

September 3, 2010

Technical Director File Reference No. 1820-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, Revenue Recognition (Topic 605): Revenue from Contracts with Customers

Dear FASB Technical Director:

I appreciate the opportunity to comment on the Financial Accounting Standards Board (FASB) Proposed Accounting Standards Update regarding Revenue Recognition. As an aspiring CPA and aspiring restaurant owner, I am greatly interested in the Board's proposals regarding this subject. After analyzing the FASB's proposed changes to revenue recognition under the exposure draft, three major issues stand out to me: Informativeness and quality of reported earnings, the effects on the construction industry, and economic reality. It seems to me that these issues need to be carefully addressed before any further consideration of the exposure draft, in its current form, takes place. I will begin my discussion with the informativeness and quality of reported earnings.

Informativeness and Quality of Reported Earnings

The FASB's discussion, in the 1976 discussion memorandum, of earnings as a focal point of a business enterprise reveals the importance of presenting earnings in a manner that is of high informativeness and quality (FASB, 1976):

Earnings (or profits or net income) of a business enterprise are the focal point of the information communicated in financial statements. Earnings are a major motivating force in the economic activities of business enterprises and a major motivating force in the economic activities of those who lend to business enterprises, those who invest in them, and those who manage them. In general, earnings reduce the risk of those who lend funds to an enterprise or acquire its debt securities. (p. 26)

As I discuss in the following paragraphs, the proposed changes to revenue recognition may result in a wavering of the informativeness and quality of reported earnings.

This is certainly not the first time that revenue recognition has been addressed by the accounting authorities. In 1999, the issue of revenue recognition was addressed in Staff Accounting Bulletin (SAB) No. 101 with much criticism. Perhaps taking a look at these issues will help guide the progression of the current proposed changes to revenue recognition. SAB No. 101 was issued because there were "concerns that firms were masking true performance by managing earnings using accelerated revenue recognition" (Altamuro, Beatty, & Weber, 2005). However, critics of SAB No. 101 stated "that it would eliminate industry-accepted revenue recognition practices and reduce the quality of reported earnings" (Ibid.). "The FASB's revenue recognition discussions echo these concerns stating that revenues recorded prior to the completion of the earnings process contain value-relevant information about future performance" (Ibid.). Users of financial statements are often concerned more with future performance than immediate performance, especially if stockholders are in it for the long haul.

An interesting finding was that "SAB 101 firms are more likely to meet earnings benchmarks" (Altamuro, Beatty, & Weber, 2005). However, it was also documented "that SAB 101 firms are more likely to have weaker corporate governance and more likely to have financial covenants, providing them with greater incentives to manage earnings" (Ibid.). The end result was that there were contradictory observations, but on average reported earnings turned out be less informative. The "regulation's prohibition of revenue recognition prior to completion of the earnings process, on average, results in less informative earnings since these unearned revenues provide value-relevant information" (Ibid.).

We may discover a prevalence of these same issues if the current exposure draft is approved, that the informative nature of earnings will be unchanged in some cases and weakened in other cases. While we currently have an equal playing field, with all earnings of all companies providing an equal level of useful information, the exposure draft may result in an un-leveling of the playing field, with some companies having more informative (by perception) earnings than others. These variations in the usefulness of information would be caused by differences in operating cycles, product delivery timeframes, etc. Under the current revenue recognition rules, these differences do not affect the informative nature of earnings. These findings may frown upon the proposed accounting changes to revenue recognition.

The Appendix to the chapter discussing the presentation of earnings in the FASB's 1976 discussion memorandum indicates that "earnings have come to be viewed as an indicator of financial success or failure" (FASB, 1976, p. 259). Under the current rules, this success would be misrepresented in the event that a significant number of products were to be returned, not delivered, or canceled prior to delivery. Under the proposed rules, there are fewer opportunities for these events to skew the company's "financial success" because the "shaky" revenue would not have been recognized in the first place. However, a delay in recognition of these revenues may result in the false appearance of unsatisfactory financial progress (if a significant proportion of revenue is tied to products that will not be delivered until next year). As a result, the numbers found in financial statements will convey less meaning and users of financial statements will find a greater need to analyze the disclosures.

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The Effects on the Construction Industry

The proposed changes to revenue recognition will have dramatic effects on construction companies that ordinarily would recognize revenue before the completion of a job "in certain long-term construction contracts" (Keiso, Weygrandt, & Warfield, 2010, p. 53). The proposed changes specify that revenue cannot be recognized unless the customer has direct use of the product or service. If the construction contract is not completed, the customer certainly cannot have direct use of the property or be able to benefit from its use. The FASB (2010, p. 5) goes on to propose that "contracts for the development of an asset (for example, construction, manufacturing, and customized software) would result in continuous revenue recognition only if the customers control the asset as it is developed." In other words, the customer must "own the work-in-progress as it is built or developed" (Journal of Accountancy, 2010). This would seem to make it very difficult for construction companies to recognize revenue before project completion. Even if this would be possible under the proposed changes, it raises other issues as discussed below.

For many construction projects, it may be unsafe for customers to "own the work-in-progress." For example, consider a new office building that is currently under construction. One floor has been completed and the customers start leasing the offices. While an office worker is on his way to his car in the parking lot, a brick falls off the roof and causes serious injury. Thus, ensuring revenue recognition for a construction company under the proposed rules may entail an increase in the risk of customers' safety. The mere knowledge of this potential may discourage construction companies from allowing such "early move-in" which would consequently prevent early recognition of revenue. Has the FASB considered these ramifications?

My view of the negative affects of the proposed changes to construction companies is shared by the Journal of Accountancy. In his 2009 article discussing early adoption of a new revenue recognition approach, Lamoreaux (2009) identified the problematic effects on the construction industry:

Under current U.S. GAAP, construction companies recognize revenue based on percentage of completion. So if a construction company has incurred the costs of constructing six floors of a 10-floor building, it is entitled to recognize 60% of the revenue. Under the preliminary views proposal, revenue recognition is based on transferring control to the customer. So if the customer does not gain control of those six floors, the construction company would be unable to recognize revenue for their construction even if it has incurred the related costs.

I would like to emphasize the closing statement: "the construction company would be unable to recognize revenue for their construction *even if it has incurred the related costs.*" It seems to me that this creates a conflict with the concept of earnings informativeness because it paints an unrealistic picture of the company's financial position. It would make it appear that no revenue had being earned for several years, while in actuality much had been accomplished.

Finally, large scale construction projects often take several years for completion. Without "early move-in," the proposals of the exposure draft would entail several years of unearned revenue in these situations! Will this discourage the growth of the construction industry and lower the economic activity of that sector?

Economic Reality

To understand the economic reality of a particular transaction or element, we must ask "which attribute is most relevant for economic decisions of investors and creditors? And what is the best measure of the relevant attribute?" (FASB, 1976, pp. 156-157). While this is referring to attributes such as historical cost versus "cost of replacement in kind" (or current exit value), it may be applied to the proposed changes to revenue recognition. For example, will investors and creditors find the inclusion of any amount of revenue received in 2009 relevant to the 2010 income statement, regardless of whether or not customers did not receive the products until 2010? Further, investors and creditors desire the most up to date information possible to make the most informed decisions possible. If companies wait to recognize revenues and expenses until customers actually receive the products, rather than when revenue is received and expenses are incurred, it will simply delay the reporting of certain revenues and expenses. Thus, the current revenue recognition principle provides a more up to date picture of the performance of the company.

Conversely, the proposed changes may satisfy "economic reality" for seasonal businesses. Consider a store that specializes in surfing gear. The company will likely have drastically increased sales during the summer months. However, what if a large number of customers had pre-ordered their gear a month or two ahead of time. Under the current revenue recognition rules, the revenue would be recognized prior to the summer months of increased sales. However, the proposed changes to revenue recognition will show a realistic picture, or "economic reality," that the revenue was earned during the actual months of increased sales when the customers pick up their surf gear. This would satisfy what the Accounting Standards Steering Committee, in the FASB Discussion Memorandum of 1976 (FASB, 1976, p. 187), defined as a desirable characteristic of the information that is presented in financial reports. Specifically, "the information presented should be complete in that it provides users, as far as possible, with a rounded picture of the economic activities of the reporting entity."

I appreciate the opportunity to comment on the Proposed Accounting Standards Update entitled "Revenue Recognition (Topic 605): Revenue from Contracts with Customers" and strongly encourage the board to consider the issues I have set forth in my above comments. I hope the board finds these comments useful and positively influential.

Sincerely,

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References

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