the attribute is satisfied. Fair value does not provide a relevant attribute and provides little methodology and little discipline.

AFTF resembles cost accumulation. In the Comparison Table AFTF would be identical to cost accumulation, except for the final two items. AFTF uses an embedded historical cost of (equity) capital rather than an embedded debt rate. This AFTF cost of capital implicitly includes a provision for capital market risk and uncertainty.

Suggestion

Interpret fair value to be,

"The capital market amount at which the asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."

The fair value of the company is the market capitalization. The total price of the company stock is the total value to the company because the company is the seller.
Indictment of Fair Value

The criticisms below present a summary of the many faults of fair value as an attribute of PVECF.

1. Fair value omits intangibles, especially assets. These values are dominant today and can't be ignored.

2. Active market values exist or they don't exist. If they exist, there is little use for PVECF. If they don't exist, it will be very difficult to determine or verify the fair value of an asset or liability. Fair value is observable only in those cases where it is not needed.

3. The fair value of an asset is the value to the seller not to the buyer. The value to the buyer must reflect the comparative advantage that the buyer has, otherwise that advantage withers.

4. Only in pathological cases is the value equal to the price, for example, in the case of a financial asset held for short term trade or in the case of forced liquidation. In these cases all alternatives to fair value would also equate value to price to reflect the real cash flows.

5. Fair market value is unsuitable for decisions. Decisions (for a publicly traded company) are made with the goal of adding value. Measuring cost or liquidation values is not oriented towards this goal.

6. The fair value concept is more strained for liabilities than for assets. "Buying liabilities" even sounds perverse. For an ongoing enterprise it is doubtful that liabilities can be fully discharged to a third party.

7. Fair value would tend to diminish assets and increase liabilities compared with current accounting practice. This may discourage prudent risk taking and stifle economic progress.

8. As defined, the fair value of component assets and component liabilities will not add up to the fair value of the total company. This value, the capital market fair value, is well defined by an active stock market. If the component measures don't add up to a well established total then those measures must be redefined.

9. PVECF is patently incompatible with fair value since expectations are prospective from the entity's perspective whereas prices are retrospective and are from the seller's perspective.

10. Fair value does not provide procedures, discipline, or uniformity. Fair value provides no guidance in determining expected cash flows or discount rates. Unless a fair market value is observable there will be no discipline on "value" assignments. Interest rates, risk and uncertainty premiums, projected cash flows may vary with each asset or liability.
AFTF generally deals with company level cash flow. However, new cash flows must be valued individually and incorporated into a revised cash flow model. For example, when a patent is purchased the cost/benefit (a prerequisite analysis) must be reflected as new information in PVECF.

See Statement of Financial Concepts No. 7