



June 2, 2009

The Financial Accounting Standards Board
401 Merritt Seven
PO Box 5116
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Attn: Technical Director
(File Reference 1660-100)

Thank you for the opportunity to comment on the Discussion Paper entitled “Preliminary Views on Revenue Recognition in Contracts with Customers” (file reference 1660-100, December 19, 2008). Mind the GAAP, LLC strongly supports the need for improved revenue recognition guidance under both international financial reporting standards (IFRS) and United States generally accepted accounting principles (US GAAP) and we are pleased that the FASB and IASB are working jointly on this ambitious and challenging project.

For the most part, we agree with the overarching principles set out in the Discussion Paper. However, we do have some reservations regarding a few of the preliminary conclusions reached by the Boards. We also feel that further clarification on several operational aspects of the revenue recognition model set out in the Discussion Paper would be beneficial when a more formal Exposure Draft is issued.

We would be pleased to discuss any aspect of our letter in more detail. If you have any questions, feel free to contact Scott Ehrlich, President and Managing Director of Mind the GAAP, LLC, at (773) 732-0654 or by e-mail at sehrlich@mindthegaap.com.

Executive Summary

As part of their deliberations and due process, Mind the GAAP, LLC encourages the Boards to consider the following comments, each of which is discussed in more detail in this letter.

- Before issuing a more formal Exposure Draft, the Boards should be confident that the overarching revenue recognition principles set out in the Discussion Paper are operational across various types of customer contracts through extensive field testing. (*See Item 1 below*)

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- The definition of a performance obligation in the Discussion Paper is not specific enough, nor does it improve upon the guidance in current GAAP standards such as EITF 00-21 (or even draft EITF 08-1); without further clarification, identification of performance obligations will be difficult in practice. *(See Item 2)*
- An entity should only separately recognize revenues for substantive performance obligations. Non-substantive performance obligations should not be separated – they should simply be ignored for accounting purposes. An Exposure Draft, as well as any final standard, should provide factors that would indicate whether a performance obligation is substantive. *(See Item 3)*
- An entity should recognize revenue when a substantive performance obligation is satisfied (i.e., control of the underlying asset is transferred to the customer), unless the substance of transaction indicates that a sale has not occurred. This could happen, for instance, when collectibility of the resultant receivable is not reasonably assured or the transaction is a sham. *(See Item 4)*
- We believe that the definition of control requires further refinement, as it is critical to the accounting model described in the Discussion Paper (once a customer obtains control over an asset, the seller's performance obligation is satisfied and revenues can be recognized). Specifically, the manner in which control is defined in the Discussion Paper could result in an opportunity to manipulate earnings. Moreover, under the proposed definition of control, two economically equivalent transactions may be accounted for in different ways. *(See Item 5)*
- Any future Exposure Draft should address the accounting for costs incurred prior to delivering a “service asset” to a customer. This is a very important accounting consideration to many companies, but one for which there presently is limited accounting guidance. *(See Item 6)*
- We believe that allocating transaction price to performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations will be challenging to apply in practice and may, in some cases, result in counterintuitive results. *(See Item 7)*

Note: Item 8 below contains a few other less significant concerns regarding materials presented in the Discussion Paper.



1. We support the overarching revenue recognition principles set out in the Discussion Paper. However, the Boards should be certain that these principles are operational across various types of customer contracts through extensive field testing prior to issuing an Exposure Draft.

To ensure that the Boards' proposed revenue recognition model is operational across various industries and types of customer contracts, extensive field testing should occur, preferably prior to the release of a formal Exposure Draft.

The field testing should include a large and diverse sample of reporting entities including:

- Both larger corporations and smaller organizations,
- Domestic and international entities applying US GAAP,
- Public companies and private enterprises (the FASB should consider consulting with the Private Company Financial Reporting Committee to identify good candidates), and
- Perhaps most importantly, a representative company from each major Standard Industrial Classification (SIC) Code (<http://www.sec.gov/info/edgar/siccodes.htm>).

This field testing should not only ensure that the revenue recognition model is operational and beneficial to users of the financial statements, but it should allow the Boards to avoid including scope exceptions or “carve-outs” to the Boards' final revenue recognition guidance. In particular, a final standard on revenue recognition should be applicable to revenues generated from transactions that were not specifically addressed in the Discussion Paper, including the origination of loans and leases, the issuance of guarantees, and the provision of insurance.

A revenue recognition model also should be robust enough to handle contingent fee arrangements (i.e., where the ultimate revenue to be recognized is based on achieving specified targets), including but not limited to the arrangements identified in the following two examples:

Example 1. A professional services firm helps find cost cutting solutions for its customers. The firm collects fees equal to a fixed percentage of client cost savings. Therefore, at the outset of its contracts with customers, the professional services firm's future revenues are unpredictable.



Example 2. A law firm enters into a client contract in which payment is contingent on litigation outcome. Again, at the outset of the contract, future fee revenues are unpredictable.

We recognize that subsequent to the release of the Discussion Paper, the Boards have discussed the potential accounting for arrangements in which the customer promises an uncertain (variable) amount of consideration. Our understanding is that the Boards agreed that when the amount of consideration is uncertain, the amount allocated to contingent performance obligations would be the entity's probability-weighted estimate of total consideration. Such allocated amounts might be constrained if the consideration amount could not be reliably estimated.

Based on the two examples outlined above, we're not sure that the Boards' tentative conclusions would be operational. In each case, we would probably conclude that a reliable estimate of the consideration could not be made. We would probably reach that same conclusion in the vast majority of cases in which contingent or uncertain amounts of revenues were present. Therefore, the Board's tentative guidance does not appear to be all that helpful, and should be reconsidered before a final Exposure Draft is issued.

2. The definition of a performance obligation in the Discussion Paper is not specific enough, nor does it improve upon the guidance in current GAAP standards such as EITF 00-21. Without further clarification, identification of performance obligations will be difficult in practice.

In Paragraph S17, the Boards define performance obligation as "a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit."

We strongly believe that constituents require a clearer, more precise and operational definition of performance obligation. Otherwise, it will be difficult to identify performance obligations in certain types of contracts, as demonstrated by the following examples:



Example 3. The terms of a software agreement stipulates that the vendor will meet with its customer twice per year throughout the contract term to discuss possible software enhancements (i.e., “product roadmaps”). After these discussions, the vendor will consider making product improvements based on the customer’s feedback; however, the vendor is under no obligation to make any proposed enhancements.

Based on the current definition set out in the Discussion Paper, we are unable to determine if these semi-annual meetings represent performance obligations.

Example 4. A digital camera vendor includes in a camera instruction manual that firmware updates, if any, will be made available for download on its website. The vendor does not need to make such updates, nor do most owners of the camera take the time to download ones that have been posted to the vendor’s web site (since the camera will likely operate just fine with the existing firmware).

Based on the current definition of performance obligation set out in the Discussion Paper, we are unable to determine if the “promise” to post potential updated firmware to the vendor’s web site represents a performance obligation.

Example 5. XYZ agrees to pay an upfront fee to a biotechnology company for rights to its undeveloped technology. XYZ will also make future payments if the biotechnology company achieves certain development milestones. Under current rules, the upfront fee is not typically considered a separable element of the transaction; hence, no revenues are recognized at contract commencement when the biotechnology company provides XYZ rights to the undeveloped technology.

Based on the definition of performance obligation set out in the Discussion Paper, though, we are unable to determine whether imparting rights to undeveloped technology is a performance obligation. If so, then the biotechnology company in the above example should recognize revenue upon commencement of the contract. This would be a significant change in practice. (As an aside, we are not sure how much revenue would be recognized since it would be difficult to estimate the selling price when the biotechnology company provides rights to undeveloped technology on a standalone basis.)



While we believe that the Boards' definition of performance obligation requires further refinement, we do agree with the Boards' conclusions that rebates, returns and warranties represent substantive performance obligations that should be accounted for in accordance with the principles set out in the Discussion Paper.

- 3. An entity should only separately recognize revenues for substantive performance obligations. Non-substantive performance obligations should not be separated – they should simply be ignored for accounting purposes. An Exposure Draft, as well as any final standard, should provide factors that would indicate whether a performance obligation is substantive.**

In Paragraph S19, the Boards write that an entity should separately account for a performance obligation if “the promised assets (goods or services) are transferred to the customer at different times.” Given our concerns set out in Item 2 above, some companies may apply the current definition of a performance obligation quite broadly, identifying dozens of “performance obligations” in every contract, thereby rendering the guidelines in the Discussion Paper non-operational.

Therefore, we believe that an entity should only separately account for those obligations which are substantive. Accordingly, non-substantive performance obligations should be ignored for accounting purposes (i.e., no arrangement consideration is allocated to these obligations).

The Boards would need to either define what is meant by a “substantive performance obligation”, or provide factors for companies to consider in assessing whether a performance obligation is substantive. The Boards might wish to consider the response to Question #2 of SAB Topic 13A(3)(c) as a starting point for identifying factors that would suggest a performance obligation is substantive (e.g., the cost to perform is significant relative to other performance obligations, the time needed to complete the performance obligation is lengthy, etc.).

- 4. An entity should recognize revenue when a substantive performance obligation is satisfied (i.e., control of the underlying asset is transferred to the customer), unless the substance of transaction indicates that a sale has not occurred. This could happen, for instance, when collectibility of the resultant receivable is not reasonably assured or the transaction is a sham.**

In Paragraph S26, the Boards write that revenue is recognized “when a performance obligation is satisfied”. However, this recognition criterion is too simplistic and fails to



consider other factors that are an embedded (and important) part of US GAAP and IFRS today.

For instance, under current US GAAP, revenue should not be recorded if collectibility of the resultant receivable is in question. Even the Boards acknowledge in Paragraph 6.13 that “when collectibility is not reasonably assured, the Boards’ proposed model, in the absence of any other criterion, could result in the recognition of revenue sooner than at present.”

In addition, under current US GAAP, a seller is prohibited from recognizing revenue until a general right of return has expired if it is unable to reliably estimate the number of product returns. However, the revenue recognition model set out in the Discussion Paper would allow for revenues to be recognized at an earlier point in time, as illustrated below:

Example 6. A TV manufacturer sells 100 televisions to one of its distributors. The manufacturer, however, has offered a general right of return, agreeing to accept returns of any unsold product at quarter’s end. The TV manufacturer has no basis or ability to estimate the amount of televisions that will be returned at the end of the quarter.

Under current rules (SFAS 48 and SAB 104), the manufacturer would not be able to recognize revenue until the return period expired, since it could not reliably estimate the number of TVs that would be returned.

Under the model outlined in the Discussion Paper, the manufacturer would be permitted to immediately recognize some portion of the contract consideration as revenue, only deferring the portion attributable to the return right (the value of which may be quite difficult in practice to estimate).

We urge the Boards to modify their revenue recognition guidance to include an overarching proviso that revenue cannot be recognized unless the substance of transaction indicates that a sale has not occurred. The Boards should include examples of situations in which the substance of a transaction does not represent a sale – such as when collectibility of the resultant receivable is not reasonably assured, the transaction is a sham, or the customer does not believe that a good or service was provided.

Please find below one final example that highlights some of the concerns we raised in Items 3 and 4:



Example 7. A washing machine repair company is hired to fix a client's broken machine. Assume that the machine needs a new agitator. The repair company delivers the new agitator and dismantles the washing machine on December 31, 20X7. However, the repairman runs out of time and does not come back to reassemble the machine with the new agitator until January 3, 20X8. The washing machine does not begin working again until January 3, 20X8.

Under the model set out in the Discussion Paper, the repair company could argue that two performance obligations (delivery of the replacement agitator and disassembly) were satisfied by the end of the year and that the associated revenue could be recognized in 20X7.

From the customer's perspective, though, the washing machine is still broken at the end of 20X7. Had the repairman never showed up again to reassemble the machine, the repair company probably never would have received payment for any work performed. Therefore, recognizing revenues in 20X7 (an outcome of applying the model in the Discussion Paper) does not seem appropriate to us.

5. We believe that the definition of control requires further refinement, as it is critical to the accounting model described in the Discussion Paper (once a customer obtains control over an asset, the seller's performance obligation is satisfied and revenues can be recognized).

The Discussion Paper seems to suggest that physical possession of goods - rather than transfer of risks and rewards – indicates control. In particular, Paragraph S21 of the Discussion Paper reads: "In the case of a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the customer's asset. Typically, that occurs when the customer takes physical possession of the good."

If our understanding is correct, then the proposed model would present opportunities to manipulate earnings; companies could "manage" reported revenues by essentially performing what amounts to channel stuffing (i.e., shipping and transferring control of products that a customer does not necessarily need):



Example 8. A company enters into a broad contract to provide ad hoc maintenance work on a gas turbine. At the end of Q1, the company delivers expensive turbine parts to a job site. There is no intent to install these parts until Q2.

Because (a) delivery of the parts probably represents a separable performance obligation based on the definition in the Discussion Paper and (b) control of the parts has transferred to the customer, the company arguably can recognize revenue in Q1.

Absent a more precise definition of control, the proposed model would also result in several changes in current practice that were not explicitly discussed in the Discussion Paper. For instance, paragraph A6 of the Discussion Paper reads: “While [a] good is in transit, no asset is being transferred to the customer (during that time the delivery service benefits Vendor because it is changing the location of Vendor’s inventory).” This guidance appears to render the recognition of revenues at the time of shipment obsolete (presuming the goods were shipped FOB shipping point):

Example 9. An appliance distributor ships refrigerators to its customer FOB shipping point.

Absent any unusual and conflicting contract terms, or vendor practices of making customers whole if/when the goods are damaged in transit, the distributor would be eligible to recognize revenue at the time of shipment under current US GAAP, even though the customer has not physically received the ordered goods.

Based on the guidance in paragraph A6 of the Discussion Paper, though, no revenue could be recognized until the customer physically received the ordered goods, resulting in a potentially significant change from current practice.

The accounting by producers or film distributors is another example of a change in practice not explicitly addressed in the Discussion Paper if the current notion of control set out in the Paper is carried forward without modification:



Example 10. A producer sells rights to air 75 completed episodes of a hit television series to a cable network. The terms of the contract require the network to broadcast all 75 episodes in sequential order. To ensure compliance, the producer releases one episode at a time by satellite transmission (i.e., one per day for 75 consecutive days).

Under current rules (SOP 00-2), the producer might be able to recognize revenue from all 75 episodes at the outset of the contract since the 75 episodes are completed and available for distribution, assuming the other criteria set out in SOP 00-2 are met.

However, application of the proposed model might result in a change in practice because the cable network customer arguably does not control (in a physical sense), say, episode 71 until 71 days into the contract. Therefore, the producer would recognize revenues ratably over a 75 day period under the model set out in the Discussion Paper.

While we would not necessarily oppose these new potential accounting outcomes, we want to be sure that we are appropriately interpreting the Boards' notion of transferring control of an asset, particularly since the Boards suggest that the principles set out in the Discussion Paper would not, in many cases, significantly change current practice (see Paragraph 6.47).

Further confusing matters, the Discussion Paper also seems to suggest that, under certain circumstances, physical possession of goods is not necessary to evidence a transfer of control. In particular, it is written in Paragraph 4.6 that "in some bill and hold arrangements, a customer controls the good even though the [selling] entity has physical possession of the good." This sentence appears to suggest that control over an asset can be transferred legally by contract (and without physical delivery).

- If our understanding is correct, the current accounting for bill and hold transactions will likely change quite significantly, resulting in the acceleration of revenue prior to time the goods are physically delivered to the customer.
- We fear that this would result in a greater number of contracts being structured so that the customer is transferred "legal control" of goods as soon as goods are manufactured, even if they are not shipped to the customer until a later date.

The ToolCo example in Chapter 4 of the Discussion Paper also seems to affirm that transfer of control can occur through legal (and not physical) means. If our

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understanding is correct, then two economically equivalent transactions may be accounted for in different ways. For instance, the substance of the transactions illustrated in Paragraphs 4.11 and 4.14 of the Discussion Paper is the same – ToolCo permits its customers to use its tools for 30 days, risk free. But in one circumstance, ToolCo can recognize revenue upfront, whereas in the other situation, the company must wait until the end of the 30 day trial period before recognizing revenues. To us, this incongruity seems like a fairly significant deficiency in the revenue recognition model set out in the Discussion Paper.

To ensure faithful representation of the economics underlying a customer contract, we again ask that the Boards consider modifying the principles set out in the Discussion Paper so that revenue recognition is not simply contingent upon satisfying a performance obligation and transferring control of an asset to the customer. Other “toll gates” also should be met, including ensuring that the substance of the transaction is in fact a sale (see Item 4 above).

6. Any future Exposure Draft should address the accounting for costs incurred prior to delivering a “service asset” to a customer. This is a very important accounting consideration to many companies, but one for which there presently is limited accounting guidance.

The Boards write in Paragraph 3.44 that “when an entity promises to provide a service, it similarly is promising to transfer an asset even though the customer may consume that asset immediately.” While we do not oppose this principle, we would like clarification around the accounting for costs incurred prior to delivery of a service asset. The following example highlights some of our concerns:

Example 11. A customer enters into a contract with an airplane repair company to fix an airplane engine. It takes one worker from the repair company five weeks to return the engine to working order and to satisfy the seller’s performance obligation.

At present, US GAAP provides little guidance on how to account for the costs of performing the repair service prior to its completion.

The Discussion Paper states that the provision of a service represents the transfer of an asset. This suggests that the repair company should account for the costs of performing the service (mainly the worker’s wages) as an asset prior to the transfer of the “service asset” to the customer. However, the Discussion Paper is not clear in this regard.



The question of whether to capitalize or expense a cost is one that many practitioners struggle with in practice. We believe it would be remiss for the Boards to “gloss over” this issue when investing so much other time in developing a new revenue recognition model.

For what it's worth, our view is that a the service provider should record the related costs of providing that service prior to transfer of control to the customer as an asset – similar to how a vendor would report goods as an inventory asset prior to transfer of control to a customer.

7. We believe that allocating transaction price to performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations will be challenging to apply in practice and may, in some cases, result in counterintuitive results.

In Paragraph 5.46 the Boards write that their “preliminary view is that the transaction price should be allocated to each performance obligation in proportion to the standalone selling price of the promised good or service underlying that performance obligation.” In principle, we agree this approach.

However, as demonstrated by the following example, estimating the standalone selling price of certain performance obligations may be extremely challenging:

Example 12. A vendor delivers a piece of equipment that comes with embedded software. The sales agreement stipulates that the vendor will make available on its website for download a new version of the embedded software if there is a change in operating systems in the future (e.g., from Windows Vista to Windows 7).

Based on the above fact pattern, we are uncertain how in practice the vendor could estimate the “standalone selling price” of this performance obligation, particularly since it has no control over when or if there will be future changes to operating systems and whether its customers would even upgrade to those new operating systems?

Moreover, we also believe that application of this transaction price allocation approach could, in some circumstances, yield counterintuitive results:



Example 13. On December 31, 20X7, a television manufacturer sells a TV with a standard 90-day warranty for total consideration of \$300. The TV cost \$280 to manufacture.

Under the proposed rules, the manufacturer would separate the sale of the warranty from the sale of the TV. Assuming that the standalone selling prices of the TV and warranty are \$270 and \$30, respectively, the sale of the television will be recorded at a \$10 loss [\$270-\$280] in 20X7, while the warranty likely will be recognized at a margin of 100% throughout the first 90 days of 20X8.

We are uncertain whether this accounting outcome provides decision useful information from investors and creditors. As noted in Item 1 above, we think it is imperative that the Boards field test the model extensively to ensure that the outcomes of the model are reasonable and faithfully represent the economics of the sales contract.

8. We have other, somewhat less significant, concerns regarding the Discussion Paper bulleted below.

- The last sentence in Paragraph 2.26 is misleading: “If the measurement of the rights is equal to the measurement of the obligations, the entity would recognize a net contract position at nil. *In other words, the entity would, in effect, not recognize the contract.*” [emphasis added] Actually, we believe that the entity would recognize the contract – but it would be measured at a value of zero.
- We have a few concerns with Example 7 in Appendix A (nonrefundable upfront payment collected by HealthCo):
 - o A similar example is found in SAB 104. Under SAB 104, the upfront payment is spread over the period of time the customer will benefit from the fee, which includes estimated renewal periods. The Discussion Paper, on the other hand, suggests that the upfront fee should be recognized over the initial contract period, and does not consider future renewal periods. We were uncertain whether the Boards were intending to change current practice in this regard.
 - o If the example is retained in the final standard, the Boards should be careful to stress that the transaction described in this example is not analogous to other transactions with upfront fees (e.g., in exchange for rights to exploit undeveloped technology).

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