# Students of Master of Science in Accounting Program Indiana University Kelley School of Business Indianapolis 801 W. Michigan Street Indianapolis, IN 46202-5151

October 29, 2009

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116
United States of America

File Reference No. 1660-100

Dear Director:

Thank you for the opportunity to review and comment on the Discussion Paper on the *Preliminary Views on Revenue Recognition in Contracts with Customers (DP)*. We are pleased with the boards' progress towards a single revenue recognition model that is consistent with the conceptual joint framework established by both the FASB and the IASB. We also appreciate the boards taking on the difficult task to provide a single contract revenue recognition principle. Our comments to the specific questions in the Discussion Paper are listed below.

# **Question 1**

Do you agree with the Board's 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?

Yes, we agree with the Boards' proposal to use a single revenue recognition principle based on changes in an entity's contract assets or liabilities. Focusing on a single revenue recognition principle will lead to a more consistent revenue recognition model among most industries and their transactions. Currently, many standards define revenue recognition inconsistently. There are also gaps in guidance on revenue recognition. For example, there is no general standard on how to recognize revenue for services. The single principle proposed in the DP should mitigate this inconsistency. Under this proposed model, recognition of revenue depends on the delivery of performance obligations. Performance obligations are delivered or satisfied when contract assets are delivered to the customer. However, the proposed approach may prove challenging to apply in cases where the asset is a service. The Boards will need to provide additional performance measurement guidance to facilitate the transition to this method. Generally, we believe the single revenue recognition principle will enhance consistency in revenue recognition when compared to existing 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?

Yes, there are certain contracts for which the Boards' proposed principle would not provide decision-useful information. One example would be long-term construction and production contracts. A construction project may take two years to complete, and while the entity has already performed part of the service, it will not hand over the asset to the customer until the completion date. In this scenario, using the percentage-of-completion method will provide better decision-useful information.

Another instance would be contracts with multiple components. The Boards' proposed revenue recognition principle is too simple, and it would require inaccurate assumptions for companies that enter into contracts involving multiple components.

The Boards' proposed revenue recognition model does not provide decision-useful information when dealing with audit or litigation service contracts. Consider an accounting firm that is hired to audit a client. The audit firm starts working on the audit and it may take over a year to complete the audit. The performance obligation will be satisfied when the audit firm delivers the audit report to the client. The audit firm has already put in many hours into the audit. If we use the Boards' proposed principle and do not recognize revenue until the audit report is delivered, then it will not provide decision-useful information because the revenue recognition does not match the way services are performed (and expenses are incurred) in the same period.

## 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 do not believe that the Boards' definition of a contract is complete. The Boards need to elaborate on the definition. The term "enforceable obligation" is too vague. The enforcement of a contract may vary in different jurisdictions, especially when it comes to international jurisdictions. A contract that is enforceable in one country may not be enforceable in another. Bribery may be legal in some countries. Some companies offer bribes to get contracts and then add those bribery costs to the cost of contract and capitalize them. However, bribery is illegal in the United States. This contract definition will lead to lack of guidance and inconsistency in corporate reporting for multinational companies that operate in different countries. The Boards should elaborate on what to do in these circumstances when certain parts of a contract may be enforceable in one jurisdiction but not enforceable in another.

Also, the Boards should discuss indirect customers in cases where a customer is entitled to a discount on behalf of an indirect customer. For example, a person who is a member of a discount association gets a discount when he stays at a hotel. The Boards should provide guidance in these cases on how to recognize contract assets or liabilities. In this case, when a customer stays at a

hotel, he forms a contract with the hotel. However, he benefits from his contract with the discount association and gets a discount from the hotel. The hotel has an arrangement with the discount association that allows them to issue discounts to customers who are discount association members. Therefore, the Boards should expand the definition of a contract and elaborate on "enforceable obligation" and "indirect customers."

### **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 generally agree that the Boards' proposed definition of performance obligations would help entities to identify consistently the deliverables in a contract. However, we question whether the Boards' proposed definition would apply to the insurance industry. In an insurance contract, the obligation of an insurance company is to compensate a customer who experiences an adverse event and files a claim. If the performance of this promised obligation is the only device that triggers revenue recognition, the insurance company may never be able to recognize any revenue unless all of its customers file claims and the insurance company reimburses them all.

### **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 entity transfers the promised assets to the customer, with regards to the determined time the assets are transferred.

If the obligations are unbundled and transfers occur in multiple reporting periods, separating the performance obligations can better reflect faithful representation, which is a fundamental quality of the proposed Conceptual Framework jointly being considered by the IASB and FASB. However, more detailed guidance is needed in separating the performance obligations before this model can be used adequately because of the complicated issues involved, such as continuous support services. For example, in the software industry, varying amounts of support may be needed in different reporting periods, which would result in varying amount of obligation recognition per period. Because the support is continuous, the performance obligation recognized would not be decision-useful.

### **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 agree that the right of return represents a performance obligation. The customer clearly controls the asset transferred to it, prompting the recognition of revenue attributable to that asset. Under the failed-sale notion, the entity would not recognize any revenue until the right of return expires. A delay in revenue recognition does not faithfully represent the underlying transfer of control. Depending on the length of the return period, an entity might not recognize any revenue for long periods of time, potentially a year or longer.

The test mentioned in paragraph 3.37 provides simple logic to support the argument that the right to return is a service. Most customers do not explicitly pay more for the right to return like the examples provided (airline or rail tickets or hotel reservations), but there is an implicit value to the right. Under IAS 18 and FASB ASC 605, entities estimate returns and only recognize revenue for the assets not expected to be returned. We believe a performance obligation is generally equivalent to this treatment. For example, in the publishing industry with its high product return rates, the right of return would have more standalone value because of the necessity of returns. This would result in a larger portion of the transaction price being allocated to the right of return obligation, and subsequent deferral of revenue until return or lapse.

The Boards have not addressed how actual returns would be recognized. The proposed method lends itself to derecognition of the previous revenue. We believe the Boards should include the recognition of returns in future discussions.

## **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 agree that most sales incentives such as discounts on future sales, customer loyalty points, and "free" goods and services that are provided in conjunction with a current transaction give rise to a performance obligation. Even though the incentives may not be exercised by the customer, they do represent an entity's promise in a contract to transfer an asset to the customer in the future, which is why the incentive would be appropriately classified as a performance obligation. Additionally, sales incentives are performance obligations because customers may be more willing to pay a higher price for the initial goods or services to obtain the incentives.

For sales including incentives, we recommend an entity to recognize the portion of the revenue related to the delivered assets at the initial inception, and then recognize the remaining revenues as incentives are used or when they expire. This method will allow revenue to be recognized by the entity when it transfers the asset to the customer, providing a clearer representation of the entity's economic performance.

## **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 concur with the Boards that an entity transfers an asset to a customer when the customer controls the promised good or receives the promised service. To a certain extent, this definition meets the terms established in the current proposed joint conceptual framework as the customer is consequently able to obtain the economic benefit of such good or service.

However, we believe that the Boards need to refine the definition of control further in order to facilitate a better understanding for its application in various settings across industries. A consistent approach to determining whether a performance obligation has been satisfied is important to ensure comparability of financial reporting information.

One recommendation is to specify whether control refers to the physical possession of a good. Under the current standard, regardless of the shipping status, once an entity ships a good to its customer, it is considered to have transferred an asset according to IAS 18 paragraph 14(a) because "the entity has transferred to the buyer the significant risks and rewards of ownership of the goods." The good may still be in transit, but the buyer (i.e. customer) has assumed all rewards related to the ownership's benefits of the goods, and all risks, which include any risks of damage or loss due to shipping and handling.

If control indeed implies the physical custody of a good, an entity that supplies products worldwide particularly may be challenged to record revenue on the actual date of when a customer takes physical ownership of a product. This requirement may pose an undue burden for the entity as it is often impractical to assess the timing of delivery when a lengthy process of transportation is involved, and it is difficult to expect a receipt confirmation with the supporting documentation in a timely manner from a customer overseas.

Additionally, we are still unsure of the proper treatment of interlinked performance obligations. In cases where there are multiple deliverables of separate assets, each of which is worthless by itself, the Boards recommend ignoring the customer's intended use of the assets, and instead focus on whether the customer has control of any of the assets. The Boards, however, also offered a contradicting presumption in paragraph 4.56 of the DP that "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." In the consulting service industry, an entity may be requested to modify or add the scope of its performance obligation under the original contract in order to change the final deliverable that is suddenly deemed ineffective due to the client's organizational restructuring or the changing market need that is common in today's business environment. We ask that the Boards consider providing a clearer guidance with respect to this position.

# **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.

Consistent with our comment to Question 8 above, we believe that the Boards' proposal would not provide decision-useful information for long-term contracts, particularly construction contracts. Although the performance obligation as a whole has not been satisfied, and thus, the customer does not have control over the asset, we hope for a better course of recognizing a continuous transfer of an asset in a long-term construction contract where performance obligation milestones are being satisfied in stages. Better direction from the Boards on how interrelated performance obligations in a contract should be treated will ensure a faithful representation of the financial reporting information.

### **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 approach more closely aligns with the qualitative characteristics outlined in the conceptual framework currently proposed by the Boards. The transaction price inherently reflects the expected costs, time value of money, and margin required of each performance obligation. As noted in paragraph 5.20 of the DP, the current exit price approach could potentially allow an entity to recognize revenue before any contract assets are transferred to a customer. Conversely, by allocating the transaction price directly to the performance obligations, no revenue would be recognized until a contract asset was transferred to a customer, making the transaction price approach a more faithful representation of the underlying economics, with revenue matching performance.

The simplicity of the transaction price approach will allow for more consistent application and, consequently, more comparable information. Additionally, we agree with the observations in paragraph 5.21 that the current exit price approach would generally require the use of estimates, which may be difficult to verify and costly to produce.

**(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 of that cost exceeds the carrying amount of the performance obligation? Why or why not?

No, while we believe that performance obligations should be monitored after initial measurement for changes in the underlying economics of a contract, we do not agree with the onerous test application described in the DP and question whether it should be included in a revenue recognition standard. The proposed conceptual framework includes the qualitative characteristic of faithful representation. The Boards' preliminary view outlined in paragraph 5.58 is that entity should only revise performance obligations upwards if "significant adverse changes" imply initial measurement was insufficient. Omitting significant favorable changes from

remeasurement seems to undermine the faithful representation the Boards are seeking by prescribing a test that is neither complete nor neutral. We also question whether the test should be applied to individual performance obligations or to all remaining performance obligations in aggregate. The economics of a transaction may be distorted by separating performance obligations for essentially impairment testing when it seems more decision-useful to consider the transaction as a whole.

We question the inclusion of the onerous test in the standard. In our opinion, the onerous test for remeasurement equates to the recognition of subsequent expense or loss. We believe this topic should not be addressed in a general revenue recognition standard; rather, it should be included in another standard regarding expense recognition or contingencies.

**(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.

As stated in the response to part b, the application of the onerous test to individual performance obligations may not be decision-useful. The test operates under the assumption that all performance obligations act independently of one another, which is unlikely. In many cases, considering all remaining performance obligations as whole will probably provide a more accurate reflection of the underlying economics.

**(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.

No, we support the concept of a general standard regarding revenue recognition. It will be impossible to develop a single standard that will be decision-useful for all industries and contracts, but a standard model will improve financial reporting for the majority of entities. We have no additional exceptions beyond those noted in paragraphs 5.88 through 5.90. We believe the Boards could scope out the revenue recognition of financial instruments, insurance, and leases in the current joint projects and other potential inadequacies in future projects.

# **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?

Yes, we agree that transaction costs charged to a customer in obtaining the contract should be included in the initial measurement of the performance obligations. We believe the costs an entity charges to a customer in obtaining a contract should be treated in conjunction with the transaction price, because the contract costs paid by the customer represent additional consideration for both the entity and the customer. Furthermore, as discussed in Question 10a, if the costs to obtain the contract were paid by the customer and not included in the initial measurement of the performance obligations, revenue would be recognized before any performance obligations were transferred to the customer. This does not meet the principle set forth by the DP.

**(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.

It is in our opinion that the revenue recognition standard should not include the determination of whether a contract origination cost should be expensed or capitalized, because it is not applicable to revenue recognition.

However, we believe that most contract origination costs should be capitalized as an asset since these costs are necessary for the creation of the contract, which the boards' joint proposed conceptual framework defines as an asset. For example telecommunications and insurance industries often pay considerable amounts to third-party agents to produce customer contracts. If these amounts are expensed rather than capitalized, we believe this would not reflect the an entity's true financial performance because the entity would not be reporting the economic benefit it receives by investing large amounts into agents to produce contracts it otherwise would not receive. Furthermore, we believe the Boards' should provide additional guidance on contract capitalization in its asset standards.

## 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 with the Boards' view that the transaction price should be allocated to each performance obligation proportionally based on the standalone selling prices of the goods or services underlying the performance obligations. We acknowledge that this method does not provide the precise transaction price that would be accessed to the performance obligations on a standalone basis. However, considering the complexity that often occurs in applying a single transaction price to multiple performance obligations, we believe that this model provides a simple and economically reasonable approach. Additionally, this model is consistent with the revenue model presented in ASC 605-25, "Revenue Arrangements with Multiple Deliverables."

# **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?

If an entity does not sell a good or service separately, for the purpose of allocating the transaction price, we believe the entity should be allowed to estimate the standalone selling price of the good or service. We agree with the Boards' view detailed in paragraph 5.47 of the DP, stating that if an entity is not required to estimate the standalone selling price of a good or service, the entity would otherwise have to account for performance obligations with other performance obligations. This could result in unsatisfied performance obligations being treated as satisfied performance obligations, or vice versa. This would fail to provide a fair representation of an entity's financial position and performance.

We also agree with the Boards that a prescribed method for estimating the standalone selling price for a good or service would not be appropriate. A prescribed method would not be reasonable in presenting a fair representation across all industries. Additionally, in order to maximize observable inputs in estimating standalone selling prices, we recommend that the boards' include a hierarchy system in the final standard. A system similar to the fair value hierarchy established in FASB Statement No. 157 may be appropriate, because it provides more transparent information in valuing the estimate of the multiple deliverables which can be applied to the estimated selling price for multiple goods and services with a single transaction price.

Sincerely,

Brent Barton	Duet W. Barton.
Cai Qunfang	aunfer (
Lufi Handri Utami	
Zeeshan Malik	Freshow Melily
Russell Simon	Hindl Ain

## **Works Cited**

- IAS 18. Revenue. International Accounting Standards Board. January 1, 2009.
- Discussion Paper. Preliminary Views on Revenue Recognition in Contracts with Customers. Financial Accounting Series No. 1660-100. Financial Accounting Standards Boards. December 19, 2008.
- FASB ASC 605. Revenue Recognition. Financial Accounting Standards Board.
- Financial Accounting Standards Board. "Conceptual Framework: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decisions-Useful Financial Reporting Information." <u>Financial Accounting Series</u> No. 1570-100 (May 29, 2008): 1-38.
- Financial Accounting Standards Board. Statement of Financial Accounting Standards No. 157, Fair Value Measurements. Sept. 2006.

### Works Referenced

- Chadwick, Jonathan. Cisco Systems, Inc. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 177." Letter to Russell Golden. 22 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.
- Culbertson, Leslie. Intel Corporation. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 35." Letter to Russell Golden. 16 June 2009. *FASB.org.* Financial Accounting Standards Board. Web.
- Ernst & Young, LLP. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 123." Letter to IASB. 19 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.
- Exposure Draft. Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information. Financial Accounting Series No. 1570-
- 100. Financial Accounting Standards Board. May 29, 2008. FASB ASC 910. *Contractors-Construction*. Financial Accounting Standards Board.
- Graziano, Joseph. SAB 101: Frequently Asked Questions. The CPA Journal. March, 2001. CPAJournal.com.
- Halliwell, James. Syngenta International AG. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 120." Letter to IASB. 19 June 2009. *FASB.org.* Financial Accounting Standards Board. Web.

- IAS 11. Construction Contracts. International Accounting Standards Board. January 1, 2009.
- KPMG IFRG Limited. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 61." Letter to David Tweedie. 18 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.
- Laux, Bon. Mirosoft Corporation. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 208." Letter to Russell Golden. 19 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.
- Maynard, Lynda. Investment and Life Assurance Group. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 58." Letter to IASB. 18 June 2009. *FASB.org.* Financial Accounting Standards Board. Web.
- PricewatershouseCoopers, LLP. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 68." Letter to FASB & IASB. 18 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.
- SAB 101. *Revenue Recognition in Financial Statements*. U.S. Securities and Exchange Commission. December 3, 1999.
- SAB 104. *Revenue Recognition, corrected copy.* U.S. Securities and Exchange Commission. December 17, 2003.
- Wild, Ken. Deloitte, LLP. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 110." Letter to David Tweedie. 19 June 2009. *FASB.org.* Financial Accounting Standards Board. Web.
- Wirz, Hermann. Nestle S.A. "Preliminary Views on Revenue Recognition in Contracts with Customers, Comment Letter No. 107." Letter to IASB. 19 June 2009. *FASB.org*. Financial Accounting Standards Board. Web.