

committee on corporate reporting

June 19, 2009

Mr. Russell Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
Sent by email to director@fasb.org

File Reference No. 1660-100, Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers* 

Dear Mr. Golden:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers*, issued by the Financial Accounting Standards Board and the International Accounting Standards Board (together, the Boards). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

We have highlighted our primary views below and, in the Appendix to this paper, provided additional context to our primary views and detailed responses to the Discussion Paper questions.

#### There is a Need for a Comprehensive Model within a Simplified Framework

We are supportive of the project's overall goals of convergence, simplification, and comparability of revenue across companies and geographical boundaries. We also support the convergence of U.S. GAAP and International Financial Reporting Standards. We believe that the volume of existing revenue recognition guidance is unnecessarily complex and can produce conflicting results for economically similar transactions. We also observe that there is diversity in practices and interpretations associated with defining an earnings process. The earnings process is, in part, identified as a potential *cause* of the problems because it is not clearly defined, consistently applied and can lead to the recognition of items that do not meet the definition of assets and liabilities.

Revenue arrangements range in complexity. Offerings, and the way in which the assets are developed, constructed, and transferred to the customer, vary significantly. Those variants necessitate contractual terms and conditions that balance the risk and reward profile between the entity and its customer according to the nature of the arrangement. For example, the contractual terms and conditions associated with transferring a custom-ordered ship (the development may serve a single purpose, construction may occur over multiple years, and there may be a single customer) are significantly different than the contractual terms and conditions associated with transferring a homogenous pool of non-customized product (development may serve multiple purposes, construction may occur over days or weeks, and there are may be multiple customers). In the former arrangement, the transfer of value and risks of loss is continuous during the multi-year contract period in order to mitigate the risks faced by both parties, whereas the transfer of value and risk of loss is generally instantaneous in the latter. Furthermore, single arrangements may have multiple elements that exhibit characteristics of construction (development of a fully functioning data storage warehouse), a lease (right to use intellectual property, such as software to manage the data storage warehouse), and insurance (multi-year fixed fee warranty of and maintenance for the warehouse).

The earnings process, a long standing accounting concept developed over decades, captures many nuances associated with those continuous and instantaneous transfers and can produce decision-useful information. For example, existing long-term construction accounting produces financial information that entities and their financial statement users understand and believe is reflective of the underlying economics of their transactions. We agree, however, that there are numerous instances in which the notion of the earnings process has been interpreted and applied differently, thereby producing inconsistent results. Standard setting is clearly necessary to resolve these issues.

A single revenue recognition standard that could be consistently applied to various transactions would resolve these issues. We evaluated the proposed model, which shifts the focus of revenue recognition from the earnings process to enhancements of assets and settlements of liabilities, in the context of being that single revenue recognition standard. However, we believe that the model raises many unanswered questions. In particular, we believe that the Boards need to provide a more robust framework around the definition of performance obligations and the aggregation criteria for performance obligations. We also believe that the definition of control needs to be enhanced. Further, numerous issues identified in Appendix C to the Discussion Paper remain unaddressed. It is therefore difficult to determine whether the proposed model could be *the* single revenue recognition standard.

Despite the lack of clarity on those issues, the examples provided in the Discussion Paper unambiguously demonstrate that application of the proposed revenue recognition model would result in certain substantial changes. As discussed in more detail below and in the Appendix to this paper, we believe that certain changes do not provide more decision-useful information than current U.S. GAAP. Rather, we believe that the proposed model could be enhanced to provide more decision-useful information while achieving the project's goals by defining performance obligations and aggregation of those obligations in a way similar to current U.S. GAAP, and interpreting "transfer of control" in a way that is similar to the "transfer of the risks and rewards of owning an asset."

#### The Definition of Performance Obligations and Their Aggregation Should Align with Stand-Alone Customer Value and Certain Existing GAAP Should be Retained

How much would you pay for a standard warranty on a brand-name drill? How much revenue should an entity recognize if that same drill is sold, then subsequently returned to the store? Finally, how much revenue should an entity recognize if it delivers something that has no utility unless some other thing that only it can provide in the future is delivered? We think the answer to all of these questions is "zero." The proposed model produces a different answer, thereby providing less decision-useful information than existing U.S. GAAP. We believe the issues, in part, lie in the proposed definition of performance obligations and how they are aggregated.

The definition and application guidance associated with identifying separable performance obligations are critical elements of a final standard. Current U.S. GAAP does not define "elements" or "deliverables." However, we believe that sufficient practice around the guidance set forth in SAB 104, *Revenue Recognition*, and EITF Issue 00-21, *Revenue Arrangements with Multiple Deliverables*, has developed to interpret "element" or "deliverable" as an asset (or group of elements that make up an asset) that has stand-alone value to the customer. This view requires preparers to evaluate value from the perspective of the customer. In doing so, deferred revenue (liabilities) that arises from entity's non-delivery or nonperformance of a deliverable can be directly associated with the asset the customer expects to receive. We believe this approach is reflective of the underlying economics from both the customer and sellers perspective and provides decision-useful information that can be explained by management to its financial statement users.

With respect to standard warranties and rights of return, we believe that the contract promises are inseparable from the sold good and, therefore, should not be separated. Further, the application of the proposed model does not provide more decision useful information than existing U.S. GAAP (FAS 5 and FAS 48) which would answer to the questions posed earlier as "zero." With respect to the proposed definition of a performance obligation, we believe that existing GAAP can be reconciled with the obligation by articulating the "promised asset" in the context of an asset or group of assets that has stand-alone value to the customer. In our view, promises that derive their value solely from other contract promises should be combined into one performance obligation. The result is that revenue would not be recognized in instances in which the customer has received something that does not have stand-alone value. Further, identifying separable performance obligations based upon individual promises that are delivered or fulfilled in different accounting periods (such as standard warranty, indemnification of intellectual property infringement, product roadmap sharing, right of return) would require extensive business process and information technology solutions to identify, measure and ultimately recognize the changes in these contract liabilities.

#### The Definition of Control Should be Expanded

Revenue recognition principles that are based upon *satisfying an obligation to the customer* encourages accounting that appropriately reflects the economics of underlying transactions. The proposed model represents an improvement over existing revenue recognition guidance which can result in the deferral of the entire transaction amount due to measurement issues. However, the Boards should provide an expanded definition of control in the proposed standard.

To illustrate our point, consider a typical consignment or contract manufacturing arrangements. Under these arrangements, the customer may have physical possession, title and an obligation to pay the entity. Further, the entity may have the explicit obligation to repurchase the goods or an implied obligation (through customary business practices) to repurchase the goods. It appears that, based upon the guidance provided in the Discussion Paper, the entity would recognize revenue because control over the assets has transferred to the buyer despite the expected repurchase. We do not agree with this result. Rather, we believe that a definition of control that is expanded to include an evaluation of the risk and rewards of ownership would produce more decision-useful information than the proposed model.

#### The Board Must Address Accounting for Costs in the Final Standard

The Discussion Paper states that costs associated with customer contracts should be expensed, unless they are eligible for capitalization under existing standards. We believe that standard setting, whether in this project or another project, must address the accounting for costs if the Boards proceed with the proposed approach. Consider, for example, the costs incurred by an entity in situations in which the entity intends to deliver a final product (development of a new technology, proof of concept, audit report, etc) at the end of the arrangement term. In these cases, it is necessary for the entity to incur the costs to generate the final product, and the entity is willing to incur those costs with the intention that it will realize a margin upon delivery of the final product. That is, the costs are associated with the development of an asset to the entity: the entity controls the work product (workpapers, the developed know-how, etc); the entity expects to derive a future economic benefit (consideration from the customer); and, the work product is the result of past events. A similar issue occurs in revenue arrangements that legally permit the entity to "recover" certain costs from the customer. We believe that entities may provide misleading financial information about their assets and liabilities if this issue is not addressed.

\*\*\*\*\*

We are supportive of the project's overall goals of convergence, simplification, and comparability of revenue across companies and geographical boundaries. We also support the convergence of U.S. GAAP and International Financial Reporting Standards. We recognize that the Boards' issued the Discussion Paper in an effort to solicit feedback during the early stages of developing the proposed model that meets these goals and, as a result, the model lacks certain clarity and completeness. We appreciate your consideration of our feedback on suggested clarifications and refinements, and are available to meet with you or answer any of your questions.

Sincerely,

Arnold Hanish

Chairman, Committee of Corporate Reporting

Financial Executives International

and Hamit

### APPENDIX RESPONSES TO QUESTIONS SET OUT IN THE DISCUSSION PAPER

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? WHY OR WHY NOT? IF NOT, HOW WOULD YOU ADDRESS THE INCONSISTENCY IN EXISTING STANDARDS THAT ARISES FROM HAVING DIFFERENT REVENUE RECOGNITION PRINCIPLES?

As stated in our cover letter, a single revenue recognition standard that could be consistently applied to various transactions would resolve the revenue recognition related problems in U.S. GAAP and IFRS. We evaluated the proposed model, which shifts the focus of revenue recognition from the earnings process to enhancements of assets and settlements of liabilities, in the context of being that single revenue recognition standard. However, we believe that the model raises many unanswered questions. It is therefore difficult to determine whether the proposed model could be *the* single revenue recognition standard.

As highlighted in our cover letter and discussed in more detail below, we believe that certain changes do not provide more decision-useful information than current U.S. GAAP. Rather, we believe that the proposed model could be enhanced to provide more decision-useful information by defining performance obligations and aggregation of those obligations in a way similar to current U.S. GAAP, and interpreting "transfer of control" in a way that is similar to the "transfer of the risks and rewards of owning an asset."

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?

We believe that, with additional guidance and clarification, the Boards' proposed principle can provide decision-useful information for many transactions and meet the goals of the convergence, simplification, and comparability of revenue across companies and geographical boundaries. However, there are contracts for which the Boards' proposed principle either does not provide decision-useful information, or it is unclear how the model would be applied. The following are a few examples that illustrate our concerns.

Certain Long-Term Construction and Production-Type Contracts
We believe that the application of the proposed model to certain long-term construction and production-type contracts would not provide decision-useful information. In particular, application of the proposed model to certain commercial long-term contracts may cause an effective transition from the percentage-of-completion method to the completed-contract method. The percentage-of-completion method captures the continuous transfer of value and risk of loss that occurs between the entity and its customer, thereby producing financial information that is timely, relevant and predictive. An effective transition to the completed-contract method would significantly reduce the transparency of an entity's results and diminish the predictability of future results, particularly in instances in which the contracts extend over multiple years. Therefore, we believe that the principles

currently in use (i.e., SOP 81-1, ARB No. 43, IAS 11 and IFRIC 15) provide more decision-useful information to financial statement users than those outlined in the Discussion Paper.

Long-term Service Contracts with Characteristics of Insurance Arrangements
Certain long-term service contracts may have characteristics of insurance
arrangements. For example, a vendor may agree to provide extended warranty and
maintenance services for a fixed fee. Under these arrangements, the vendor
assumes the risk of all maintenance and product repair costs over the coverage
period. These arrangements have similar measurement and potential remeasurement issues as insurance contracts.

#### Rights-to-Use Intellectual Property

It is unclear how the proposed model would be applied to arrangements that provide the customer with right-to-use intellectual property assets (such as software or product or process designs). In those cases, the arrangement between the entity and its customer enables the customer to use the property with certain restrictions while not transferring ownership of the underlying intellectual property. One could argue that the asset is the ownership of the underlying intellectual property. Under that view, the customer never controls the asset because ownership of the underlying intellectual property does not transfer. It is unclear whether the arrangement should be viewed as a service and, therefore, revenue would be recognized over the service period. Another view is that asset is the right to use the intellectual property. Under that view, the customer controls the rights conferred in the arrangement once access to the intellectual property is granted. Application of this view would result in revenue recognition once the customer has control over its rights as promised in the contract. We believe that the latter approach produces financial information that is consistent with the economics underlying the arrangement.

#### Cooperative Agreements

Entities occasionally enter into cooperative agreements with their customers. Cooperative advertising and joint development arrangements are common examples in which the entity contracts with its customers separately from sales contracts with the same customers. Under such arrangements, entities reimburse customers for certain activities. In accordance with EITF 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*, entities classify the cooperative costs outside of revenue to the extent that a benefit separate from the revenue transaction can be identified and the fair value of that benefit received is determinable. Any excess in cash paid over the fair value of the benefit received is recognized as a reduction in revenue. It is unclear in the Discussion Paper whether such cooperative arrangements are in scope of the proposed revenue recognition model.

We believe that it is reasonable to conclude that such arrangements would not be within the scope of the proposed standard since the arrangement is not a provision of goods or services, nor is it an "output" of the ordinary revenue generating activities. If these arrangements are included within the scope of the proposed standard, we believe that the services received would represent a contract asset and the cash to be paid to the customers would represent a performance obligation (contract liability). We believe that identifying the services as a contract asset most faithfully reflects the economics underlying the cooperative arrangement. Such arrangements represent a payment for a benefit (developing, advertising, etc), when

the benefit provides an identifiable benefit to the entity that is sufficiently separable from the customer's purchase of the entity's products. If the arrangement is not sufficiently separable from the underlying sales contract, then it would be treated as an additional discount under that arrangement.

Due to the absence of principles on combining contracts and the identification and recognition of non-cash contract assets in the Discussion Paper, there may be inconsistencies in how different entities interpret and apply the guidance in the proposed standard.

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.

We generally agree with the Boards' definition of a contract as being "an agreement between two parties that creates enforceable obligations." The application guidance provided in the Discussion Paper bears substantial resemblance to existing guidance associated with "persuasive evidence of an arrangement" under SAB 104, Revenue Recognition. In particular, both definitions recognize that an agreement between an entity and its customer can arise from agreed-upon terms that are written, oral, legal (including local laws or jurisdictional) or based upon customary business practices. However, it is unclear whether the definition establishes the same high threshold of "persuasive evidence of an arrangement" as set forth under SAB 104. That is, existing U.S. GAAP requires a "burden of proof" that an arrangement between the entity and its customer has been established via the entity's customary business practices of documenting such arrangements. We support the proposed definition if it is another way of articulating "persuasive evidence of an arrangement" under SAB 104. If there is a difference in interpretation and application between the proposed definition and SAB 104, we believe further guidance is necessary in order evaluate the definition and understand its implications.

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? 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.

The proposed definition raises a number of questions such as: what is the "promised asset" and whether a promise should be separated from another promise if it has no stand-alone value. Certain contracts require the entity to share its product or technology roadmap with its customers. Is this a performance obligation? Many contracts contain indemnifications that guarantee, for example, that the customer is protected against technology infringement claims. Do these performance obligations have any value apart from the associated product? Can a customer control the economic benefits of an asset (a delivered hardware product) if the functionality of a delivered asset is dependent upon another asset (an undelivered component or service)? It does not appear that the definition will help entities to identify consistently the deliverables in a contract. Moreover, we are not convinced that breaking contract promises into accounting units that are lower than the level at which the customer derives significant value will provide decision-useful information.

Rather than creating an entirely new concept of liabilities associated with revenue transactions, we believe that existing GAAP can be reconciled with the proposed definition of a performance obligation by articulating the "promised asset" in the context of an asset or group of assets that has stand-alone value to the customer. The model could provide factors to consider in determining whether a performance obligation has stand-alone value, such as:

- 1) Whether the item (deliverable, element, performance obligation) is sold separately;
- 2) Whether the customer can transfer the item to another party absent another item in the arrangement;
- 3) Whether the payment terms, coupled with customer acceptance provisions and non-refundability clauses, are tied to specific performance or delivery of the item.

In summary, our concern is that the proposed definition will give rise to obligations that do not result in value being transferred to the customer apart from other assets. In our view, promises that derive their value solely from other contract promises should be combined into one performance obligation. Our concerns and views are articulated in more detail below through standard warranty, certain multi-element arrangements, long-term construction contracts, and perfunctory promises.

#### Standard Warranty

The proposed performance obligation definition identifies standard warranties as performance obligations. We do not agree that standard warranties are performance obligations. Standard warranties provide customers with a contractual right which guarantees that the delivered product will function according to specifications for a certain period of time. The contractual promise embodied in the arrangement, in our view, is a functioning product. In that regard, standard warranties are indiscernible from the delivered product and do not provide customers with additional assets beyond the delivered assets. Said another way, the guarantee does not provide the customer with an asset absent the associated product. We believe that the proposed interpretation is overly theoretical and does not accurately reflect the economic realities associated with entities' obligations to their customers, and will not necessarily result in more decision-useful information to users of the financial statements.

#### Multi-Element Arrangements with Functional Dependencies

The Discussion Paper sets forth a multi-element painting example in which paint is delivered to a customer site prior to the delivery of the painting services. The Discussion Paper states that the paint and painting service could be separated if transfer of control of the paint and painting services occurs in different periods. If the customer has physical possession and title to the paint prior to the provision of services, the customer can derive value from the paint if the painting company is unable to deliver the service. Therefore, the customer can receive stand-alone value from the paint if it has the right to the paint in the event of the painter's nonperformance. However, in more complicated arrangements, the customer may not receive any value from the delivered item (despite physical control and title) without the future product or service that only the entity can provide. For example, an entity may sell a product that only operates via the delivery of a service in which

the entity is the only provider. Without the service, the product does not function. Such cases raise the question: what is the "asset promised to the customer?" One view is that there are two promised assets: a product and a service. However, we believe that in instances in which the value of the delivered asset (product) is solely dependent upon the delivery of an undelivered asset (another product or service), the delivered item cannot produce the economic benefits intended under the arrangement and, thus, should not be viewed as a stand-alone accounting unit. In those cases, the "promised asset" is the provision of services since the customer cannot derive economic benefits from the product apart from the service.

#### Certain Long-term Construction, Production-Type, and Project-Based Service Contracts

Many entities enter into very large complex contracts that often extend over multiple accounting periods. In addition, while performance periods and delivery dates may be estimated at contract inception, given the highly technical and customized nature of the contracts, performance periods and delivery dates for elements regularly change. Accordingly, each entity's identification of performance obligations under similar contracts (based on the guidance in the Discussion Paper) may vary significantly, as judgments would need to be made as to which explicit and implicit rights and obligations (including products or services) are delivered separately. Furthermore, different judgments may be made as to which products or services are expected to be delivered at the same time such that they may be combined. Absent further clarification regarding the level at which performance obligations should be ascribed, the proposed model appears to require revenue to be recognized at a level lower than the contract profit center or substantive milestone, which does not align with how contracts are bid, negotiated and managed.

#### Insignificant or Perfunctory Promises

Contracts can contain many individual promises, such as the promise to share a product or marketing roadmaps, the right to arbitration in the event of a dispute, or telephone support. Clearly, the delivery or performance against each one of the aforementioned may occur in different accounting periods (precluding aggregation). We believe that it would be extremely onerous from a business process and information systems standpoint to identify contract promises to such a level of detail. Further, we do not understand how identifying such promises at this level of detail will provide decision-useful information. We therefore recommend that the Boards' conduct further analysis about whether the costs of disaggregating performance obligations at the proposed level of detail exceed the benefits.

# 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? WHY OR WHY NOT? IF NOT, WHAT PRINCIPLE WOULD YOU SPECIFY FOR SEPARATING PERFORMANCE OBLIGATIONS?

We agree that items should be separated if they are delivered in different accounting periods. However, the Discussion Paper provides minimal guidance regarding whether performance obligations can be aggregated, other than to state that (a) performance obligations that are transferred to customers at different times should be separated, and (b) an asset that is used in satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation. We believe the framework needs to be enhanced to bring more clarity, which will in turn ensure consistent application of

this guidance. We highlight this concern using post-contract customer support arrangements and certain long-term construction contracts.

#### Post-Contract Customer Support

Entities commonly sell post-contract customer support arrangements. These arrangements often include multiple services, such as when and if available software updates, bug fixes or other extended warranty support, and phone support. Each service within post-contract customer support arrangements can be delivered to the customer at different times. Existing literature and practice has evolved such that aggregation of these elements is fairly consistent among entities. However, it is unclear whether these services would be aggregated and considered part of the same stand-ready performance obligation, or if each service should be recognized as a separate promise in the contract and revenue allocated to each performance obligation and recognized accordingly. We believe that viewing the promises as a single stand-ready performance obligation simplifies the accounting while providing decision-useful information to financial statements users.

Certain Long-Term Construction Contracts, Production-Type Contracts, and Project-Based Service Contracts

Certain long-term construction, production-type and project-based contracts may provide highly customized engineering, design and manufacturing services over extended periods. Accordingly, services (the promised asset) and risk of loss are transferred to the customer continuously throughout the performance of the contract. Further, the benefits associated with the services may be ascribed to the production of a specific product (or group of products). Separation of performance obligations based on timing of delivery is impractical when applied to such highly customized project-based contracts.

## 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?

We understand how the Boards' support their conclusion that a right of return is a performance obligation. However, we believe that the proposed method of accounting produces misleading financial information. For that reason, we believe that an entity's obligation to accept a returned good and refund the customer's consideration should not be viewed as a performance obligation.

It is our understanding that application of the proposed model will result in the following financial reporting *after* a good is returned:

- Revenue recognized at 100% of the transaction amount;
- Cost of sales recognized at 100% of the product sales cost, and
- The net product margin is recognized as a write-up of inventory (the refund is viewed as a repurchase of the sold good); and
- Revenue recycling (upon resale of the returned good).

This result makes the financial information appear as though the entity has completed a sale and increased the value of its assets. This is misleading because, in fact, the entity's net economic position remains unchanged. Furthermore, for inventory intensified industries, the proposed model will require business process and information technology solutions to segregate returned product, measure it at

the sales price, apply the appropriate lower of cost or market adjustment, and explain margin fluctuations (margin deterioration) to financial statement users.

In our opinion, it is more important to produce financial information that is a faithful representation of the economic phenomenon than to produce information that is based upon a conceptually pure accounting model. FAS 48 properly reduces revenue and cost of sales by reflecting estimated returns. In other words, FAS 48 results in financial information that eliminates transactions that, in effect, do not occur as a result of a return. We therefore believe that existing FAS 48 concepts more accurately reflect the economics underlying a customer's return than the proposed approach. We observe that FAS 48 is similar to the income statement results that would be obtained under the alternative "failed-sale" approach described in paragraph 3.41 of the Discussion Paper, provided that the entity is able to recognize revenue for the proportion of transactions that the entity expects **not** to fail.

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?

We agree that some sales incentives, such as loyalty programs, should be considered performance obligations if they are provided in a contract with a customer. We acknowledge that our support for sales incentives as performance obligations and our rejection of standard warranties as performance obligations may appear inconsistent since both items are contractual promises. However, the right to a free product or a discount on a future product has value to the customer apart from the other promises (assets) in the current arrangement. Again, we believe that only items that have stand-alone value to the customer should receive separate accounting.

We also recommend that a final standard provide sufficient measurement guidance to determine whether the sale incentive is incremental to the incentive offered absent the current transaction. For example, we believe that the value associated with a 10% discount on future product as the result of a current transaction would have little to no value if the entity frequently offers 10% discounts to similar prospective customers.

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.

The Boards need to provide an expanded definition of control in the proposed standard. We provide two examples (subcontracting and consignment arrangements and shipping terms) to illustrate this need. Further, we do not believe the transfer of control notion articulated in the Discussion Paper produces decision-useful information for long-term construction and production-type arrangements.

Subcontracting and Consignment Arrangements

Under certain subcontracting arrangements, an entity sells its goods to a subcontractor; the subcontractor assembles the entity's goods with other products and sells the final assembled product back to the entity. These arrangements can include the following terms: title of the entity's product passes to the subcontractor, the subcontract is obligated to pay the entity within a customary period of time, and the entity is under no obligation to purchase the final product from its customer (though it is customary for the entity to do so). Assuming that this transaction is within the scope of the Discussion Paper and the subcontractor qualifies as a customer, it is unclear whether control has transferred from the entity to the subcontractor. On one hand, it appears as though the subcontractor has control since it has physical possession of the good, is obligated to pay, and has title. However, the economic substance of the arrangement is that the subcontractor is performing a service that enhances the entity's asset (the goods). Therefore, control over the economic benefits associated with the goods does not ultimately transfer. The application of the proposed model would require the entity to recognize revenue once the subcontractor controls the goods, and recognize a performance obligation associated with the implied promise to repurchase the goods.

Consignment arrangements face a very similar issue. Under certain consignment arrangements, the title of the entity's product passes to the consignee, the consignee is obligated to pay the entity within a customary period of time, and the consignee has a right of return. Again, we believe that the application of the model would require the entity to recognize revenue once the consignee controls the goods, and recognize a performance obligation associated with the promise to repurchase the product.

In these instances, we question whether the proposed application of the control notion provides decision-useful information. In our opinion, the notion of control requires a broad economic view of the risks and rewards associated with ownership. Certain seller obligations, such as a probable or expected repurchase of goods, suggest that the customer does not control the economic benefits associated with the goods. We believe that controlling the economic benefits is an integral characteristic of the definition of an asset. The determination of whether delivery/performance has occurred under SAB 104 captures this important economic evaluation. We also observe that once the repurchase occurs under the subcontracting or consigned arrangement, the entity would recognize 100% of the transaction price as revenue. This does not produce decision-useful information.

#### FOB/CIF Shipping Point/Ex-Ship Destination

A similar problem with the transfer of control notion can be demonstrated via customary shipping terms. Under typical arrangements, the customer assumes the "risks and rewards" of the product either FOB/CIF shipping point or ex-ship destination. The customer may not have physical possession of the good but, at that point, they may substantively control the future economic benefits of the goods because:

- the seller cannot use the good to satisfy other performance obligations;
- the buyer controls the means by which it takes physical possession; and
- the buyer assumes all inventory risk (other than standard warranty)

Under the proposed standard, it is unclear if the entity controls the resources underlying the asset until the point that the good is in the physical possession of the

customer. Or, is it the customer, who dictated the method of delivery and assumes the risk via that delivery mechanism (FOB shipping point or at destination) that controls the resources underlying the asset. We believe that control for goods shipped should be considered to transfer concurrently with the transfer of risks and rewards.

In more complicated arrangements, the lack of a clear and consistent definition of control in the proposed standard may result in different entities interpreting the guidance differently, thereby obfuscating the objectives of the Boards' revenue recognition project.

Certain Long-Term Construction and Production-Type Contracts
Certain long-term construction and production-type contracts differ from other arrangements since the customer participates significantly in the design of the underlying product and monitoring of the production phase, and the highly customized product has little to no value to the contractor or any other customer. For these reasons, we believe that the customer has substantive control of the asset under construction or production. The Discussion Paper is unclear as whether a strict definition of control should be applied, as opposed to one that is more principles-based. A strict definition of control (based upon transfer of title and customer acceptance) may give rise to different revenue attribution models (i.e., continuous versus non-continuous transfer of assets) for contracts that embody the same economics. Applying a different revenue attribution model to two economically similar contracts would not provide decision-useful information.

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.

We generally support the Boards' proposal that an entity should recognize revenue when a performance obligation has been satisfied. As mentioned, we are concerned about the lack of clarity on the definition on "control" and the broad definition and identification of performance obligations. Further, as mentioned in Question 2, certain arrangements convey the right for a customer to use intellectual property, such as software arrangements, but to not transfer control of the asset underlying the arrangement.

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?

We agree that performance obligations should be measured initially at the transaction price. We also generally concur with the IASB's April 1, 2009 decision to allow estimation and recognition of contingent revenue items; however, we recommend a best-estimate approach (similar to that promulgated under Statement of Financial Accounting Standard No. 5, Accounting for Contingencies), instead of a

probability-weighted estimation approach. In most circumstances, a best-estimate approach is more precise as it is predicated on the single "most likely" probability outcome as compared to a probability-weighted estimate that can be skewed by "unlikely" (low-probability or high probability) outcomes. Accordingly, we believe the best-estimate approach is a better reflection of current performance under a contract. We also believe that a best-estimate approach allows for judgment as to whether it is appropriate to include amounts attributable to contingent items when the weighted probability is less likely than not. For example, consider a contract that embodies a binary (i.e., event-based) incentive fee (i.e., an incentive fee attainable according to whether the designed product "hits or misses" a specified target). Under this example contract, a target "hit" results in a \$10 million fee and a target "miss" results in \$0 fee. Assuming the probability of a target "miss" is 70% and the probability of a target "hit" is 30%, applying the probability-weighted approach would result in \$3 million estimate of contingent revenue, when the best estimate of that contingent revenue is zero. We believe it is inappropriate to value the contingent revenue in this example at \$3 million when most third parties would likely discount it significantly more than that estimate given its unique nature.

(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?

We generally agree that a performance obligation should be deemed onerous and remeasured at the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation.

However, with respect to long-term contractual arrangements, we believe the Boards' guidance needs to be modified. The lowest unit of account should be based on the specific product or service that represents a stand-alone profit center to the entity. Specifically, there may be instances in which a contract is negotiated and accounted for as a single project (i.e., not segmented), and the contract is profitable overall. However, that contract may contain an onerous element. For example, because of budgetary constraints, many times the negotiation process will result in a re-alignment of scope and/or profit from periods in which funding is constrained to those in which funds are available. This may result in instances in which profit is front-loaded or back-loaded (creating what may appear to be an onerous element) purely to meet the U.S. Government's funding profile requirements. Applying the proposed guidance could result in immediate loss recognition with respect to that onerous element. Such immediate loss recognition does not faithfully represent how the overall contract is bid, negotiated and managed.

To illustrate this point, consider an arrangement to build four complex deliverables under a low-rate initial production (LRIP) contract. Under the existing guidance, this contract is a single profit center (performance obligation) and revenue recognition is based upon the percentage-of-completion method, utilizing a cost-to-cost attribution model, as no reliable output measure exists due to the significant length of time required to produce one deliverable (e.g., two years). The profit-booking rate utilized for revenue recognition purposes is based on an estimate at completion analysis of the entire contract. Under the proposed model, assuming each deliverable represents a separate performance obligation and the first deliverable is more costly to produce than the remaining deliverables (due to learning curve), producing the first deliverable could result in an interpretation that it is an onerous performance

obligation and require immediate loss recognition, thereby producing results that do not align with the overall economics of the transaction or how contracts are bid, negotiated and managed. This would not only diminish the predictability of future results, but also fail to provide users with decision-useful information.

(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.

While not discrete performance obligations, items such as claims, change orders and contract options may effectively modify the terms of underlying contracts. The guidance for such items is not outlined in the Discussion Paper. As the amount of revenue or costs related to such items is often uncertain, we request that the Boards clarify how to account for these items.

(d) DO YOU THINK THAT SOME PERFORMANCE OBLIGATIONS IN A REVENUE RECOGNITION STANDARD SHOULD BE SUBJECT TO ANOTHER MEASUREMENT APPROACH? WHY NOT? IF SO, PLEASE PROVIDE EXAMPLES AND DESCRIBE THE MEASUREMENT APPROACH YOU WOULD USE.

The discussion paper identifies standard warranties and rights of return as performance obligations. We believe that these items are better suited to cost model. Example 3 in Appendix A of the Discussion Paper illustrates that the transaction price is allocated to the standard warranty and recognized as revenue over the warranty period. Under the FAS 5 model, standard warranty costs are recognized at the date of sale and adjusted as the entity's estimates of warranty costs change. For example, the warranty liability is increased under FAS 5 if the entity experiences a substantial increase in its warranty cost due to an unexpected and undetected manufacturing excursion associated with sold product. Under the proposed approach, the warranty cost would not be adjusted unless the excursion causes the contract to become onerous. This is often not the case and, as a result, an entity would not recognize any change to its liabilities under the proposed model. In these situations, the measurement of the liability under FAS 5 may produce a larger liability than the measurement under the proposed model. Therefore, the measurement of standard warranties under the proposed model does not provide timely and relevant information in these situations. Rather, existing practice under FAS 5 would appropriately reflect warranty costs on a timely basis and, in doing so, would continue to provide decision-useful information.

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.

(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?

In some cases, including amounts that an entity charges to a customer to recover the costs of obtaining the contract in the initial measurement of an entity's performance obligations overstates the performance obligation relative to its economic value. However, we generally agree with the Discussion Paper that this disadvantage is preferable to the disadvantages of the current exit price.

(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.

Expensing cost in situations in which services are being provided over a long period of time with the intention of delivering a final product (development of a new technology, proof of concept, audit report, etc) at the end of the arrangement term does not provide decision-useful information. In particular, it is necessary for the entity to incur the costs to generate the final product and the entity is willing to incur those costs with the intention that it will realize a margin upon delivery of the final product. That is, the costs are associated with the development of an asset to the entity: the entity controls the work product (workpapers, the developed know-how, etc); the entity expects to derive a future economic benefit (consideration from the customer); and, the work product is the result of past events. We believe that standard setting, whether in this project or another project, must address this issue if the Boards proceed with the proposed approach. Otherwise, entities offering certain services will provide misleading financial information about their assets and liabilities.

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?

The level at which performance obligations are identified and separately recognized is an essential consideration to our response. If performance obligations are disaggregated to the level of individual warranties, indemnifications, rights to roadmaps, etc, then the process of allocating transaction price to standalone selling prices will be a theoretical and costly exercise. If, on the other hand, performance obligations are aggregated at a level in which the customer derives value from the offering, then we agree that the transaction price should be allocated to the performance obligations on the basis on an entity's standalone selling prices of the goods and services. Furthermore, allowing preparers to estimate standalone selling prices where observable prices are not available represents a considerable improvement over existing revenue recognition guidance. This will allow revenue to be recognized when individual performance obligations have been fulfilled, rather than requiring performance obligations to be aggregated and revenue deferred due to an inability to measure value according to a threshold (like vendor specific objective evidence). The change in the measurement approach from current practice

to the proposed standard will allow companies to better reflect the underlying economics of an arrangement.

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?

Again, the level at which performance obligations are identified and separately recognized is an essential consideration to our response. We 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. However, we believe that an entity should not separate a group of items that, when combined, are the lowest level at which the customer can derive stand-alone value. We also believe there should be a hierarchy for estimation similar to the concepts proposed in EITF 08-1.