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VIA EMAIL TO: director@FASB.org

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

Re: Proposed Accounting Standards Update, *Revenue from Contracts with Customers*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We appreciate the opportunity to provide comments on the FASB's Proposed Accounting Standards Update, Revenue Recognition (Topic 605): *Revenue from Contracts with Customers* (the ED).

We commend the FASB for its work to date on this project. We believe the accounting literature on revenue recognition requires improvement, as it currently suffers from a number of inconsistencies and, despite fairly extensive industry guidance, omissions. We believe that correcting these deficiencies through the publication of a comprehensive standard on revenue recognition will be an improvement to the US generally accepted accounting principles (GAAP).

We believe that the model proposed in the ED would address many of the deficiencies in the current revenue recognition literature. We are encouraged that the guidance in the ED has the potential to increase consistency across reporting companies, provide principle-based guidance to address issues that are not currently addressed, and improve the relevance of reported information about revenues, while reducing the volume of revenue recognition literature. However, having practiced in an environment with detailed guidance on many aspects of revenue recognition, we are unsure of how practice in the US will react to a more principles based approach. We therefore believe it will be important for the Board to monitor this situation to help ensure that the benefits of having a principles-based model are not lost in the implementation and application of the standard.

We have a number of comments both in response to the questions posted in the ED, and in other areas. We first present some general comments immediately below, and then provide responses to each of the questions in the ED.

General Comments

Elimination of Certain Restrictions on Revenue Recognition

Revenue is, obviously, a key measure for almost all companies. Changes in revenue are analyzed in great detail by financial statement users, and any changes in reported or expected revenues can have a significant effect on users' view of the company's prospects. In part because of this, accountants have often felt that revenue should not be reported unless there is a high degree of reliability that such revenue has indeed been earned and will be realized. To that end, GAAP has historically included many provisions which serve to restrict the recognition of revenue when uncertainty about that revenue exists.

The ED proposes to loosen those restrictions in several areas, including:

- Allowing an entity to use probability-weighted estimates to record revenue when the transaction price is variable based on future events if the company has relevant experience with similar types of contracts.
- Allowing recognition of revenue on completed performance obligations based on relative standalone selling prices, even when a portion of the amount recognized is contractually contingent upon the completion of additional performance obligations.

While we agree with relaxing these restrictions in some instances, we believe that the ED's proposals go too far in that direction. Amongst the risks of recognizing revenue whose collection is contingent upon future events is the reduction in the reliability of reported revenue. In addition, using probability-weighted estimates as freely as proposed in the ED would result in revenue commonly being recorded at an amount that is not a possible outcome. To illustrate, if the contingent revenue for a contract is $100 and the company can earn either $100 or nothing, a 60% probability will result in reporting $60 of revenue even though there is no possibility that the company will receive $60. We believe that such a result is counter-intuitive, and will reduce confidence in reported revenue.

In general, we believe that any recognition of revenue based, in substance, on predictions of the outcome of future events, should be limited to situations in which a large pool of homogeneous transactions exists. In that situation, we believe that the probability-weighted estimates generally would have a sufficient degree of reliability on which to base revenue recognition. In addition, when considering the large pool as a whole, the recorded revenue amounts based on probability-weighted estimates would generally represent the most likely outcome as well.

When a large pool of homogeneous transactions does not exist, we prefer to limit the estimate of the transaction price to the amounts that are not subject to change based on future events. While we acknowledge that this will have the effect, on the whole, of underestimating the economic value of revenue at the time that performance obligations are completed, we believe that the importance of reporting reliable, understandable amounts of revenue justifies this restriction.

We expand on these thoughts in response to several of the questions in the ED below.

Uncertainty of Performance Obligations

The ED provides clear principles for addressing situations in which the transaction price under the contract is variable. However, it does not provide principles to address situations in which the

performance obligations are subject to variability. This is an issue that frequently arises in revenue transactions, often for services but occasionally for goods. Some examples include:

- A fitness club charges an initial membership fee, which is paid at inception, and monthly fees thereafter. The customer is entitled to remain a member for as long as he or she pays the monthly fees, and will not be charged an additional "initial" fee for the entire length of that membership. The length of the fitness club's obligation to provide service to that customer is not definitively known. The exposure draft does not articulate the principle one would use to determine the period over which the initial fee should be recognized as revenue.
- A mobile telephone company sells a handset below its cost if the end customer signs a two-year contract to purchase a minimum level of mobile telephone service. However, because the customer may cancel the contract early without penalty in certain situations (e.g., relocation to an area where service is not available), and may cancel with the payment of a penalty in other situations, there is no definitive period over which the performance obligation to the end customer will be satisfied. Here again, what is the principle governing the recognition of revenue?
- A company's contracts provide its customers with the right to a certain volume of products or services in exchange for a fixed fee, but customers may not request the entire amount of products or services to which they are entitled. This is common, for example, with companies that sell gift cards, as a portion of gift cards is invariably not redeemed. As above, we do not believe the exposure draft explains the principle that should apply to the recognition of revenue.

While several of the examples in the Implementation Guidance provide clues as to how to handle these uncertainties, we believe the final standard should articulate the principle governing this common fact pattern.

Consistent with our view regarding recognition of revenue that is contingent upon future events, we believe that when a large pool of homogeneous transactions exists, it is appropriate for a company to estimate the period over which it will satisfy its performance obligations and transfer control using probability-weighted estimates.

However, in the absence of a large pool of homogeneous transactions, we believe that a company should assume the maximum contractual period over which the customer is entitled to receive goods or services without an additional fee.

Need to Expose Changes to Codification

We believe the ED is well-written and generally clear. Nonetheless, our clients and others have raised many questions about exactly how the guidance would appear in the Accounting Standards Codification, and we are aware of questions regarding exactly how sections of the Codification other than Topic 605 would change if the ED's proposals were adopted. These questions all point to the importance of exposing for comment the proposed changes to the Codification.

In addition, it is impossible to be confident that the effects of the proposals can be entirely understood without exposure of the specific changes to the Codification. More fundamentally, we believe an important element of due process is to expose for comment the expected changes in the authoritative literature, rather than provide a description of the effects of those changes.

While we understand the time-pressure facing the FASB at this point, we are surprised by the decision

not to expose the proposed changes to the Codification. The Board's decision to codify GAAP has resulted in a significant change to the way in which financial reporting standards are organized, presented and written. While constituents have been largely supportive of the codification project, we believe that support was premised on an expectation that the Board would continue its long standing due process of exposing changes in the literature. Failure to provide constituents with the intended changes to codification is, in our view, inconsistent with the objective of due process. .

Responses to Questions in the ED

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?…

Combination and Segmentation of Contracts

We believe it is important that GAAP include a principle to help an entity determine whether to combine separate contracts into one for accounting purposes or to segment single contracts into more than one contract for accounting purposes, as the issue of "linkage" of contracts has been the source of difficult questions in the application of GAAP. We therefore commend the Board for proposing a principle to address this issue.

In addition, we believe that the concept of price interdependence is a logical principle to use for this purpose, and we believe that faithful application of that principle should produce reasonable conclusions.

We believe the final standard could usefully discuss or provide examples that illustrate how the analysis of whether pricing in multiple contracts is interdependent would be affected by a situation in which a vendor offers a discount to all customers that agree to purchase multiple products or services at the same time, each product or service purchased is documented in a separate contract, and the products and services often are sold separately.

Modifications

We also believe it is important that GAAP include guidance on how contract modifications affect revenue recognition. However, while we agree that price interdependence is a logical part of the analysis to determine how to reflect contract modifications in revenue recognition, we believe it is insufficient on its own to determine the accounting.

To begin with, the discussion and examples in the ED leave us confused as to the principle and how the Board believes it should be applied.

Example 2, Scenario 1 presents a situation in which the pricing of the modification is considered independent. However, it seems clear to us from the facts presented that the reduction in the amount to be charged for Year 3 is clearly dependent upon the fact that the customer is purchasing an

additional 3 years of service. Without the modification, the entity would have been entitled to the originally-negotiated (and now above-market) fee for Year 3, but the entity accepts the now-lower current market fee because it also gets the additional 3 year commitment. Thus, we believe that Example 2, Scenario 1 represents a situation where prices are interdependent.

However, despite the Board's conclusion in Scenario 1 that pricing is independent, the resulting accounting involves a change in the consideration allocated to the third year of the original contract. We do not believe this is consistent with the stated principle that when prices are not interdependent, the modification is treated as a separate contract. Here, despite the conclusion that the prices are independent, the Board believes the modification and remainder of the original contract should be combined for accounting purposes. As it happens, while we disagree with the conclusion in Scenario 1 that the prices are independent, we agree with the accounting specified, albeit for a different reason.

The ED proposes that a modification in which the pricing is interdependent should always result in cumulative catch-up of the revenue recognized under the contract to date. For long-term contracts, this could result in very significant revenue adjustments throughout the course of the contract, as such contracts are often modified several times. Often, those modifications are driven by changes in circumstances that alter the customer's future needs but are entirely unrelated to the goods or services provided earlier in the contract. In such circumstances, we believe that changing the revenue allocated to already-completed performance obligations would be confusing and may not effectively portray the economics of the modification.

To take such situations into account, we propose the following framework:

1. If the pricing in the modification is entirely independent of the pricing in the original contract (i.e., the prices are not interdependent), treat the modification as a separate contract. In that situation, the recognition of revenue on those performance obligations that were in the original contract would continue as if no modification occurred. In a situation involving the addition of incremental products or services, independent pricing would mean that the entity performs and collects exactly as required by the original contract, and performs and collects for the current standalone selling price (allowing for customary volume discounts as noted in paragraph 14 of the ED) for the incremental products or services.

2. If the pricing in the modification is interdependent with the pricing in the original contract and the modification does not represent or include a concession, the remaining performance obligations in the modified contract (including those that were contemplated in the original contract) would be considered a new contract for accounting purposes. Thus, the modification would affect the accounting for the contract, but only prospectively. In a modification involving the addition of products or services, the fact that the modification does not involve a concession, despite the pricing being interdependent, would be evidenced by the entity being entitled to receive at least the then-current standalone selling prices (allowing for customer volume discounts, as noted in paragraph 14 of the ED) for the performance obligations remaining to be completed. Example 2, Scenario 1 illustrates this situation.

3. If the modification includes a concession, the modification would be treated as a change in the original contract and the accounting for the new modified contract would be adjusted on a cumulative catch-up basis. In a modification that adds products or services, the fact that the modification includes a concession would be evidenced by the fact that the entity agrees to receive less than the current standalone selling price for the remaining performance obligations in the modified contract. This would evidence an implicit adjustment of the pricing

on the completed performance obligations. A reduction in price without a commensurate reduction in performance obligations would also be considered a concession.

While our proposed model for modifications is somewhat more complex than that in the ED, we believe it more faithfully portrays the business decisions inherent in contract modifications and that reported results will be more understandable.

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?*

While we generally support the proposed principle, we believe that the reference in paragraph 23(b)(ii) to "a distinct profit margin" is circular in the context of a principle that addresses the separation of elements because a "profit margin" implies the existence of a known selling price. While the discussion in paragraphs BC53-BC56 is helpful in illustrating the Board's intent, that discussion will not be considered GAAP. We would suggest replacing the phrase "it has a distinct profit margin" with "it is subject to distinct risks and uses distinct resources" to more clearly articulate the principle.

In addition, based on the proposed principle, in Example 23 we would not have concluded that slotting fees paid for product placement are distinct from the products to which the slotting fees apply. The Board seems to have concluded that because an entity could "purchase" display space for its products from third parties in an attempt to sell those products, that product placement services are a distinct service. But in the example, the vendor pays the reseller to display products that are owned by the reseller, not the vendor. The only reason such a transaction would ever occur is because the vendor is trying to facilitate the sale of those products by the reseller in order to sell more products to the reseller. As such, it would appear to us that the product placement services do not have a distinct function.

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?*

We commend the Boards for using a consistent principle to determine when revenue should be recognized in all transactions. However, we have two significant concerns with exclusive reliance on the notion of "transfer of control" as described in the ED.

Non-substantive Transfer of Control

First, we believe that there are situations in which the transfer of control is non-substantive (that is, the customer is essentially indifferent to having control of the products) because the customer has assumed virtually no risk related to the items it controls.

The ED identifies, in paragraph 30(c), a consignment arrangement as one arrangement in which physical possession of a product does not connote control. We note, however, that a company may achieve the same economics in a transaction by transferring title and ownership to products (and therefore control), but excusing payment until the products are resold and providing the customer with a right of return. We believe that the ED would require a company that enters into such an arrangement to record revenue, except to the extent of products it expects to be returned, and to treat the deferred payment as a financing element. In addition, if the contract also called for the vendor to help the customer market the product to end consumers, that marketing obligation would not prevent revenue

recognition (as it would today under ASC 605-15-25-1(e)) on the sale of the products, as the marketing service would almost certainly be considered distinct from the products. In our view, the transfer of control in a fact pattern such as this, when the economics are equivalent to a consignment arrangement, is wholly non-substantive. We believe such situations illustrate an opportunity for abuse and deceptive accounting that arises from a reliance on control to the exclusion of all other information.

We believe that the Board could address this issue by requiring that where the terms of the contract decouple risks from control, the vendor should evaluate the substance of the arrangement, and should not recognize revenue if the terms of the arrangements essentially make the transfer of control unimportant to the parties. This would be similar in concept to the guidance in other literature such as ASC 718 (Stock Based Compensation) that require consideration of the substantive arrangement.

Additional Guidance on Assessing Whether Control is Transferred as Performance Occurs

Second, we believe that additional guidance is needed to clarify whether control transfers as performance occurs, or only upon completion of performance. This is particularly true with respect to: 1) service transactions, because the notion of 'control' as applied to a service is not well understood and the listed indicators are largely unhelpful in identifying when control of many services passes to the customer; and 2) contracts to build an asset to customer specifications, because it is unclear which facts and indicators should take precedence in the likely event that there are indicators pointing in opposite directions.

In one analysis of the proposed principle, the conclusion would be that any restriction of the customer's rights to the asset in construction, or rights to the partially completed results of the service transaction, is an indication that control has not passed to the customer, and revenue therefore may not be recognized. This analysis, which many in the construction industry fear is intended by the Board, is based on the fact that "control", as used elsewhere in the GAAP, generally connotes complete, unfettered authority (unilateral control).

While we do not believe that the analysis is intended to be as described in the previous paragraph, we are confused by the wording in the ED. Certain passages seem to focus on the vendor's ability to use the good or service in another contract, some focus on whether customer would have rights to the asset and be required to pay for work done to date in event of contract termination, and others focus on the customer's ability to direct the provision of the service or design of the asset. These indicators will not always point in the same direction, and it is not clear from the ED on what basis the entity should resolve such situations.

We believe that a more definitive explanation of control based on when the customer has the right and ability to benefit from the entity's satisfaction of its performance obligation would help. Therefore, if the performance obligation involves building an asset to customer specifications, revenue would be recognized during construction if the customer has the right to stop construction and take the asset in return for payment of work completed to date (including a termination fee), even if the customer did not have authority to change the specifications of the asset during its construction. If the customer did not have the right and ability to take the partially completed assets in return for payment for work performed to date, the performance obligation would only be satisfied upon completion.

If the performance obligation involves provision of a service, we believe the principle of control should focus on whether the customer can benefit from the service as the work is done or only upon completion. The 1978 FASB Invitation to Comment, *Accounting for Service Transactions* includes some discussion that may be useful in this regard, as it notes that "…the proportion of services to be

performed in the final act may be so significant in relation to the service transaction taken as a whole that performance cannot be deemed to have taken place until execution of that act."

We believe that focusing the evaluation as we suggest would make it easier to reach conclusions as to whether there is continuous transfer of control or whether control occurs only upon completion. In addition, we believe this analysis would continue to allow recognition of revenue during construction for the vast majority of construction contracts. As the recognition of revenue in construction contracts has not raised significant concern over the years, we believe this is a logical outcome.

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?

Under current practice, at least for public companies, when the transaction price could vary based upon future events, revenue recognition is generally based only the amount that is "fixed or determinable" based on events that have already occurred. The conclusion to limit revenue to those amounts that are fixed or determinable improves the reliability of reported revenue figures. However, it does indicate a bias towards under-reporting rather than over-reporting revenue, and therefore does not appear to be a neutral accounting standard. For that reason, we agree that relaxing the strict application of the fixed or determinable criterion is appropriate.

However, we do not believe that financial reporting transparency is helped by recognizing revenue if there is significant uncertainty about whether it will ever be due. The Board seems to have similar concerns, as reflected in the prohibition on estimating the transaction price in certain circumstances, as described in paragraphs 38 and 39. We believe that the discussion in these paragraphs is based on an appropriate principle. However, we believe it is open to significant interpretation and diversity in practice is sure to develop. We believe the principle is so broad that two companies with identical facts could reach different conclusions regarding their ability to estimate outcomes either because they have different tolerances for uncertainty (and thus different definitions of what constitutes "reasonable estimates) or because they have different financial reporting objectives. That outcome is troubling to us because it significantly reduces comparability.

For example, we believe that construction contracts for customer-designed assets would generally be considered to be unique enough that relevant experience with similar contracts would not exist. In those situations, the effects of variable consideration would only be recognized when they are determined. However, we are aware that others reading the ED believe that the effects of variable consideration for events such as target completion dates, bonuses or penalties for being over- or under-budget, and the like could be anticipated even if the asset is customer-designed. Similarly, we believe that contracts such as those considered in ASC 605-28, *Revenue Recognition – Milestone Method* would almost never lend themselves to reasonable estimates of the transaction price. However, we are aware of differing views.

As explained earlier in this letter, we are also concerned that the effect of using a probability-weighted estimate to record revenue in any single transaction can produce an estimated transaction price that does not represent a possible outcome of the transaction. We believe that this situation is counter-intuitive and could reduce confidence in reported results.

To address these concerns, we recommend allowing the estimation of revenue that is contingent upon future events only when there is a large pool of homogeneous transactions. This would effectively tighten the "experience with similar transactions" requirement in paragraph 38(b) to situations in which it is clear that relevant experience exists. This will not only reduce diversity in practice but it will ensure that where estimates are used, they are objectively determined. In addition, when probability-weighted estimates are applied based upon a large pool of transactions, the resulting accounting, on the whole, will likely represent a possible outcome,

When a large pool of homogeneous transactions does not exist, we believe it is appropriate to recognize revenue when the uncertainty about future events is resolved. However, if the Board believes that our approach is overly conservative, we recommend taking revenue contingent upon future events into account in the transaction price only when the outcome of the contingency that will result in the additional payment is probable, as that term is used in ASC 450, *Contingencies*. Using the "probable" threshold will better ensure that relevant experience exists than allowing the use of probability-weighted estimates, as concluding that realization of an uncertain amount is probable necessarily requires significant knowledge and experience.[1]

An additional question we have about this situation is whether the resolution of uncertainty regarding the transaction price after period-end but before the financial statements are issued should be a recognized or non-recognized subsequent event. For example, consider a situation in which a company with a calendar year end satisfies a performance obligation to deliver a product on October 30, and is due a performance bonus if the product performs to certain specifications in the first 90 days of operation. At December 31, presuming the company believes that it can reasonably estimate its chances of earning the bonus, such an estimate will be made and additional revenue will be recorded in an amount greater than zero but less than the potential bonus amount. Before the financial statements are issued, however, the evaluation period will end, and the vendor will know for certain whether the bonus was earned. Should this subsequent knowledge be reflected in the December 31 financial statements?

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?*

We agree conceptually with reflecting credit risk in the amount of revenue recognized when the performance obligation is completed, and we are comfortable with probability-weighted estimates of collectibility when evaluating a large pool of homogeneous transactions.

However, if collection of the transaction price from a specific transaction (that is not evaluated as part of a homogeneous pool) is not considered to be probable (again, as that term is used in ASC 450, *Contingencies*), we would prefer to see revenue recognition delayed until collection becomes probable. We believe that the recognition of revenue in a situation where significant uncertainty about realization exists (and in an amount that is unlikely to represent an actual outcome) will reduce confidence in reported revenue figures.

[1] We acknowledge that IFRS and US GAAP differ as to the definition of probable in the context of a contingency. For purposes of revenue recognition, we believe the two standards should use a converged definition of that term.

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?*

We believe that the time value of money should be considered in determining the transaction price when there is a substantive financing component. However, the consideration of whether a financing component exists in every transaction is likely to be burdensome and add little value to financial reporting. Although the Board has acknowledged that the time value of money may be immaterial in many transactions, the burden of proving immateriality is on the preparer of financial statements, and it is likely that substantial work would need to be performed to confirm that the time value of money is immaterial on the whole. We believe there is little value in this effort in most situations.

To avoid significant work that would add little value, we would suggest that a one year period be specified as being a non-substantive financing period. That is, we recommend that the final standard indicate that the time value of money need only be recognized in a revenue transaction to the extent that the timing of revenue recognition and cash collection is expected to differ by more than one year.

In addition, we believe the reference to materiality in this provision of the ED serves to confuse the situation, not clarify it. If a company has only a few arrangements (out of many revenue arrangements) with a substantive financing component, it might reasonably conclude that whatever financing component exists would be immaterial to the financial statements taken as a whole, and therefore ignore such component even if the financing element is significant to each individual contract. However, the explicit mention of materiality in this paragraph of the ED seems to indicate that materiality of the financing component should be considered only in relation to the individual contract, perhaps leading to a need to account for it despite it not being material to the financial statements taken as whole. We believe that if the Board does not adopt a bright-line to scope out small financing components as we have suggested in the previous paragraph, it is best not to separately discuss materiality in regards to this one issue. Practitioners are comfortable with using materiality, in general – any specific discussion in regards to a particular item can only confuse the issue.

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?*

We generally agree with this part of the ED. However, we believe the Board should consider two potential modifications to this principle.

First, we believe the Board should allow the use of the residual method (as developed in SOP 97-2 for software transactions and carried forward into EITF Issue No. 00-21 on multiple element arrangements) to simplify the implementation of the standard without significantly impairing the usefulness of information. It is our sense that a number of companies are encountering a surprising amount of complexity in applying the relative selling price model as they prepare to adopt the provisions of ASU 2009-13 on multiple element arrangements and believe that end result will not differ substantially from the residual method.

Second, we believe that the Board should reconsider the accounting model for situations in which revenue allocated to a completed performance obligation (and therefore recognized as revenue) is contractually contingent upon the completion of additional performance obligations. We agree with the Board's broad decision to move away from the complete bar on recognition of such amounts that

currently exists in GAAP. In our view, where the uncompleted performance obligation represents a performance obligation with which the vendor has significant experience and there is little uncertainty regarding the vendor's ability to complete the obligation, there is no need to hold back the recognition of revenue. However, we believe that when there is substantial uncertainty as to the entity's ability (or willingness) to complete the performance obligation on which payment is contingent, the contingent amount should not be recognized as revenue. This result could be accomplished by changing the allocation of revenue when such circumstances exist, or by taking the uncertainty into account in assessing impairment of a contract asset.

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?

We agree with the provisions of paragraph 57 of the ED. We note that the principles stated are consistent with current practice in most regards, and provide a basis for analyzing such costs that currently does not currently exist in GAAP. In this regard, we believe that the inclusion of this guidance represents an improvement to the accounting literature.

We are curious, however, as to the principle underlying the recognition of an asset for costs incurred in fulfilling "a specific contract under negotiation" as provided in paragraph 57(a). We believe that the definition of an asset is not met until a contract, as defined in paragraph 10 of the ED, exists.

As Question 8 asks about contract costs, we will take this opportunity to provide feedback on the "onerous performance obligation" guidance in paragraphs 54-56. We agree that principles for recognizing so-called "loss contracts" should be included in the final standard. This issue arises frequently in practice, and GAAP currently provides little useful guidance in this area. However, we have several concerns with the guidance as proposed.

First, because the present value of the probability-weighted costs is compared to the amount of the transaction price allocated to a performance obligation, in situations where a significant part of the transaction price is contingent and the outcome cannot be reasonably estimated, many performance obligation will initially appears to be "onerous" under this definition, when, in fact, the company reasonably believes the contract will be profitable.

Second, we believe a more appropriate approach to determining whether a liability should be recorded is for the unit of account to be the contract as whole, rather than each performance obligation. We believe that vendors may agree to some performance obligations that they know they will realize a loss on (because other vendors can provide the service more efficiently) to strengthen their relationship with a customer. In these situations, we do not believe it appropriate for the company to recognize a loss at contract signing for the "onerous" obligation when the contract as a whole is expected to be profitable.

Finally, we would prefer that the test consider only incremental costs of fulfilling the contract. Therefore, rather than including all of the costs identified in paragraph 58, we would exclude the costs described in paragraph 58(c) in determining whether a liability for an onerous performance obligation (or onerous contract) should be recorded.

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?

We agree with the guidance in paragraphs 58 and 59. While some might assert that inefficiencies incurred early in a contact involving repeated performance of the same acts are expected and provide a benefit in terms of knowledge that can be applied to future performance obligations, we concur with the ED's prohibition on capitalization of related costs.

While we agree that costs of obtaining a contract do not represent an asset, we note that paragraphs BC135-BC140 of the IASB's Exposure Draft on Insurance Contracts explain that contract acquisition costs are a cost of the contract, with the logic for such treatment being that the seller of the insurance contract would price the contract with the intent of recovering such acquisition costs. That same logic should clearly apply to other contracts as well, and we are therefore confused by the inconsistent proposals. Similarly, the FASB Exposure Draft, *Leases (Topic 840),* does not require the expensing of such costs, as they are included in the definition of initial direct costs in paragraph B14. Different conclusions for contract acquisition costs based upon the type of contract or the industry are not principle-based, and we urge the Board to treat costs of obtaining a contract consistently

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?*

As an initial observation, we believe the stated disclosure objective is so broad and generic as to be unhelpful. As written it could be applied to any standard: for example, lessor disclosures could be described as having the objective "…to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from lease contracts." There is nothing in paragraphs 69 and 70 that is tailored to disclosures about revenue recognition, and therefore we do not believe the objective will be helpful to preparers in evaluating what should be disclosed. For that reason, we are not encouraged by inclusion of paragraph 71 which suggests that the Board believes that despite the ten paragraphs of specific disclosure requirements, there will be situations where even more disclosure is required to meet the disclosure objective. Given that it is always possible to identify additional potential disclosures, how could a company ever defend its conclusion that it had complied with the vague disclosure objectives? While a practicability exception is mentioned in the paragraph IG96, this seems insufficient to govern the potential limitless disclosure.

It is our sense that even the proposed required disclosures will overwhelm preparers, particularly those with multiple products and services and multiple classes of customers in multiple jurisdictions. While it is difficult to criticize any individual element of the disclosure requirements, we note that in sheer volume alone the disclosure requirements run to over ten paragraphs (excluding the disclosure principle), many of which in turn have multiple subparagraphs. While we believe that the current disclosure requirements are not consistently resulting in sufficiently robust disclosures regarding revenue recognition, we encourage the Board to field test this proposed disclosure framework with a wide cross section of preparers and users to determine which of the required disclosures are truly operational and meaningful.

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?

It is our sense that this information would be useful. We note that the United States Securities and Exchange Commission currently asks for similar disclosures in in the Business section of periodic filings. Specifically Regulation S-K, Item 101(C)(1)(viii) requires disclosure of "The dollar amount of backlog orders believed to be firm, as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog."

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?*

We agree with this provision of the ED. Obviously, significant judgment would be required to determine the appropriate disaggregation, but we believe companies will not have difficulty making the necessary judgments. We would observe, however, that in respecting the judgments of individual companies, there likely will be significant diversity in the amount and nature of disaggregation

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.

We believe the requirement of retrospective application is both overly burdensome and unrealistic. In many instances, retrospective application will be virtually impossible because companies will not have tracked information about necessary components of the accounting. The ED is rife with possibilities for this situation, including: estimated selling prices may not have been calculated, making application of the allocation guidance in the ED impossible; cost information to apply paragraph 57 appropriately might not be available; transaction price estimates reflecting probability-weighted outcomes of uncertain events would not have been determined; the effect of credit risk may not have been determined at the time of revenue recognition; etc.

Even where sufficient data is available to make the necessary recalculations, we believe the costs of doing so would be excessive for many companies.

We suggest, as an alternative, that the Board consider the transition method provided for in ASU 2009-13.

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?*

Although we have noted above concerns with a small number of examples in the Implementation Guidance, we believe that the implementation guidance in the ED is helpful in many respects.

We believe, however, that more implementation guidance is needed. We anticipate that many respondents to the ED will similarly make this suggestion, and the Board will no doubt receive feedback that additional guidance is needed in many areas. Rather than add to the long list of specific suggestions, we will instead explain two of the most significant factors that lead to our conclusion that either further guidance is needed or the related principles should be more clearly articulated.

First, many organizations, particularly the large global accounting firms, have published a substantial amount of analysis of the ED. These analyses are informational and enlightening, and provide a great deal of insight into how practitioners will view and attempt to apply the guidance in the ED. We were struck, in reading this material, by the frequency with which the analysis indicated that the application of the guidance in the ED to a particular situation or fact pattern was unclear. We believe that the Board (or its Staff) would gain significant insight into areas that could benefit from additional implementation guidance by reviewing these analyses. In addition, the Board is likely to identify, through this review, specific principles that may be in need of clarification, so as to avoid application uncertainty and an unacceptable level of non-comparability and diversity.

Second, we have noted over time that some of the most difficult revenue recognition issues arise in the context of collaboration agreements (like those discussed in ASC 808, *Collaborative Arrangements*) in the biotechnology field. We believe that a field test of the revenue recognition ED with several biotechnology companies that are parties to such collaboration arrangements could provide insight into areas that would benefit from additional implementation guidance. Questions that we believe are difficult to answer in the context of one of these arrangements include:

- How would a party to a collaboration determine whether its collaboration partner is a customer, given that the goal of the collaboration is to develop a product to sell to others?
- How can “one revenue recognition method” (as required by paragraph 32 of the ED) be applied to a performance obligation (e.g., R&D services) when the arrangement fee is a combination of fixed payments, milestone payments, and payments that reimburse all or part of actual expenses incurred?
- Under the guidance in the ED, in what fact patterns, if any, might a milestone payment be deemed a distinct performance obligation?
- Is there any pattern of acceptable revenue recognition that would allow milestone payments to simply be allocated to the work done to achieve the milestone, or must such payments, when “earned”, be attributed to all of the performance obligations in the contract, as an adjustment of the transaction price?

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?

We agree with the Board that all warranties should be taken into account in the recognition of revenue.

We understand the distinction that the Board is making with respect to different types of warranties, and, given those distinctions, we understand the Board's proposals for accounting for the different types. However, we believe that it will be difficult for practitioners to determine which type of warranty exists in a particular arrangement. Moreover, in our experience, many if not most warranties are, substantively, a combination of the two types of warranties identified in ED. This leads us to conclude that the Board may be creating a distinction that has little meaning to customers or vendors. To make these provisions more operational, we believe the Boards should allow companies to use the performance obligation approach for all warranties, rather than attempt to distinguish the between the two types.

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?

We are not persuaded that control of the rights embodied in a license to intellectual property transfers to the customer at different points based on whether the license is exclusive or non-exclusive.

The ED notes the similarities between exclusive licenses to intellectual property and leases of tangible assets. While we acknowledge these similarities, we note that the FASB Exposure Draft, *Leases*, describes the lessor's recognition of lease income under the performance obligation approach as being based on "the pattern of use of the underlying asset by the lessee." This is a very different principle for determining when a performance obligation is satisfied than "transfer of control to the customer." As different principles are used in the two exposure drafts to determine when performance obligations are settled, we do not believe that the licensor's accounting for exclusive license to intangible assets and the lessor's accounting for leases should necessarily mirror each other, as the Basis for Conclusions in the ED suggests.

Further, we note that the proposals with respect to exclusive licenses are not consistent with the lessor's accounting under the performance obligation approach, as proposed in the FASB Exposure Draft *Leases,* as the lessor is required, at lease inception, to record a receivable representing the right to receive lease payments and a lease liability representing the entire term of the lease, while the licensor in a revenue transaction would presumably record contract assets and liabilities only as performance occurs or payments are received.

We believe the Board should reconsider the guidance on licenses of intellectual property to ensure that the guidance is consistent with the "transfer of control" notion. Some have suggested that perhaps another way to analyze an exclusive license would be to identify a second performance obligation, i.e., the obligation the licensor undertakes to not use (or license to others) the intellectual property that it still owns. If that obligation were considered a performance obligation, it would clearly be satisfied over time, rather than at the inception of the license. We note, however, that it is unclear whether refraining from taking certain actions can or should be considered a performance obligation under the ED, as there is debate about whether doing nothing can be considered a service provided to a customer.

In addition to our concerns regarding the proposed accounting for exclusive licenses, we believe more guidance is needed on distinguishing between licenses that are in-substance sales and those that are not. Paragraph IG33 indicates that a license should be considered a sale "if a customer obtains control of substantially all the rights associated with the company's intellectual property…" We are unsure how to apply this provision in certain situations. For example, assume that a company licenses to a customer, perpetually and on an exclusive basis, all of its rights related to certain intellectual property for use in a particular industry, but retains the rights to the intellectual property for use in other industries. While paragraph IG37 seems to make clear that such a license would be considered an exclusive license, it is not clear to us if such a license could be treated as a sale of intellectual property, because it does not represent "substantially all of the rights associated with the entity's intellectual property", as required in paragraph IG33. Presuming this model is retained, we believe the Board should clarify the intent of the guidance as applied to situations like this.

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?*

We agree that the same concepts that are involved in the sale of revenue-generating products should be applied to the sale of other nonfinancial assets. We do not believe there is any conceptual reason to apply different principles to the sale of long-term operating assets than to the sale of inventory.

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?*

We do not see any conceptual support for different recognition and measurement principles for private companies. We do not have expertise in accounting for not-for-profit entities.

Once again we appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Revenue Recognition in Contracts with Customers*. If there are any questions, please contact Scott A. Taub at 312-345-9105.

Sincerely,

Financial Reporting Advisors, LLC

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