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Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
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File Reference No. 1660-100

Dear Director,

As graduate students of Accounting at Indiana University, we are pleased to have the privilege of commenting on the above referenced Discussion Paper. Our responses to the specific questions in the Invitation to Comment are attached in the appendix to this letter. Below you will find our comments on the more general concepts set forth in the Discussion Paper.

Overall, we agree with the Boards' efforts to create a single contract-based revenue recognition standard that can be applied to financial reporting across all industries. However, because revenue is such an important part of an entity's financial statements, we see room for improvement in the final standard. In order for the standard to apply broadly to all industries, more guidance is needed for specific industries as the economic substance of revenue transactions varies considerably among industries such as manufacturing, construction, insurance, and financial investment.

Performance obligations are vaguely discussed in the Discussion Paper and need further improvement and clarity. Generally speaking, the issues of construction contracts and customized goods raise questions on performance obligations and transfer of title. While the Discussion Paper attempts to clearly define the transfer of title and performance obligations, a more significant discussion or possibly the use of further examples for industry-specific transactions would help to increase consistency and comparability and provide more decision-useful information. Furthermore, very little distinction is made between different types of sales incentives and how they should be handled. Clarity as to the distinction between incentives that are classified as performance obligations and those that are accounted for in the measurement of rights would greatly improve the discussion on performance obligations.

We also see issues arising with goods containing a right of return. Clear distinction is needed between a good with a right of return and a good with a trial period. This is cause for concern as the Discussion Paper addresses a right of return as a performance obligation that is to be accounted for separately but does not further address a good with a trial period. In addition, with regard to the right of return, goods held on consignment are not held to be different than goods held for sale. No provision is noted for consigned goods to be carried with a right of return.

We agree that onerous performance obligations should be remeasured upwards and a loss recognized. However, the level at which performance obligations should be assessed is not discussed in totality. Whether assessment should occur for a bundle of contracts, an individual contract, or a deliverable within a contract should be more clearly identified. According to Paragraph 5.60 of the Discussion Paper, "the Boards have not yet discussed all of the issues associated with an onerous test and how it would work." Depending on that discussion, the results could have a large material effect on an entity's financial statements. Therefore, in order to support consistency, we encourage the Boards to define this area very clearly.

Again, we appreciate the opportunity to respond to the Discussion Paper.

Respectfully,

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# Appendix

## 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?

We agree with the Boards' proposal that a single revenue recognition principle based on an entity's contract asset or contract liability is appropriate. This creates consistency because most often revenue recognition policies involve a contract asset or liability. Also, in accordance with comment letters from Dell Inc. (C.L. No. 36), Intel Corporation (C.L. No. 35,) The Boeing Company (C.L. No. 132), and KPMG (C.L. No. 61), we believe that a single revenue recognition principle simplifies a process that has become quite cumbersome for companies in recent years. Overall, we believe the Boards' proposal is a step toward improving consistency, simplification, and convergence of the Boards' standards.

## **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?

Other than the three types of contracts highlighted in the Discussion Paper, we agree with The Boeing Company (C.L. No. 132), KPMG (C.L. No. 61), and Grant Thornton International LTD (C.L. No. 60) that long-term construction contracts would go beyond the scope of the broad definition that underlies this revenue recognition principle. While there are various types of revenue recognition methods for long-term construction contracts including percentage of completion and completed contract, the new literature must specify what "obligations" should be fulfilled in order to recognize revenue. A similar example from the KPMG's comment letter has to do with aircraft manufacturing for a governmental entity and a civilian. Overall, we believe that the proposed single revenue recognition principle encompasses the majority of scenarios that could be encountered, but some areas must be addressed separately in order to attain consistency throughout.

# **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.

In general, we agree with the Boards' definition of a contract. It is a simple, basic concept that combines the FASB's and IASB's definitions of a contract into one, unified statement. This creates the consistency necessary to assure a successful integration of the Boards' standards going forward. However, we share the concerns of several other companies including Intel

Corporation (C.L. No. 35), The Boeing Company (C.L. No. 132), and KPMG (C.L. No. 61) regarding what is meant by the term enforceable obligations.

Certain conditional agreements represent another difficult area to apply the definition of contracts. How would enforceable obligations be defined, and when would they apply to a given situation? This could be one potential area of difficulty for the Board. Overall, we agree with the Boards' definition of a contract with a few minor concerns going forward.

## **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.

We agree that the definition of a performance obligation is broadly acceptable as a starting point to assist entities in identifying deliverables within contracts, but the Discussion Paper contains insufficient guidance for users to consistently apply in practice. In Paragraph 3.2, the Discussion Paper defines an entity's performance obligation as a promise in a contract with a customer to transfer an asset (such as a good or service) to that customer. We believe that further clarification of the definition of a performance obligation, a framework of factors to consider and the relative importance of those factors are needed to enable entities to consistently identify the deliverables in (or components of) a contract in accordance with KPMG's logic in Comment Letter No. 61. Greater clarity is needed for issues such as:

- What is the role of the customer perspective in determining the performance obligation?
- What framework is applied when distinguishing between goods and services?

# **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?

Yes, we agree that an entity should separate the performance obligations in a contract on the basis of when the promised assets become assets to the customer. We believe it is the most representationally faithful depiction of the economic transaction between a vendor and a customer in most transactions, given the overall model selected by the Boards; this conclusion is also reflected in Ernst & Young's opinion in Comment Letter No. 123.

## **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?

Yes, we believe an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation. We agree with Ernst & Young (C.L. No. 123), that a sale with a right of return is economically similar to a sale of a good with a put written by the vendor on the asset transferred to the customer. In accounting for such a transaction, the asset should be derecognized from the accounting records and the return right (the "put option") accounted for separately.

#### **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?

Yes, we believe that customer loyalty points and free goods or services give rise to performance obligations when included in a contractual agreement with a customer. We agree with Deloitte LLP (C.L. No. 110), that sales incentives give rise to performance obligations in accordance with the logic articulated in IFRIC 13, Customer Loyalty Programmes.

## **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.

We generally agree with the objectives of the Discussion Paper to set up a single revenue recognition model which can be applied to various transactions to improve consistency and comparability in measuring and reporting revenue. We also agree with the Boards that a focus on control results in more consistent decisions regarding when assets are transferred. However, we have concerns with the Discussion Paper as it is currently written and believe several areas need to be addressed. Of particular concern is the area that relates to satisfaction of performance obligations. We suggest the Boards deliberate the following:

As indicated in the Discussion Paper, in determining when a performance obligation is satisfied, an entity must consider the effect of the customer's intended use of those goods and services. We agree with the Boards that the customer's intent of use plays a crucial role in deciding who takes control of the asset, the conclusion of which will make a difference in determining revenue recognition. Take the example of paragraph 4.27 from the Discussion Paper.

"Equipment X, Y, and Z are separate performance obligations because they are separate assets (evidenced by the fact that they could be sold separately) that EngineeringCo promises to transfer to the customer. Without equipment Z, the customer cannot use equipment X and Y as intended."

The example implies the customer's intent is to use the equipment instead of selling the components separately. However, the Boards reached the conclusion that "it does not matter that the customer does not intend to (or cannot) use equipment X and Y without equipment Z. The fact that the customer has the promised assets means that the entity no longer has an obligation to transfer those assets".

We found this conclusion contradictory in several ways. First, as indicated in the Discussion Paper, the premise for an entity to recognize revenue is to satisfy the customer. In this example, the customer is not satisfied by receiving only equipment X and Y because the customer cannot fulfill the intent of use. Second, the intent of use is different from the intent of selling. From our understanding, the intent to sell can be fulfilled by receiving any single asset. The intent of use, however, can only be reached by receiving all assets required to place the asset(s) into service in its entirety. The Boards confuse different concepts and override the intent of use by the intent to sell, which then leads to a contradictory conclusion with the initial consideration of intent of use as an important factor.

Third, what concerns us most is the concept of control. The Boards do not clearly define control, nor do they provide clear guidance regarding the application of this concept. The potentially different understanding and application of the concept may have a significant impact on the financial statements. In the example provided above, we agree with the conclusion that EngineeringCo should recognize revenue separately, although we do not agree with the justification as provided by the Boards.

We reach the same conclusion regarding ownership of the goods or services. In detail, the concept of control is not limited to whether the goods or services are delivered or whether the customer has the right to use them, but also whether the goods or services are customized for the customer's special use, whether the customer has the economic benefits from the goods or services, and how the customer makes payments. For example, if the seller or producer manufactures or designs the product according to the customer's special request, the product will most likely be delivered to the customer. Then, it could be argued the customer maintains control during the process, and the producer or seller recognizes revenue during the process by payments or by goods or services being delivered. However, if the seller or producer manufactures the product as part of its normal process without any special customization for the customer, the customer takes control either by making nonrefundable payments and accepting delivery or by deciding when the economic benefits take effect. The seller or producer recognizes revenue either by receiving nonrefundable payments and delivering assets or by determining when the customer has the right of economic benefits. Therefore, we 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" upon clarifying and revising the concept of control.

## **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 find two examples of contracts for which that proposal would not provide decision-useful information.

We agree with Australian Constructors Association (ACA) (C.L. No. 10), that construction contracts are an example of such contracts. First, as indicated in Paragraph 4.8 of the Discussion Paper, "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." However, as discussed above in Question 8, we believe that if contracts are customized or made for a customer's special use and the products will most likely be delivered, the customer takes control during the process not upon delivery of the goods or services. This is plausible because the substance of the contracts indicates that the customer hires a manufacturer to design or produce the products specifically for the customer's own use and the producer will only be able to sell the goods or provide the services for that customer. In construction activity, the contractor's role is often to construct under the request and requirements of the customer, and "contracts generally contain clauses that entitle the customer to terminate works and take control of the site after making appropriate payment to the contractor for unpaid works" (ACA).

Second, under construction contracts, the customer often provides all the materials necessary in the construction process and makes payments in the process of construction. This also indicates the substance of the contract is more than purchasing. The customer takes control of the process, which recognizes an asset under construction, despite not having legal control. "A move to focus on a pure legal concept of control would most likely have the impact of deferring the recognition of revenue on construction contracts until legal control has passed to the customer at completion" (ACA).

Additionally, we agree with Morgan Stanley & Company International PLC (C.L. No. 44) that financial instruments are an example of contracts for which the proposal would not provide decision-useful information. The objectives of the Discussion Paper are to establish a single revenue recognition model which can be applied to various transactions and to improve consistency and comparability in measuring and reporting revenue. As indicated in Paragraph 3.2 of the Discussion Paper, the concept of performance obligations is "a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer". Financial instruments often exist for trading or hedging purposes, a concept that is inconsistent with a revenue recognition model based on the promise of transferring an asset to a customer.

#### **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. The transaction price is the most observable value at the outset of the contract, and it should most obviously represent the fair value of the goods or services to the customer and to the reporting entity. As the Discussion Paper notes in paragraph 5.26, "the transaction price reflects the amount an entity requires in exchange for taking on the related performance obligations." Otherwise, one or both parties would presumably be unwilling to transact. Therefore, the transaction price most faithfully represents the economic phenomena underlying the transaction itself.

(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 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. We believe this approach will increase the consistency across industries and increase comparability between entities in similar industries.

The level at which performance obligations should be evaluated to determine whether they are onerous is unclear, however, and should be addressed in the final standard. For instance, should performance obligations be valued at the contract level when a portion of the deliverables has been deemed onerous while the overall contract remains profitable albeit with a smaller margin? Should an entire class of similar contracts be evaluated together? The possibilities are numerous, and the results could not only vary significantly but could, in fact, be misleading. An example would be that of a mortgage broker who trades in bundles of mortgage contracts where the risks related to individual loans may be high. However, the very intent of the transaction is to reduce the risk within the overall bundle. Furthermore, depending on the size, complexity, and number of contracts for which performance obligations are remeasured, the cost of remeasurement could exceed the benefit gained.

The Discussion Paper does not clearly identify the costs to be included when assessing whether cost exceeds the carrying amount of the performance obligation. It can be argued that all costs, direct and indirect were included when the entity entered into the contract and that these costs plus an acceptable margin represent the transaction price. However, when applying the

standard in evaluating whether a performance obligation should be deemed onerous, should all costs be estimated and included?

Clarity of the Boards' intent regarding both the level of evaluation and the costs included will reduce inconsistencies and provide more 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.

We believe the proposed measurement approach would provide decision-useful information regarding performance obligations in many if not most industries. We support a simplified standard with a single overarching principle for revenue recognition. However, the transaction price for contracts such as insurance contracts and derivative contracts for nonfinancial items, as discussed in Paragraphs 5.88-5.90 of the Discussion Paper, may not provide decision-useful information. Comment Letter No. 58 from the Investment and Life Assurance Group (ILAG) highlights the issue. ILAG points out,

"Life Insurers earn money from investment management services and by taking on uncertain risk from a large portfolio of clients. Insurance works by allowing individuals to pool their risk and in so doing benefit from being part of a portfolio. While individual parts of the portfolio will be subject to risks of significant volatility, the portfolio as a whole exhibits much less volatility as a result of the law of large numbers."

The inherent risks and uncertainties of these transactions lead us to remain unconvinced that the proposed measurement approach can lead to faithful representation and decision-useful information related to every performance obligation. As such, we agree with KPMG's response in Comment Letter 61 that arrangements involving financial instruments and insurance contracts may need to be scoped out of the standard.

(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.

Given our response to Question 10(c), we believe some performance obligations in a revenue recognition standard should be subject to another measurement approach. This includes financial instruments, insurance contracts, and long-term construction contracts for which this measurement approach may not 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 the 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?

We believe performance obligations should be measured initially at the transaction price, which should include amounts an entity charges a customer to recover the costs of obtaining the contract as we believe this represents the value of the contract to the customer. We also agree performance obligations should be recognized as expenses unless they qualify for recognition as an asset.

(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?

If contract origination costs qualify for recognition as an asset, they should be capitalized and the expense recognized over the life of the contract. However, we agree with PriceWaterhouseCoopers (C.L. No. 68) that the "Boards should consider whether there is sufficient guidance in the relevant asset standards to enable an entity to determine when the costs associated with these cash flow streams should result in the recognition of an asset."

# **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?

We 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. For the most part, this is consistent with the direction U.S. GAAP is headed as evidenced in the Pending Content of Codification Topic 605-25-30-2, Revenue Recognition Multiple-Deliverable Arrangements, Initial Measurement, which is effective June 10, 2010. The Pending Content states, "Arrangement consideration shall be allocated at the inception of the arrangement to all deliverables on the basis of their relative selling price," although exceptions follow this statement. Allocating on the basis of the entity's standalone selling prices, however, is relatively straightforward, as we believe the standalone selling price provides the clearest evidence of the value of the goods and services underlying a given performance obligation. We believe this practice demonstrates both predictive and

confirmatory value in assessing an entity's current financial position and its ability to generate positive future cash flows.

## **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, 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 for purposes of allocating the transaction price. Again, this is consistent with the direction U.S. GAAP is headed as evidenced in the Pending Content of Codification Topic 605-25-30-2, Revenue Recognition, Multiple-Deliverable Arrangements, Initial Measurement which is effective June 10, 2010. "If neither vendor-specific objective evidence nor third-party evidence of selling price exists for a deliverable, the vendor shall use its best estimate of the selling price for that deliverable." We agree with Paragraph 5.48 of the Discussion Paper that the Boards should refrain from "precluding or prescribing any particular method as long as it is consistent with the standalone selling price basis [and that] observable inputs should be maximized regardless of the estimated method." This policy should allow an entity to arrive at an allocation that most faithfully represents the underlying transaction. However, in order to ensure consistency and comparability, the Boards should include appropriate disclosures regarding the methodology and controls implemented by an entity to estimate the standalone selling price.

## **Resources Cited:**

Codification Topic 605-25-30, Revenue Recognition, Multiple-Deliverable Arrangements, Initial Measurement. <a href="http://asc.fasb.org/">http://asc.fasb.org/</a>.

Intel Corporation, Comment Letter No. 35,

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Dell Inc., Comment Letter No. 36,

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Investment and Life Assurance Group (ILAG), Comment Letter No. 58, <a href="http://www.fasb.org/jsp/FASB/CommentLetter-C/CommentLetter-Page&cid=1218220137090&project-id=1660-100">http://www.fasb.org/jsp/FASB/CommentLetter-C/CommentLetter-Page&cid=1218220137090&project-id=1660-100</a>

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