

January 31, 2011

Ms. Susan M. Cospers, CPA  
Technical Director  
FASB  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

**Re: June 24, 2010 Exposure Draft of a Proposed Accounting Standards Update (ASU),  
Revenue Recognition (Topic 605): Revenue from Contracts with Customers [File  
Reference No. 1820-100]**

Dear Ms. Cospers:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC appreciated the opportunity to discuss its views on the ED with selected Board members and staff at the November 11, 2010 FASB/TIC Liaison Meeting and is now providing the following written comments for your consideration.

### **GENERAL COMMENTS**

TIC commends the Board for its efforts in developing this ED. It is comprehensive, understandable and well organized. TIC especially appreciated the generous number of illustrative examples of the core principles and the special section on accounting for contract costs.

Some of TIC's responses to the questions below include requests for additional clarification of certain principles, including guidance on:

- Determining when the continuous transfer of goods and services has occurred, particularly for the construction industry (Question 2);
- Contract costs (Question 8)
- Nonrefundable upfront fees (Question 14).

TIC also disagreed with (or had significant concerns about) certain requirements in the ED, three of which would apply to all entities:

- Bifurcating the presentation of credit risk (uncollectible accounts) in the income statement (Question 5);
- Disclosing forward-looking information about the expected satisfaction of remaining long-term performance obligations as of the balance sheet date (Question 11); and
- Differentiating latent v. subsequently occurring defects in the accounting for product warranties (Question 15).

TIC believes the proposed requirements listed below should not be adopted for nonpublic entities:

- Criteria that would increase contract segregation in the construction industry (Question 2);
- The probability-weighted approach to determining the amount of consideration that is expected to be received (Question 4);
- The need to determine the material financing component of a receivable due in less than one year (Question 6);
- Disclosure of the reconciliation of contract balances (Question 10); and
- Disclosure of disaggregated revenue (Question 12).

Details regarding each of TIC's concerns are provided below under the specified question.

## **SPECIFIC COMMENTS**

### **Recognition of revenue (paragraphs 8–33)**

*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?*

TIC agrees with the principle of price interdependency for determining the nature of a contract for accounting purposes.

*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?*

TIC agrees with the stated principle for identifying distinct performance obligations.

However, TIC believes the guidance for determining continuous transfer of goods or services is insufficient, especially for the construction industry. In particular, the Board's intent behind the notion of continuous delivery is not readily understood. TIC recommends that Example 11 on page 48 of the ED be revised to focus on the timing within which the transfer would be recognized.

TIC also believes the ED provides too much flexibility in the criteria for the segregation of contracts compared to the criteria in SOP 81-1 (FASB *Accounting Standards Codification*<sup>TM</sup> (ASC) paragraph 605-35-25-10), which is very specific. A high level of contract segregation would be onerous on preparers and auditors of private company financial statements. Therefore, TIC believes that segregation should only be required when a lack of segregation would produce financial statements that are materially misleading and not representative of the economic substance of the overall transaction.

*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, the guidance on transfer of control is sufficient. The guidance is helpful because it addresses practical examples and avoids complex legal jargon.

### **Measurement of revenue (paragraphs 34–53)**

*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?*

TIC agrees that using an estimated transaction price would be appropriate, and that the disclosure requirements in the ED are appropriate to alert the financial statement user as to significant estimates and assumptions related to the estimated transaction price.

However, TIC disagrees that the probability-weighted amount of consideration that an entity expects to receive from the customer is the best methodology for estimating a variable transaction price. A tremendous amount of data would have to be obtained and an inordinate amount of time would be expended to perform the necessary probability-weighted calculations. For example, in the health care industry alone, complex models would need to be developed and tremendous amounts of data gathered to estimate revenue to be received from Medicare, various insurance companies, self-pay patients, etc. Even a simple entity, such as a physician practice, would likely have hundreds of, if not in excess of a thousand, services for which probability-weighted calculations would be needed. Such an effort would be overwhelming to these types of entities.

This approach would be costly and impractical and, in most cases, might not yield a transaction price that was materially different from management's best estimate (i.e., the most likely amount). In some cases (e.g., those involving a binary scenario, where there is a 50% chance that the revenue will be either zero or 100), the approach yields an incorrect answer. For example, a contract may establish a base price of \$50,000, with a fixed performance bonus of \$5,000 if the project is completed ahead of schedule. In this case, revenue will be either \$50,000 or \$55,000—any value in between these two amounts would be incorrect.

Probability-weighted calculations provide no discernible benefit to financial statement users, are too complex for preparers and are more difficult to audit. TIC prefers the most likely amount approach because it takes probability into consideration without the burden of probability-weighted calculations. As a practical matter, both financial statement preparers and users more clearly understand the concept of "most likely amount", and this technique would be less subject to manipulation than a probability exercise.

*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?*

Revenue should not be recognized until collection is realized or realizable. Assets representing realizable claims to cash are, by definition, probable future economic benefits to the entity. The "probable" threshold does not imply absolute certainty; rather, it "refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved" (FASB Concepts Statement No. 6, paragraph 25, footnote 18). Therefore, preparers and users of financial statements understand there is always some credit risk inherent in amounts receivable from customers.

TIC does not agree that, once the "probable" threshold is met, the amount of revenue recorded should contemplate expected credit risk. By adjusting revenue for expected credit risk, and then recording subsequent revisions to that estimate as expense, the credit impact would be separated into two areas of the income statement. The bifurcation of original and subsequent estimates of credit risk will be difficult to implement in certain situations. It also adds to the difficulty of managing a business. The information would not be relevant, especially for users of private company financial statements. The end result will be financial statements that will be more difficult to analyze, since the impact of bad debts will no longer be isolated within one financial statement line item. TIC believes users want to see the net impact of credit risk presented in one line on the income statement.

*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?*

TIC agrees that in certain circumstances, a contract may contain a material financing component that requires separate recognition. In these cases, there will probably be significant preparer and auditor effort to apply the concept, including accounting system changes to comply with the new requirements. However, TIC believes the proposal

introduces unnecessary complexity for entities with short-term contracts. Due to the costs of analysis and implementation, TIC would recommend a practical expedient to exclude time periods under one year from this requirement. Because any interest expense would be offset by increased revenue, resulting in no net difference in the results of operations, TIC believes a practical expedient provides a reasonable solution, reduces complexity, and would not adversely impact financial statement users.

TIC members also believe the application of the time value of money concept may, in certain circumstances, produce financial statements that are not clearer or more understandable than current practice. For example:

A company may collect cash deposits from customers for a contract to build custom equipment that has a long manufacturing period. The deposits are generally used to fund material purchases and conversion costs. These assets are measured at cost, not fair value. Including a time value of money component on the deposit appears to introduce an element of fair value accounting for the liability. This creates a mismatch between the asset and the related liability, which could cause analysis of the balance sheet to be more difficult.

In the case of a prepaid service contract, TIC members have not seen provisions that would call for interest to be included in potential refunds if the contract is canceled. Therefore, over the time period in question (before performance occurs), the liability would appear to be overstated.

TIC also disagrees with the proposed methodology for determining the discount rate. In paragraph BC104, the Board concluded that applying the risk-free rate would not be useful and that using the stated rate in the contract could be inappropriate if the entity was offering cheap financing as a marketing incentive. Par. BC104 goes on to say that: "...an entity should use the rate that would be used in a financing transaction between the entity and its customer that did not involve the provision of goods or services because that rate would reflect the characteristics of the parties to the contract." As a practical matter, that rate could not be determined in a cost-efficient manner. Vendors and customers are not likely to enter into a financing transaction that would not include goods or services. So, there would be no basis to determine a discount rate based on that assumption.

In summary, TIC does not believe the Board's proposal to segregate financing components in all cases is operational in the private entity environment.

*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 agree with this approach for allocating the transaction price to all separate performance obligations in a contract.

## **Contract costs (paragraphs 57–63)**

*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?*

TIC believes the guidance on accounting for contract costs is operational. This topic has historically had very little guidance outside of industry-specific guidance, and the general principles set forth provide a good starting framework. However, we believe additional guidance would be helpful.

For example, paragraph 57(b) requires that costs to be capitalized “generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is, the costs relate to future performance).” This provision would seem to allow for capitalizing costs that were also incurred in obtaining the contract, particularly in the bid and proposal phase. Often, extensive effort and cost is required to win large contracts, and those costs incurred serve as know-how and intangible knowledge in satisfying the terms of the contract. TIC believes this guidance should be clarified to explicitly include or exclude costs related to generating intangible knowledge or work plans that will be utilized if the contract is won.

Another question arises as to costs incurred in connection with direct response catalog advertising. Under existing standards, ad campaigns are capitalized and amortized over the benefit period. Under this ED, it is unclear whether all direct response advertising will be expensed as incurred or whether costs incurred in advance of the mailing (including paper and printing cost) could be capitalized as prepaid expense when incurred and then expensed as soon as the catalog has been mailed to customers. Such details should be clarified in the final standard.

*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?*

TIC agrees with the direct costs of a contract specified in paragraph 58.

## **Disclosure (paragraphs 69–83)**

*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?*

With two exceptions, TIC agrees that the proposed disclosure requirements will be useful to financial statement users. Some of the required disclosures support auditor's past efforts to encourage preparers to present more transparent disclosures.

TIC's concerns regarding the disclosure of disaggregated revenue are discussed under Question 12 below. TIC is also concerned about the proposal in paragraph 75 to require reconciliation of contract balances. TIC believes this requirement would be very costly to prepare for preparers and would require the auditor to perform more audit procedures. Users of private company financial statements are not asking for this information and therefore would not use it. This requirement is also covered under the Financial Statement Presentation project, but tentatively private companies are excluded from its scope. In addition to being overly burdensome and not useful for users, this disclosure could also be prejudicial to the entity's confidentiality. TIC therefore believes this disclosure should not be applicable to nonpublic entities.

*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?*

TIC believes that this disclosure appears to relate more to forecasting future events, as opposed to reporting historic financial information. An entity should discuss revenue streams and related costs qualitatively, including provisions for onerous contracts. However, the proposed disclosure of the expected timing until completion of remaining performance obligations for certain contracts represents forward-looking information, which has historically not been a part of financial reporting under GAAP for private companies and which would be difficult to audit.

*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?*

TIC believes this requirement should be optional for nonpublic entities. The suggested disclosure categories under paragraph 74 of the ED are similar to the disclosure requirements in ASC Topic 280, Segment Reporting, which are currently encouraged, but not required, for nonpublic entities. Some entities may consider such disclosures to be competitively disadvantageous or otherwise confidential and would not want to present them in "general purpose" financial statements. Private entities also may not have systems in place to report the requested categories of disaggregated revenue information. Before requiring this disclosure for all entities, TIC recommends that the Board ask financial statement users of nonpublic financial statements whether this disclosure is necessary for their analysis purposes. Absent a clear user need, TIC believes optional disclosure for nonpublic entities would be consistent with ASC Topic 280, while providing guidance to preparers that prefer to (or are asked to) include such additional disclosures.

## **Effective date and transition (paragraphs 84 and 85)**

*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.*

TIC believes retrospective application of the new standard would be operational only if a long implementation period is provided. TIC will be studying this issue further as part of its response to the FASB Discussion Paper, *Effective Dates and Transition Methods*.

### **Implementation guidance (paragraphs IG1–IG96)**

*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?*

In general, TIC believes the implementation guidance is operational and illustrative of the general guidance.

However, further guidance is requested for nonrefundable upfront fees. Paragraph IG28 indicates that the revenue recognition period would extend beyond the initial contract period if the entity grants the customer a renewal option that provides the customer with a material right. Example 7 infers, but does not directly state, that a right to renew at current market rates without paying another upfront fee would be considered a material right. This should be clarified in the final standard.

*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?*

TIC members had mixed views as to whether the accounting for product warranties (not separately priced) should be changed. It is unclear how an entity could definitively distinguish between latent and subsequently occurring defects. As written, preparers will encounter practical difficulties in analyzing the relevant data to determine what percentage of revenue represents a sale that has not yet occurred v. a cost of doing business after the sale. TIC believes the proposed accounting needs further study before being adopted in the

final standard. Differential accounting for the two types of product warranties may not be operational.

*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?*

TIC agrees with the proposed pattern of revenue recognition and having the pattern depend on whether the license is exclusive.

### **Consequential amendments**

*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?*

TIC supports the view that the proposed revenue model should be applied to the accounting for gains and losses on the sale of certain nonfinancial assets.

### **Nonpublic entities**

*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?*

As discussed in the responses to the above questions, TIC believes the proposed requirements listed below should not be adopted for nonpublic entities:

- Criteria that would increase contract segregation in the construction industry (Question 2).
- The probability-weighted approach to determining the amount of consideration that is expected to be received (Question 4).
- The need to determine the material financing component of a short-term (less than one year) receivables (Question 6).
- Disclosure of the reconciliation of contract balances (Question 10).
- Disclosure of disaggregated revenue (Question 12).

TIC's concerns about the bifurcation of the original and subsequent estimates of credit risk (Question 5), the disclosure of the expected timing to satisfy remaining long-term performance obligations as of the balance sheet date (Question 11) and differentiating latent v. subsequently occurring defects in the accounting for product warranties (Question 15) apply to both public and nonpublic entities.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

A handwritten signature in black ink, appearing to read "Philip J. Santarelli", with a long horizontal flourish extending to the right.

Philip J. Santarelli, Chair  
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees