



September 20, 2010

Financial Accounting Standards Board
401 Merritt Seven
PO Box 5116
Norwalk, CT 06856-5116
Attn: Technical Director
(File Reference 1820-100)

Thank you for providing the opportunity to comment on the Proposed Accounting Standards Update entitled “Revenue Recognition (Topic 605): Revenue from Contracts with Customers”, issued on June 24, 2010 and hereafter referred to as the “Proposed ASU”.

Although we support a number of the principles set out in the Proposed ASU, we do have reservations regarding some of the tentative conclusions reached by the Board.

Our most significant concern relates to the potentially unintended consequences of solely employing a control-based model to recognize revenue. Specifically, we are worried that control legally can be transferred to customers – allowing for revenue recognition under the Proposed ASU – even though the significant risks and rewards associated with a product or service are substantively retained by the seller.

As a simple example, assume that goods are shipped Freight on Board (FOB) Shipping Point, which means that title and control over the goods is transferred to the customer once the product leaves the seller's shipping dock. Nonetheless, the seller may have a practice of replacing or repairing damaged product while in transit. The control-based revenue recognition model set out in the Proposed ASU would allow for a significant amount of revenue to be recognized upon shipment, with only a relatively minor portion deferred for the seller's performance obligation related to the repair/replacement of goods damaged in transit. In our view, this accounting does not faithfully represent the underlying economics of the transaction, in which the seller retains significant risk of loss until the products are received in good condition at the buyer's intended destination. We instead believe that no revenue should be recognized until the customer's receipt and acceptance of the undamaged goods.

In sum, we are concerned that the control-based revenue recognition model set out in the Proposed ASU may entice some companies to backslide to “form over substance”

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practices such as channel stuffing or bill and hold arrangements to meet the control-based criteria for revenue recognition.

- We do feel, though, that our concerns can be relatively easily addressed – while retaining the basic tenets of the control-based model – by simply establishing some additional “tollgates” (beyond transfer of control) before revenue can be recognized.
- These tollgates could include, for example:
 - o Affirming that the underlying transaction is not a sham
 - o Ensuring collectibility of the resultant receivable is reasonably assured
 - o Obtaining customer acceptance, if required under the terms of the arrangement or by standard industry practice.

In a related matter, we feel it will be difficult to operationalize the “distinct” notion described in the Proposed ASU, which is used to identify separate performance obligations for revenue recognition purposes. As currently written, we believe that many aspects of an arrangement potentially would be considered distinct and therefore deemed separate performance obligations under the Proposed ASU – perhaps more so than intended by the Board. Again, though, we believe our concerns can be easily remedied – while retaining the basic tenets set out in the Proposed ASU – by requiring that only **substantive** performance obligations be separately identified for revenue recognition purposes. Question #2 of SAB Topic 13A(3)(c) may be a starting point for identifying factors that would suggest a performance obligation is substantive.

The remainder of this letter sets out our comments on these and other matters in more detail.

If you have any questions or require further information regarding the views expressed in this letter, please contact Scott Ehrlich, President and Managing Director of Mind the GAAP, at +1 (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

1. Satisfaction of Performance Obligations

Sellers should meet additional “tollgates” (beyond transfer of control) before revenue recognition is permitted.

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The Proposed ASU's definition of control focuses on the customer's ability to direct the use of, and receive the benefit from a good and service. We agree that the transfer of control should be a necessary condition in determining whether the conveyance of goods or services has occurred. However, we believe that transfer of control is insufficient by itself to demonstrate that a performance obligation has been satisfied and that revenue can be recognized.

In particular, we do not agree with the views set out in the Proposed ASU that customer acceptance is, in effect, a formality that does not affect when revenue should be recognized. The following example demonstrates our concerns:

Example. A seller negotiates to sell a piece of equipment to a hospital. The hospital is invoiced for the equipment upon shipment, and is provided with standard 45-day payment terms.

As part of the customer agreement, the hospital insists on a six week trial period to ensure that the equipment meets its needs. At the end of the trial period, the hospital will either provide formal customer acceptance or will return the equipment to the seller. In this latter circumstance, the hospital will either be relieved of its obligation to pay any amounts due, refunded all amounts paid, and/or provided a credit towards a future purchase.

Under the Proposed ASU, because the hospital has obtained control over the equipment, the seller has satisfied its performance obligation and can recognize revenue. The amount of revenue recognized will be based on the probability-weighted amount of consideration that the seller expects to receive from the customer, considering the customer's return rights following the trial period.

Assume that:

- The equipment was delivered in 20X1 and the trial period ended in 20X2
- The probability-weighted amount of consideration that the seller expected to receive from the customer was \$60
- The amount invoiced to the customer was \$100.

Based on our understanding the revenue recognition model in the Proposed ASU, one of two possible outcomes will result:

1. Seller recognizes revenue of \$60 in 20X1 upon transfer of control of the equipment and satisfaction of its performance obligations. Upon customer acceptance, seller recognizes an additional \$40 as income – but not revenue – in 20X2.

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2. Seller recognizes revenue of \$60 in 20X1, but then completely reverses out that revenue in 20X2 if and when the customer decides to return the equipment.

In either case, we do not believe that the model faithfully represents or transparently reflects the economics of the arrangement.

- In our view, the customer acceptance clause is substantive, and should preclude *recognition* of revenue until customer acceptance is received. This is true even though control over the equipment has been transferred to the customer at an earlier point in time.
- In addition, we disagree with the conclusions set out in the Proposed ASU that the acceptance clause would be considered solely in the *measurement* of revenue to be recognized. We feel this approach is inappropriate because doing so results in the misleading outcomes shown above. Specifically, neither outcome #1 or #2 shown above, in our view, transparently reflects the nature of the arrangement between the seller and the hospital.

Note: In a related scenario, we do not agree with the proposed accounting outlined in Example 13 of the Proposed ASU. In our view, existing U.S. GAAP (which would require the seller to defer revenue recognition while the product is in transit) better represents the economic reality that the seller still bears significant risk of loss over the “transferred” product until the point in time it is accepted by the customer.

We also are concerned with an analogous situation involving sales transactions in which collectibility is not reasonably assured. Again, the control-based model in the Proposed ASU would allow for revenues to be recognized even if there was substantial uncertainty regarding whether the seller will be paid for the goods or services provided. Instead, the nonpayment risk would be reflected in the *measurement* of any recognized revenue. As discussed in more detail in Item #4 below, we again feel that this outcome would be confusing to the primary users of the financial statements.

- This is because the accounting set out in the Proposed ASU results in a misleading depiction of an entity’s revenue generating activities. In our view, revenues would be recognized too soon if the guidance in the Proposed ASU were to be employed (for the same reasons described earlier in this section of the letter). In addition, the amount of revenue recognized under the model in the Proposed ASU would bear no relation to the amounts billed or collected under the arrangement. To demonstrate:

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- o Assume that a seller bills \$100 for a delivered product, but only expects \$20 to be ultimately collected. In this fact pattern, the seller would record revenues of \$20 initially based on the guidelines in the Proposed ASU.
- o If the probabilities hold true, the seller will most likely not collect any amounts related to this transaction, and would reverse the revenues recognized in a subsequent period. Thus, in our view, the effects of this transaction are misreported in two periods.

Note: A seller could take advantage of the subjectivity and judgments afforded by the model set out in the Proposed ASU to inappropriately meet analyst consensus estimates for a given period. For instance, given the example described above, the seller could slightly and inappropriately tweak its probability estimates so that the amount of revenue to be recognized from the \$100 transaction would be \$30, not \$20. This reassessment might not be picked up by internal auditors, external auditors, or other financial reporting gatekeepers, but would allow the seller to meet consensus estimates for the given reporting period.

- The model set out in the Proposed ASU makes it difficult for financial statement users to truly evaluate the effectiveness of the seller's subsequent collection efforts. If a particular company tends to take conservative views regarding collectibility of receivables, it may recognize relatively small amounts of revenue initially, and large "gains" from subsequent collection efforts. Conversely, if another organization is takes more aggressive positions, it may record too much revenue initially, and have large reversals in subsequent periods. In both circumstances, though, the two entities may have similar customers and equally effective underwriting and collections departments. This fact, however, gets masked by the accounting requirements set out in the Proposed ASU and its requirement for sellers to use substantial judgment in measuring the amount of revenue to recognize, rather than taking a more simplistic (and arguably more transparent) approach in precluding revenue recognition until certain hurdles are met, including first determining that collectibility is reasonably assured.

In sum, we are concerned that the control-based revenue recognition model set out in the Proposed ASU is not robust enough on its own. In a number of circumstances, we feel that the underlying economics of a particular transaction will

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be misrepresented if revenue was recognized solely based on the transfer of control.

We do believe, though, that our concerns can be relatively easily addressed – while retaining the basic tenets of the control-based recognition model – by simply establishing some additional “tollgates” (beyond transfer of control) that must be met before revenue can be recognized. These tollgates could include, for example:

- Affirming that the underlying transaction is not a sham
- Ensuring collectibility of the resultant receivable is reasonably assured
- Obtaining customer acceptance, if required under the terms of the arrangement or by standard industry practice.

Consistent with our observations discussed in the previous section, we do not agree that the accounting for bill and hold transactions described in the Proposed ASU is appropriate.

The Proposed ASU would allow for revenues to be recognized in a bill and hold transaction prior to delivery to the intended customer location. This accounting outcome would be a substantial change from long standing practice, as set out in SAB Topic 13.A.3.a. It is our understanding that the guidelines under SAB Topic 13.A.3.a. were developed over a number of years in response to perceived “loopholes” in the standards and actual abuses.¹

Not surprisingly, we are concerned that if the guidelines in the Proposed ASU were adopted as currently outlined, some companies would begin to structure their contracts such that the customer would be transferred “legal control” of goods as soon as the goods were manufactured, even if they were not shipped until a later date.² In this circumstance, the seller would be able to recognize quite a bit of revenue before it has substantively fulfilled its main performance obligation – that is, delivering a completed and usable product to the customer. This accounting, in our view, does not appear to transparently reflect the underlying economics of the arrangement.

¹ See In the Matter of Stewart Parness, AAER 108 (August 5, 1986); SEC v. Bollinger Industries, Inc., et al, LR 15093 (September 30, 1996); In the Matter of Laser Photonics, Inc., AAER 971 (September 30, 1997); In the Matter of Cypress Bioscience Inc., AAER 817 (September 19, 1996).

² Customers might be willing to accept legal control in exchange for a price concession from the seller or other side arrangements.

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Again, we would ask the Board to consider adding additional conditions (beyond transfer of control) before allowing revenue to be recognized. For instance, requiring that companies positively assert that the transaction is not a sham would likely result in the deferral of revenue in most if not all bill and hold transactions until physical delivery of the underlying goods to the intended customer location.

Irrespective of our views set out above, the Proposed ASU's model for exclusive licensing arrangements does not seem to be consistent with the notion that transferring control equates to revenue recognition.

The Proposed ASU distinguishes between nonexclusive and exclusive licenses as follows:

IG34. If a customer does not obtain control of substantially all the rights associated with the entity's intellectual property and the entity has promised to grant exclusive rights to the customer, the entity has a performance obligation that it satisfies continuously during the period in which it permits the customer to use its intellectual property.

IG35. If an entity grants rights that are not exclusive, the promised rights give rise to a single performance obligation. The entity satisfies that performance obligation when the customer is able to use and benefit from the rights, which is no sooner than the beginning of the license period.

After reviewing this guidance, it seems counterintuitive to us that companies can recognize revenues at license inception for nonexclusive arrangements, whereas revenues from exclusive licenses must be amortized over the license period. If anything, granting an exclusive license arguably affords the customer greater control over the underlying intellectual property rights than under a nonexclusive license. Hence, we would have expected that the granting of an exclusive license would equally or even better satisfy the “transfer of control” notion set out in the Proposed ASU versus a nonexclusive license. Therefore, we believe that the transfer of an exclusive license should allow for 100% revenue recognition at the beginning of the license period, similar to the accounting conclusion reached for nonexclusive licenses.

We note that paragraphs BC223 and BC224 of the Basis for Conclusions analogize exclusive licenses to leasing arrangements, hence supporting a recognition model in which revenues are reported over the license term. However, we feel that this comparison is inconsistent with the views set out in the Leases (Topic 840) Proposed Accounting Standards Update. In particular, paragraph 5 of the proposed leases accounting standards update specifically excludes arrangements involving intangible assets from the scope of the proposal. Hence, it seems circular to us that the revenue recognition literature would look to a lease accounting model in accounting for exclusive licenses (which involve access to intangible rights), but the

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leasing literature would specifically exclude arrangements involving intangible assets from its scope.

We ask the Board to reconsider its conclusions regarding the accounting for exclusive versus nonexclusive licenses, or better explain its rationale for the disparate approaches set forth in the Proposed ASU.

2. Identifying Separate Performance Obligations

The Proposed ASU requires that “distinct” goods and services within a customer contract be separately accounted for as performance obligations.

We are concerned that the requirements for determining whether a good or service is “distinct”, as set forth in paragraph 23 of the Proposed ASU, are unnecessarily broad. Under these guidelines, companies could conceivably identify vast numbers of “performance obligations” in every contract – thereby rendering the proposals in the Proposed ASU nonoperational.

In particular, paragraph 23(b) indicates that a good or service is distinct if it **could** be sold separately (emphasis added). But as the Board acknowledged in BC49, practically anything could be sold separately in theory. So, to limit the number of potential performance obligations emanating from a contract, the Proposed ASU indicates that a “separable” good or service must have both a distinct function and distinct profit margin.

Unfortunately, we’re not sure this additional guidance will help limit the number of potential performance obligations arising from a customer contract for several reasons:

- Virtually any conceivable good or service could have a distinct function, given that the utility of a given good or service does not have to be based on the customer’s intended use of the goods or services (as indicated in BC50-BC52 of the Proposed ASU).
- It seems illogical to consider a notion of “distinct profit margins” when evaluating goods and services that are not sold separately. The very fact that these goods and services are not sold separately indicates that it is an artifice to determine whether there are distinct profit margins for these items. Said another way, it is difficult for sellers to know whether a good or service has a distinct profit margin when the company does not actually sell the good or service separately, which is the trigger for looking to the guidance in paragraph 23(b) in the first place.

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- We recognize that the Board has provided additional guidance on determining whether a good or service has a distinct profit margin in paragraph 23(b)(ii), but we are not sure how to operationalize this guidance. To demonstrate our concerns, please consider the following example:

Example. A production studio sells rights to air 80 completed episodes of a television series to a TV network.

As it is important for the series to be shown in sequence, the studio imposes a condition in the customer contract that the TV network must air the series in sequential order. To better control this requirement, the studio will transfer to the TV network, by satellite link, the current episode to be aired 24 hours before its scheduled broadcast.

Assume that the TV network decides to air one episode per day for 80 consecutive days. Accordingly, the studio will transmit the appropriate episode on a daily basis to the TV station (i.e., one episode per day, in advance, for 80 consecutive days). This type of daily transmission is a unique arrangement which is not generally done on a regular basis either by this studio or other studios.

In analyzing the contract for separate performance obligations, we note that the studio's provision of the daily transmission services fails the first criteria in paragraph 23(a) because it is not sold separately.

However, one could argue under paragraph 23(b)(i) that the daily transmission service has a distinct function of ensuring that the TV series is televised in the correct sequence. We are not sure, though, whether the daily transmission service has a distinct profit margin. It is certainly fair to conclude that satellite transmission uses different **resources** (e.g., communications equipment) and faces different **risks** than those involved in the production of a TV show. Based on paragraph 23(b)(ii) of the Proposed ASU, this would suggest that the transmission services are a distinct performance obligation in the contract.

Taking a step back, though, this seems like an incongruous result. From the customer's perspective, the TV network likely would not ascribe any value to the transmission services, since they are probably more of an inconvenience than a value added function (i.e., it would be more convenient for the network to simply receive all 80 episodes upfront rather than one per day).

After some thought, we are uncertain as to which of the following methods the studio should use to recognize revenue from this arrangement:

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1. Recognize revenue upfront to the extent of the value of all 80 completed episodes that are now legally/contractually controlled by the TV station, and defer some portion of revenue until the daily transmission service is provided, or
2. Recognize 1/80th of the revenue each day over 80 days, as each episode is transmitted by the studio to the TV station, or
3. Some other method

To address our concern, we would suggest that sellers only be required to separately account for those performance obligations which are **substantive**. Nonsubstantive performance obligations should be ignored for accounting purposes.

From a process perspective, companies could still assess whether a good or service is distinct (using improved guidelines that respond to the issues we highlighted earlier in this section of our comment letter). Once all distinct goods and services have been identified, companies could assess whether they are substantive by considering certain factors, such as those set out in Question #2 of SAB Topic 13A(3)(c). For example, a distinct good or service would be substantive if two or more of the factors set out below are present:

- There is a right to a full or partial refund if the good or service is not delivered
- The good or service is essential to the functionality of other delivered products or services
- The seller does not have a demonstrated history of delivering the good or service in a timely manner and reliably estimating their costs
- The cost or time to deliver the good or service for similar contracts historically has varied significantly from one instance to another
- The skills or equipment required to deliver the good or service are specialized or are not readily available in the marketplace
- The cost of delivering the good or service is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting

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- The period before the good or service will be delivered is lengthy.
- The timing of payment of a portion of the sales price is coincident with completing delivery of the good or service

3. Transaction Price Based on Reasonable Estimates including Contingent Revenues

We disagree with the Board's view that the transaction price should incorporate reasonable estimates of contingent amounts.

In particular, we feel that this accounting requirement will not be well understood by investors and creditors. Most financial statement users have been conditioned to assume that any revenues recognized will result in realizable assets – namely receivables that will be collectible. This will certainly not be the case if estimates of contingent revenues are required to be included in the transaction price, since it is inevitable that some estimates of contingent revenues will not come to fruition.

Furthermore, we are concerned about whether the guidance in paragraphs 38-41 of the Proposed ASU is operational. The following example demonstrates our concerns:

Example. Entity A provides a customer with a nonexclusive distribution license to a pharmaceutical compound under development. Entity A also agrees to perform related research and development (R&D) services necessary to gain regulatory approval for the compound under development.

For simplicity, let's assume that the contract requires:

- An upfront, nonrefundable payment of \$5 million.
- Milestone payments of \$2 million each after three distinct and substantive milestones are completed (\$6 million in total):
 - o Filing a new drug application, or NDA
 - o Completing Phase III trials
 - o Obtaining regulatory approval

As the license is nonexclusive, the principles of the Proposed ASU would result in immediate revenue recognition related to this performance obligation at the commencement of the license arrangement.

In determining the amount of revenue to recognize, Entity A would need to

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determine whether the transaction price can be reasonably estimated. If Entity A can reasonably estimate some, but not all, of the consideration amount, the transaction price includes only the amount that Entity A can reasonably estimate.

The upfront portion of the arrangement fee (\$5 million) is fixed and can be reasonably estimated. However, the milestone payments totaling \$6 million represent contingent or variable revenue. It would take substantial judgment to determine whether the variable revenue aspect of the arrangement consideration could be reasonably estimated.

Some practitioners might conclude that a reasonable estimate of the contingent milestone consideration cannot be made because of the substantial uncertainty around whether the milestones *specific to pharmaceutical compound under development* will be achieved. Such practitioners would therefore limit the transaction price to the noncontingent amount of \$5 million.

Other practitioners may take the position that a reasonable estimate of the milestone consideration can be made based on the entity's own product development experience or the experience of other entities that have developed similar pharmaceutical compounds. Practitioners holding this view would calculate total transaction price at some amount between \$5 million and \$11 million.

As a result, those companies that believe they can make a reasonable estimate of the transaction price, including the variable revenue element, would recognize a larger amount of revenue at the commencement of the license arrangement than companies who were unable to reach the same conclusion.

Our concern, therefore, is that the measurement of the contingent revenue element would be highly subjective, even considering the guidelines set out in paragraphs 38-39 of the Proposed ASU. In particular, we suspect that some companies, in practice, will determine that the four factors described in paragraph 39 are not relevant to the fact pattern described above, while others would take the complete opposite view. Similar conflicts could arise for other types of variable revenue arrangement including those in which sellers are entitled to a percentage of cost reductions generated over time, or when sellers are entitled to "performance bonuses" if equipment stays up and running for a guaranteed period of time. Such diversity in practice would defeat the Board's stated objective for a new revenue standard to "improve comparability of revenue recognition practices across entities, industries, jurisdiction, and capital markets."

As an aside, we also unsure how the general disclosure required by paragraph 83(a) of the Proposed ASU would help users in comparing the judgments made by

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various enterprises around similar transactions.

On another note, we are apprehensive that the process set out in the Proposed ASU for updating previous estimates of probability-weighted transaction prices may potentially mislead or confuse users of the financial statements.

Example. Following on from the previous example, assume that Entity A had determined that it was able to make a reasonable estimate of the variable milestone consideration.

After Entity A considers various probabilities associated with the milestone payments, it estimates the total transaction price to be \$9 million. In, addition, Entity A determines that the standalone value of the nonexclusive license is \$10 million, and the standalone value of the development services is \$5 million. In accordance with the Proposed ASU, \$6 million of the transaction price would be allocated to the nonrefundable license [$\$10 \text{ million} / (\$10 \text{ million} + \$5 \text{ million}) \times \9 million] and would be recognized as revenue at the start of the nonexclusive license period.

This outcome occurs despite the fact that Entity A is only contractually allowed to invoice \$5 million under the terms of the arrangement, and may not be able to invoice any additional amounts if the development efforts do not trigger a milestone payment. So, if Entity A is unsuccessful in its development efforts, Entity A would have to reverse revenue of \$1 million at a later date [$\$6 \text{ million recognized} - \$5 \text{ million invoiced and nonrefundable}$].

In this instance, we fail to see how investors in Entity A are being provided with useful or even reliable information about revenues the customer contract. In our view, the amount of revenue recognized by Entity A should be limited to the noncontingent portion of \$5 million, consistent with current U.S. GAAP. We reject the Board's conclusions in BC82, which suggest that setting such a parameter would be arbitrary. We actually think it would be *far less* arbitrary to restrict the transaction price to the noncontingent portion of arrangement consideration as compared to the model set out in the Proposed ASU.

In sum, we would propose to eliminate guidelines in paragraphs 38-41 of the Proposed ASU and replace them with existing U.S. GAAP guidelines around contingent revenues. Specifically, contingent or variable revenues should not be reflected in the transaction price until the moment that the contingent or variable revenue becomes fixed or determinable. As demonstrated in the above example, a measurement based on existing U.S. GAAP is far more reliable and objective than a

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measurement based on probability-weighted estimates, and would better serve the primary users of the financial statements while reducing operational complexity for reporting entities.

4. Incorporation of Credit Risk into Revenue and Accounts Receivables

As discussed in Item 1 of this letter, we do not agree with the proposal to incorporate credit risk into the measurement of revenue and the related accounts receivable. We instead would prefer to consider credit risk as part of the decision process as to whether revenues can be recognized in the first place.

We have outlined our understanding of the requirements set out in the Proposed ASU, and our concerns regarding these guidelines, in the following example:

Example. An entity sells a product for \$100. It estimates that there is a 2% chance that payment will not be made. Based on the guidelines in the Proposed ASU, revenue recognized from this arrangement would be reported at \$98 [$\$100 - (\$100 \times 2\%)$]. Accounts receivable would also be recorded at \$98.

Assuming that the selling entity does in fact collect all \$100 due, it would record the following journal entry:

Dr. Cash	\$100	
Cr. Accounts receivable		\$98
Cr. Gain from change in creditworthiness		\$ 2

We disagree with this measurement approach because it obfuscates an investors' ability to analyze a company's ability to collect the amounts that it has contractually billed. Moreover, investors do not gain any incremental or particularly useful information for decision-making purposes when subsequent collections of amounts billed are reported as gains instead of as revenues.

In sum, the above accounting – in our view – understates revenues and overstates the impact of the seller's collection efforts.

Another point we wish the Board to consider is that the accounting required by the Proposed ASU imposes additional (and in our view unnecessary) operational burdens on companies to reconcile between:

- Their accounts receivables subsidiary ledger – comprising amounts actually invoiced to customers – and

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- The amount of accounts receivable presented in the financial statements, which consists of invoiced amounts adjusted for credit risk and the time value of money.

Therefore, this particular aspect of the Proposed ASU increases the operational complexity for financial statement preparers while reducing the decision usefulness of information presented to users of the financial statements.

Our recommendation would be to eliminate collectibility considerations from the measurement of revenues and instead require companies to ensure that collectibility is reasonably assured as a tollgate before revenue can even be recognized. Refer to our comments in Item #1 above for additional details.

5. Contract Costs

We commend the Board for providing guidance on accounting for costs incurred in fulfilling a contract. However, we feel that the Proposed ASU contains potentially conflicting guidance around whether or not costs incurred in negotiating a specific contract should be capitalized or expensed.

Paragraph 57(a) in the Proposed ASU states that one of the criteria for capitalizing contract costs is that those costs must “*relate directly to a contract (or a specific contract **under negotiation**)*” (emphasis added). However, Paragraph 59(a) in the Proposed ASU goes on to state that an entity should expense costs of obtaining a contract (or example, the costs of negotiations).

As demonstrated by the following example, we’re not sure how to distinguish between the paragraph 57(a) costs that relate directly to a contract under negotiation versus the paragraph 59(a) costs of obtaining a contract:

Example. Company A, a provider of training services, is negotiating a contract with a potential client. In order to demonstrate that its services are right for the client’s needs, Company A spends 40 hours creating a detailed course outline for the potential client. Upon reviewing the detailed outline, the potential client agrees to award the project to Company A. The client signs a contract on January 1 to engage Company A to develop the course based on the detailed course outline that was created in the previous month during the contract negotiation phase.

Based on the above fact pattern, it is unclear as to whether the costs of developing the detailed course outline would be capitalized or expensed:

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- Paragraph 57(a) suggests that Company A would capitalize the cost of the 40 hours that were incurred to create the detailed course outline, as these 40 hours relate directly to a specific contract under negotiation with the potential customer.
- On the other hand, paragraph 59(a) suggests that the outline development expenditures were a cost of obtaining or negotiating a contract with the new client, and therefore must be expensed.

We ask that the Board revisit the language in paragraphs 57(a) and 59(a) so that there is clear guidance on whether companies should capitalize or expense costs incurred for contracts under negotiations.

6. Unit of Account

The Board should clarify whether the proposals set forth in the Proposed ASU should be applied (a) at the individual contract level, (b) based on a portfolio of homogenous contracts, or (c) considering all customer contracts entered into during a reporting period.

For the most part, the language and examples in the Proposed ASU seem to indicate that the guidelines in the Proposed ASU should be applied at an individual contract level. Nonetheless, the Proposed ASU also suggests that it would be appropriate to group contracts when applying certain aspects of the Proposed ASU. For example:

- Example 3 in the Implementation Guidance suggests that a portfolio approach be used to estimate refund liabilities associated with rights of return. Similarly, Example 4 in the Implementation Guidance suggests that a portfolio approach be used to estimate the value of performance obligations for warranties.
- However, Example 20 and paragraph IG80 in the Implementation Guidance suggest that either a portfolio approach or an individual contract approach can be used to measure credit risk.
- Example 26 in the Implementation Guidance suggests that customer loyalty points be estimated based on all customer contracts during a reporting period.

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In our view, it would be appropriate and pragmatic to allow reporting entities to group large volume, homogenous transactions and contracts when applying any of the requirements set out in the Proposed ASU. However, it is not clear from the language in the Proposed ASU whether our views are consistent with the Board's intent.

Accordingly, we would ask that the Board provide further information as to when it would be permissible to use a portfolio approach in complying with the guidelines in the Proposed ASU, versus when companies would be required to look at individual contracts as the proper unit of account.

6. We have some other, less significant, concerns regarding the Proposed ASU bulleted below:

❖ **Example 11 (Construction Contract)**

This example states that *“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 principle in paragraph 23(a) would appear to render each of these tasks (site preparation, foundation development, structure erection, etc.) distinct, and therefore each task should be regarded as separate performance obligations for revenue recognition purposes.

However, Example 11 states that some of the aforementioned tasks cannot be separated but instead must be combined as a single performance obligation together with the contract management services. The rationale appears to be that the contract management services are not distinct, because such services do not have different risks than the other tasks to be performed under the contract. This view suggests to us that **any and all** projects that include contract/project management services would mostly be regarded as a single performance obligation, apart from preparation and finishing tasks.

While we would not necessarily be opposed to this accounting outcome, we want to be sure that we have appropriately interpreted the Board' logic and rationale.

❖ **Example 22 (Customer Payments in Advance)**

We do not agree that customer payments in advance should be increased for the time value of money. The application of this principle to the scenario outlined in Example 22 results in a further \$800 of revenue above and beyond the \$8,000

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amount that was actually invoiced to and received from the customer. The proposal to inflate customer advance payments for the time value of money results in “artificial” revenue growth that may mislead and confuse investors, since these revenues do not equal the actual amount of cash received from customers.

In addition, the cost and effort involved in remeasuring a receivable for the time value of money is not commensurate with the usefulness of any additional information users will receive. We feel that financial statement users simply want to know whether a seller bills in advance, or receives cash in arrears, as well as the typical time lag between the provision of products and services and the collection of cash. That information can be gleaned from existing financial statement analysis techniques, as well as from data provided in other sections of a public financial report.

It is unnecessary, in our view, to create artificial and offsetting revenue and interest cost figures that will not provide any incremental benefit to financial statement users (and may actually mislead them), while increasing compliance costs to financial statement preparers. We would strongly urge the Board to eliminate the requirements of paragraph 44 of the Proposed ASU for payments received in advance, along with the corresponding content in IG 82 and Example 22.

❖ **Combining Multiple Contracts**

The Proposed ASU proposes that a company would account for two or more contracts together if the prices of those contracts are interdependent. While the Proposed ASU does contain several indicators of price interdependence, we suggest that the Board also consider including relevant guidance from FASB ASC 815-10-25-6 (derived from DIG Issue No. K-1, Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit) and FASB ASC 810-10-40-6, which outlines the circumstances that indicate that when multiple arrangements should be accounted for as a single transaction.

Making the complex *understandable*