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Technical Director
Financial Accounting Standards Board
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File Reference No. 1820-100, Exposure Draft: *Revenue from Contracts with Customers*

Dear Technical Director:

I appreciate the opportunity to comment on the 2010 Jun 24 Proposed Accounting Standards Update, *Revenue from Contracts with Customers*. Please note that the views expressed in this comment letter are my own and not those of any of my employers, current or past.

For the most part, I support the proposed standard. It is theoretically sound. It does not sacrifice representational faithfulness to achieve some other desired presentation of financial results, such as the smoothing of revenues resulting from use of the percentage-of-completion method. It also does not sacrifice representational faithfulness and sound theory due to concerns that financial statement preparers will abuse the discretion involved in making accounting judgments, as seems to have guided some prior accounting standard setting (for example, accounting for real estate sales). Lack of bias in the use of judgment when applying accounting standards should be achieved through professional ethics, internal controls, and the oversight of external audits; attempts should not be made to compensate for potential bias in applying judgment to accounting decisions by embedding a maze of rigid, one-size-fits-all strictures and rules within the accounting standards.

Some entities might have significant implementation costs as they create new processes to meet the changed revenue recognition requirements in the proposed standard, but once adopted, many entities might save ongoing compliance costs as a result of the simplification of the guidance from current GAAP. The proposed standard requires additional use of judgment and estimates, but I expect that most entities will find that they can equip themselves to make reasonable judgments and estimates without undue difficulty. Well-run entities should already be making many of the judgments and estimates required by the proposed standard when they analyze the profitability of their products or services. The simplification of accounting for real estate sales should benefit financial statement preparers and also

provide more meaningful information to users. Improvements to accounting for arrangements with multiple deliverables/performance obligations should also benefit financial statement preparers and users.

In general, accounting standards have been moving away from valuing the reliability of historical amounts and amounts determined by specific rules toward amounts that are based on judgments and estimates. When using historical and/or rules-based accounting, it is often easy to tell when the work is complete on determining an accounting amount – the invoice has been read and/or the steps in the rule have been followed. However, when using estimates and applying judgment to determine accounting amounts, it often requires judgment to determine whether a calculated amount is “good enough”. An accountant can often keep grinding at a calculation without end trying to get a “better number”. This causes the application of accounting standards based on estimates and judgment to become cumbersome and expensive. Accounting standards should be made the best they can, and this often includes requiring the use of estimates and judgments; I believe that the proposed revenue recognition standard makes reasonable requirements to use judgment and estimates. But to make the standard operational, it is incumbent on financial statement preparers, their auditors, and the regulators to use sound judgment in determining the reasonable amount of accuracy needed to meet financial statement users’ needs. All parties involved with financial statements need to understand that financial statement amounts arising from estimates and judgments will never be “right”. Therefore, they need to limit the effort (and cost) to make estimates and judgments to ensure that they are good enough, but no more.¹

My thoughts about the FASB’s specific questions for comment are as follows:

Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

Yes, I agree with the principle of price interdependence to determine whether to combine or segment contracts or to account for a contract modification as a separate contract or as part of the original

¹ I will leave the complicated topic of how much cost to incur to achieve a “reasonable” estimate with this one paragraph. There is much more to be said about it (as one example, I did not even mention the effect of litigation risk on making financial statement estimates and judgments), but I think a brief mention is in order in this comment letter because estimates and judgments are such an important part of the proposed standard.

contract. I believe that price interdependence is the fundamental economic consideration for defining what is considered a single “contract”. The Boards should ensure that they provide sufficient implementation guidance to ensure that preparers that have long-term contracts with frequent change orders clearly understand how to apply this principle.

Question 2: The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

Yes, I agree with the principle for determining whether a good or service is distinct that is presented in paragraph 23.

However, I recommend that the Boards consider providing more implementation guidance about how they intend the performance obligation identification process to be applied to long-term construction contracts. The guidance in Example 11 at paragraph IG43 just devotes a portion of one paragraph to the evaluation of the actual construction activities in a construction contract for multiple performance obligations. The first two relevant sentences read as follows: “During construction, the entity performs various tasks including site preparation, foundation development, structure erection, piping, wiring, and site finishing (for example, paving a parking lot and landscaping). The customer could contract separately with other entities to perform each of those tasks.” The paragraph then departs from discussion of these activities and begins addressing the performance obligation associated with the contract management services that coordinate these activities. The paragraph does not demonstrate a clear evaluation about whether any of the various listed construction activities meet the criteria at paragraph 23 for being considered “distinct”. I think that the perfunctory comment in the second to last paragraph that site preparation and site finishing are separate performance obligations due to having distinct risks is insufficient to clearly demonstrate this evaluation.

Example 11 at paragraph IG43 also pertains to a construction project that has multiple steps, which might be performed by multiple contractors, but the resulting constructed asset appears to be a unified whole. The issue addressed by this example is whether the steps in constructing this single asset are separate performance obligations. Other construction contracts might involve the construction of a project that could be viewed as comprising multiple sub-projects. For example, I am particularly familiar with the construction of large solar power plant projects. These projects can sometimes be divided into separate “blocks” of solar module arrays that can be energized and begin generating revenue for the owner once the block is completed, but before the entire power plant is completed. Perhaps there are other types of construction projects, including in the real estate industry, that have similar

characteristics of staged completion.² It might be helpful for the standard to provide an example or implementation guidance that addresses the application of (or lack of applicability of) the performance obligation identification principles to projects completed in stages.

Also, while example 15 at IG66 regarding a manufactured project does provide some relevant guidance, it might be desirable to have an example that specifically illustrates how the concept of continuous satisfaction of a performance obligation (and continuous revenue recognition) applies to a real estate construction project.

Question 3: Do you think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

Yes, I think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer.

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price. Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

Yes, I agree that an entity should recognize revenue on the basis of an estimated transaction price.

Yes, I agree with the proposed criteria in paragraph 38.

Question 5: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

² Example 17 at paragraph IG68 tangentially touches on this matter with respect to construction of an apartment complex, but the purpose and emphasis of this example is to address the different issue of whether continuous revenue recognition applies to a particular unit of a construction project.

Yes, I agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue. I believe that this is an elegant approach that accords well with other trends in accounting, including evolving approaches to fair value measurement, and compares favorably with the clumsy approach of addressing credit risk through whether revenue can be recognized. Financial statement preparers should generally be able to make estimates of the effect of customer's credit risk for application of this accounting principle that provide a more meaningful revenue amount than using the present recognition-based approach.

Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

Yes, I agree that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). This approach faithfully represents the true nature of the transaction, and financial statement preparers should be readily able to obtain information to make a reasonable determination of the effect of the time value of money on an entity's revenue transactions. After all, an entity would not enter into an agreement that involved, in economic substance, a lending arrangement without some consideration of the cost of that lending arrangement (would it?).

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

Yes, I agree that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. I believe that financial statement preparers will usually be able to obtain or make a reasonable estimate of the standalone selling price of the good or service underlying each performance obligation. Crude allocation methods used in current GAAP, such as the reverse residual method, are almost certainly inferior to the proposed allocation approach, even considering the lack of precision that may result from judgments required to make estimates of standalone selling prices. Recent developments in accounting standard setting, including this proposed standard, demonstrate an acknowledgement that it is better to be imprecisely correct than precisely wrong. That said, I think that implementation guidance for long-term construction contracts would be helpful.

Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, Intangible Assets), an entity should recognize an asset only if those costs meet specified criteria. Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

Yes, I think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient. The guidance should be sufficient to permit financial statement preparers to implement procedures to appropriately comply with the principles involved.

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

Yes, I agree with the costs specified.

Question 10: The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

Yes, I think that the proposed disclosure requirements will meet the objective of helping users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The disclosures expand those currently required under GAAP, but I believe that they are reasonable and can envision approaches to presentation that should be understandable to users of the financial statements.

Question 11: The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

Yes, I agree with the proposed requirement that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. I can readily identify two benefits from this disclosure, which both financial statement preparers and users will share. First, the proposed standard, if implemented, might lead recognition of revenue for some long-term contracts that is less smooth than under the

current accounting guidance. The timing of revenue recognition under the proposed standard is appropriate in that it reflects the actual way a business engaged in long-term contracts operates and fulfills its performance obligations. The proposed disclosure will help the financial statement preparer articulate that volatility in revenue is inherent in the business, but is not necessarily an indicator of financial distress, since the roll-out of revenue in future periods will be documented in the notes to its financial statements. Financial statement preparers should have information relevant to preparing this disclosure available as a result of on-going forecasting processes. Second, in my experience financial statement users often have difficulty understanding amounts presented on the balance sheet related to long-term revenue contracts, such as the "asset" that results when revenue is recognized before contractual billing milestones are reached or the "liability" that results when contractual billings exceed revenue that can be recognized. Although the proposed disclosure will not directly correspond to the amounts disclosed on the balance sheet, the proposed disclosure might help, in part, financial statement preparers to articulate to users how these balance sheet amounts relate to and will play out through revenues on the income statement.

Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

Yes, I agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors.

Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

This is a tough question, as I am sure the Boards and their staffs know from their efforts developing this proposal. Retrospective application will require the determination of revenue two times for each comparative year. For many entities, this will just be a moderate nuisance. For entities that have revenue arrangements with many performance obligations (deliverables) and long contract terms, the burden will be much greater. This burden can be mitigated somewhat by the timing of the effective date of the final standard. Based on issuing the final standard in 2011, if the standard becomes effective for 2014, entities can determine revenue for 2012 and 2013, which would be the prior comparative years during the year of adoption of the standard, using the existing guidance and the new standard simultaneously. It will be easier to apply the new standard as an entity goes along performing its routine bookkeeping than having to dig back into prior period records, which would be required if the effective date of the new standard is earlier than 2014.

I believe that the precision required for determining revenue under the new standard for the comparable years could be somewhat lower than required for determining revenue for a current year. I expect that users of financial statements would attach the most importance to the current period information and accept somewhat lower precision for information from prior periods, which they use mainly to identify trends. To the extent that my perspective on the requisite accuracy for prior comparative periods is widely accepted, it could somewhat reduce the burden of retrospective application.

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Yes, except as specifically noted elsewhere in this comment letter, I think that the implementation guidance is sufficient to make the proposals operational. My preference, for ease of use, is to have implementation guidance integrated with the main guidance of the standard, but I understand that this form of presentation does not match the structure of the *FASB Accounting Standards Codification*, into which the final standard will be integrated.

Question 15: The Boards propose that an entity should distinguish between the following types of product warranties:

- (a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.
- (b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

I agree with the proposed accounting for each type of warranty. For a warranty that ensures that a product meets a base-line or standard level of quality and/or functionality, the warranty is a mechanism for meeting the performance obligation inherent in an agreement for the sale of a product. Therefore, to the extent that future actions will be necessary under such a warranty for products already shipped, the need for future actions indicates that those shipments did not entirely meet the performance obligation under the arrangement. Consistent with the principles of the proposed standard, revenue is not recognized until a performance obligation is fulfilled. Some other types of warranties entail a commitment by the seller that the product's quality and/or functionality exceeds a base-line or standard

level. This seems to me to be a performance obligation beyond the delivery of a standard product that is generally acceptable in the market, and therefore, accounting as a performance obligation that is separate from the product sale seems representationally faithful.

However, as may be apparent from the way I described the two types of warranties in the preceding paragraph, I have some confusion about how the proposed standard distinguishes between the two types. I think that the intent of the proposed standard is to provide an unambiguous way of saying, "Account for a standard warranty as part of the performance obligation, and account for an extended warranty as a separate performance obligation." Like pornography and art, most people will be able to distinguish a "standard warranty" and an "extended warranty" when they see them, but it is still incumbent on the Boards to clearly define their terms. Unfortunately, I do not think the proposed standard describes a warranty that is part of the performance obligation to deliver a product or service and a warranty that is a separate performance obligation adequately or appropriately.

I am not convinced that there are many sales arrangements that include "warranties" that truly "... provide a customer with coverage for faults that arise after the product is transferred to the customer". Instead, I think that most separately sold warranties that extend a standard warranty still protect the customer against "latent" defects in product construction, but just provide assurance regarding those latent defects that would only become evident upon long-term product use. Such a warranty might reasonably be considered an additional performance obligation, especially if we accept the premise that most latent defects will evidence themselves during the "first 90 days" (or so) of a product's use. Sure there are some so-called "warranties" that have "no-questions-asked" type provisions that make them operate to some extent like an insurance arrangement, but I think most extended warranties are just extensions of a standard warranty and limit their coverage to problems with the inherent performance of the product.

Now if the Boards' intent really is to only allow accounting as a separate performance obligation for those warranties that truly provide coverage for events that arise after the product is transferred to the customer, they should clarify this in the standard and note that the warranty agreement for such an arrangement would have terms that make explicit the insurance-like nature of this arrangement. Maybe this is the intent of the Boards, but they actually only use the term "insurance" in the basis for conclusions to the proposed standard. However, by using the word "faults" (rather than "events", like I used in the first sentence of this paragraph), the Boards are signaling that covered incidents are still due to the inherent nature of the product, which would still be a latent defect at the time of shipment. Likewise, factors (b) and (c) at paragraph IG 18 suggest that the Boards did not intend a separate performance obligation related to warranties to only pertain to situations in which the arrangement protects against externally generated damage to the product; these factors focus on the salability of the product without the added warranty and the length of the warranty coverage period.

I think there *is* a distinction between a "standard" warranty, which guarantees a minimum level of product performance and, therefore, relates to the performance obligation to deliver the product, and an "extended" warranty, which guarantees a level of performance beyond a market base-line and,

therefore, is a separate performance obligation. To clarify the guidance regarding distinguishing these two types of warranties, I recommend revising factors IG 16 (b) and (c) as follows:

“(b) whether the product could have been sold without the warranty – if a warranty is not sold as an optional extra, that indicates that the warranty is not a performance obligation. Conversely, if a warranty is sold as an optional extra, it is a separate performance obligation in accordance with paragraph 23(a).

(c) the length of the warranty coverage period – if the length of the period of time covered under the warranty does not exceed the period of time of warranties typically included as part of the cost of the product, that indicates that the warranty is not a performance obligation.”

I also recommend removing references to “latent defects” and “faults that arise after the product is transferred to the customer” from the standard. I believe that the key issue when determining whether or not a warranty is a separate performance obligation is whether the warranty warrants that the quality and functionality of the product meet the requirements typically demanded in the market or whether the warranty warrants some higher level of quality and functionality. Of course, the Boards could add further guidance relating to arrangements described as “warranties” that do protect the buyer from hazards exogenous to the product itself; this would indeed be an insurance-type arrangement, which would also be a separate performance obligation.

Question 16: The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and**
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.**

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

Yes, I agree that the pattern of revenue recognition should depend on whether the license is exclusive, and I agree with the patterns of revenue recognition proposed by the Boards. An entity's granting an exclusive license over a period of time cedes control of the license to the licensee, and that control is associated with a particular period of time. The licensor earns revenue from its intellectual property over time by entering into a single relationship for that time, and the arrangement would be expected to provide sufficient consideration to compensate for this time element. Therefore, it seems reasonable to

recognize revenue in a manner that gives regard to the time element of the performance. When granting a nonexclusive license, the element of time has less significance to the licensor. The licensor earns revenue from its intellectual property over time by churning multiple sales contracts over that time, and each arrangement would not need to compensate the licensor for a time element. Therefore, in that case, immediate revenue recognition upon delivery of each instance of the product seems reasonable.

Question 17: The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

Yes, I agree with the Boards' proposal that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Transactions with the same economic substance should be accounted for in the same way.

Question 18: Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

No, none of the proposed guidance should be different for private companies. In general, I am not persuaded that the needs of the users of private company financial statements are so different from those of public company financial statements that accounting principles should be developed to differently present, for each type of entity, transactions and balances with the same economic substance. In the particular case of revenue recognition, I certainly do not see any way in which the technicalities of the owners' equity structure affects the substance of revenue earning transactions that are otherwise identical among the entities.