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Certified
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Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*

The Accounting Principles and Auditing Standards Committee (the “AP&AS Committee”) of the California Society of Certified Public Accountants (“CALCPA”) is pleased to provide our comments to the Financial Accounting Standards Board (“FASB”) on this Discussion Paper (“DP”).

The AP&AS Committee is the senior technical committee of CALCPA. CALCPA has approximately 32,000 members. The Committee is comprised of 50 members, of whom 67 percent are from local or regional firms, 23 percent are sole practitioners in public practice, 5 percent are in industry and 5 percent are in academia.

We support the FASB’s efforts to work jointly with the International Accounting Standards Board in order to clarify the accounting principles for recognizing revenue. Most of our comments are presented as responses to the questions posed in the DP.

We recommend that the Boards analyze implementation issues and discuss them in detail in any Exposure Draft of a new revenue recognition standard. While accounting for many relatively simple transactions would not be affected by the Boards’ proposal, many of the detailed standards under U.S. GAAP exist because of questions over how to apply the basic standards, and we are concerned that many of those questions may persist, and some new questions may arise. We are not suggesting detailed standards, but are suggesting a comprehensive explanation of what the new standards mean and how they will affect practice.

Chapter 2

Question 1

Do you agree with the Boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We basically, agree, but

- Exclude contracts currently covered by SOP 81-1. They have not followed the “delivery” model required in most other revenue recognition rules, and the scope of SOP 81-1 is well understood, and there is no call, or apparent need, for elimination.

- Insurance contracts need further consideration. It is uncertain whether the Boards' proposal can be applied to those contracts.
- Finance and lease transactions should continue to have separate accounting principles, and we question whether the Boards' proposal could be applied to those transactions.
- Significant uncertainty as to collectibility should preclude revenue recognition. A customer may not have adequate financial ability to fulfill its contract obligations, or may not have a sufficient financial stake in the transaction to feel compelled to fulfill its contract obligations, or the contract may not be sufficiently enforceable to create certainty that the entity's net contract position with a customer can be considered a contract asset.

Each exclusion can be dealt with by setting a clear and limited scope, a clear communication for the basis for exclusion, and clear rules to be followed for transactions outside the basic scope.

An example of sufficient uncertainty as to collectibility that may preclude revenue recognition is real estate transactions currently covered by Statement of Financial Accounting Standards ("SFAS") No. 66, *Accounting for Sales of Real Estate*, and SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. While the standards may have some seemingly arbitrary "bright lines," and can be difficult to apply, they are well understood and the need for the bright lines has not diminished. We believe real estate transactions continue to be accounted for under separate standards.

The Boards should also reject inclusion in revenue increases in the value of goods produced, such as agricultural products and real estate. These are fair value measurements, and if it is desirable to permit or require them, the revaluations from cost should be excluded from revenue and net income, and included in Other Comprehensive Income.

Question 2

Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Yes. See response to Question 1.

Question 3

Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We agree with the definition of a contract. However, the definition of a "customer" in paragraph 2.21 is too narrow in that it is limited to parties obtaining assets that are outputs of the entity's ordinary activities. For example, the sale of real estate may or may not be an ordinary activity for a particular entity, but would create revenue. The revenue may not be displayed as "top line" revenue if it is not an ordinary activity, but the display should not affect the accounting measurement. All similar transactions should be accounted the same way, regardless of the business of an entity. Therefore, we believe the definition should be:

"A customer is a party that has contracted with an entity to obtain an asset, such as a good or service."

The reference to ordinary activities stems from the FASB's and IASB's definition of *revenue*; the DP is dealing more broadly with *revenue recognition*, which encompasses ordinary and non-ordinary activities of the entity.

Chapter 3

Question 4

Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Yes.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Yes. The sales transaction has distinguishable parts, and each part should be accounted for separately if all parts have not been delivered.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Yes. To the extent that a refund may be granted, a portion of the obligation has not been satisfied and that portion should be accounted for as a performance obligation.

It is unclear how the Boards intend the performance obligation be measured. Would it be the refund amount, or the refund amount minus the value of the returned goods (e.g., the gross margin, if the returned goods are saleable at full price)? We believe it should be the latter, because the net liability position should consider the value of the goods the customer would return for refund.

It is unclear how the performance obligation for a large single item would be measured, or whether further consideration needs to be given to accounting for a performance obligation of this type. For example, if an aircraft manufacturer occasionally granted a customer the right to return an aircraft (assume it has been paid and the amount is material), would it still be appropriate to estimate the outcome, or should conservatism dictate that recognition of the entire sale be deferred until the outcome is known?

Question 7

Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

We do not believe sales incentives should be accounted for as performance obligations. They should be accounted for as sales or marketing costs, and the expected cost of the sales

incentive in excess of the expected proceeds should be accrued as a liability at the time of the initial transaction.

A discount on future sales promised in a contract with a customer is a pricing decision and should be accounted for as part of the sales price of the future sale, as long as the sales price exceeds the cost of providing the goods or services.

Loyalty points should be accounted for as either free goods or discounts, depending on their terms. We recognize that customers' discretion on how to use loyalty points can cause them to be either free goods or discounts. We suggest that the choice most advantageous to the customer be used in accounting for them unless a pattern of use by customers exist that is different, in which case that pattern should be used.

Chapter 4

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

We agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service. The elements of "control" in paragraphs 4.59 through 4.61 should be included in a definition of what the Boards mean by "control." It should be made clear that:

- Customer acceptance provisions cause the transfer not to occur until they are fulfilled unless the seller can objectively determine at the time of delivery to the customer that the provisions will be met with no further performance by the seller and the customer has no right to reject the goods or services that have been delivered. (This would mean, among other things, that partial deliveries are not transfers if the customer can reject what has been delivered if the final item is not delivered, even if title to the partial deliveries passes to the customer on delivery.)
- Customer intended use of the goods or services delivered have no bearing on whether the transfer has occurred, but only if customer has unequivocally accepted them.
- Customer payment has no bearing on whether the transfer has occurred.
- An asset that is used in satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation.

In addition, the Boards should make it clear that while delivery of the goods or services would normally occur when or before the "transfer" is accomplished, the "transfer" may occur before, at, or after the time of delivery. Further, there should be a stated presumption that transfer of control is coincident with transfer of legal ownership unless there is convincing evidence to the contrary.

Paragraphs 4.32 through 4.37, in attempting to explain why customer payment may help the entity to assess whether the customer has an asset, totally confuse the issue, and should be changed to point out that in no case is customer payment useful in determining whether the customer has an asset. See comments below on the examples.

Several of the examples are more confusing than helpful.

- Paragraph 4.30: Example should be clarified to state that customer has unequivocally accepted X and Y before delivery of Z. Example as stated is confusing because in most arrangements of this type, failure to deliver Z would cause the sale of X and Y to fail.
- Paragraph 4.33: It states that over the life of the contract “a nonrefundable payment from the customer may suggest that the customer controls the partially completed asset” thereby causing recognition of revenue. We believe this is wrong; the customer has neither possession nor ownership, so it is wrong to say the customer controls it. Take a simpler example: customer makes a nonrefundable payment with his order for a product that the seller has in inventory; the example would lead to the conclusion that the seller can recognize revenue before delivery, a conclusion that we think is wrong. Further, while payments may be described as “nonrefundable,” performance by the seller is still required, or the customer would generally be entitled to legal relief.
- Paragraph 4.36: This raises a question that is not dealt with adequately in the DP. Most professional service firms, in GAAP accrual financial statements, recognize revenue based on the hourly value of hours incurred, regardless of what the delivery obligation may be. The revenue earning activity is considered providing the services, not providing the report or other deliverable.
- Paragraph 4.42 through 4.44: The confusion here is because the customer may have some control over the steel because it can take that control if it chooses to, but until it does, the customer does not control the steel – it only has a right to control. Since the right to control is not actual control, seller has no basis to recognize revenue until actual delivery when control passes to customer. This example is, as an aside, an example of why the accounting in SOP 81-1 should be retained; with no compromise of the basic principle the Boards are seeking, the contract would be accounted for under percentage-of-completion, and revenue recognized as work progresses, regardless of payment or termination terms.
- Paragraphs 4.45 through 4.48: This is a poor example in several respects. First, it is a real estate transaction, but the example ignores FAS No. 66. Second, the customer is buying a completed house; any transfer of ownership of materials and services during construction is likely a security condition negotiated by the buyer, but only becomes relevant if the buyer exercises its right to actually assert its control over a partially completed home. Third, the provision of paragraph 4.56, that “An asset that is used in satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation,” would preclude revenue recognition before completion by the seller.

Question 9

The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Contracts currently covered by SOP 81-1 should continue to be accounted for in the manner prescribed by SOP 81-1. To require transfer of control of an asset to satisfy a performance obligation in order to recognize revenue would cause revenue to be recognized at points that are meaningless, and would not provide decision-useful information.

The satisfaction of the performance obligation occurs as work progresses on the contract. Contract terms are generally very explicit, and the buyer and seller simply perform under the pre-negotiated terms. The contract itself controls the underlying asset and the production process, and generally neither the buyer nor the seller separately controls the subject of the contract while under production. Changes generally require joint resolution by the parties. Transfer of ownership may occur as work progresses, at completion, or at other intervals, but such transfers may or may not be indicative of actual performance under the contract. Although not a requirement of SOP 81-1, termination provisions usually assure payment by the buyer if terminated by the buyer and usually call for transfer of work-in-progress to the buyer if termination is by the contractor and the buyer does not already have title. The parties have little discretion other than to perform.

Chapter 5

Question 10

In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

Yes. We agree with the Boards that the transaction price is a better measurement than the exit price for the reasons cited in the Discussion Paper.

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

Yes. There is an expected loss on the transaction, and that loss should be recorded at the time it becomes known. We agree with the Boards' preliminary view in paragraph 5.82 that the onerous test should be done using cost. We do not believe any attempt should be made to ascribe a profit margin to the performance obligation, which would have the effect of increasing the loss recorded at inception, offset by profit recorded on performance of the contract obligations, because that is not a faithful representation of the transaction.

We believe the remeasurement should be performed using a cost trigger as described in paragraphs 5.62 through 5.67 of the Discussion Paper. We do not believe the current price trigger described in paragraphs 5.68 through 5.72 of the Discussion Paper provides useful information, and it is unnecessarily complex.

We suggest the Boards consider what disclosures may be appropriate for costs accrued on onerous contracts, including whether accruals for loss contracts and the future impact of onerous contracts on gross margins should be disclosed.

Paragraph 5.67 raises a question of what costs should be considered in the onerous test. Costs included should be the same ones that are included in inventory and charged to the contract; this would normally include direct costs of providing goods and services and allocable production overhead. It would not include any administrative costs, unless those costs are specifically reimbursed under the contract.

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

We believe the proposed measurement approach provides decision useful information at each financial statement for sales of goods and services. We have reservation as to whether the proposed approach would be useful, or even practical, for financing and insurance transactions. As stated above. It does not provide decision-useful information for contracts currently accounted for under SOP 81-1 because the nature of those transactions is substantively different from other sales of goods or services.

Paragraphs 5.83 through 5.86 express concerns about remeasuring performance obligations only when deemed onerous. The concerns point to difficulties in the estimation process and the effects of these difficulties are reduced by using the cost approach in measuring whether the performance obligation is onerous. We are not aware of any practical method to overcome these difficulties.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

We believe that transactions for which the related assets and liabilities are recorded and carried at cost should be subject to the measurement approach in the Discussion Paper. However, for transactions for which the related assets and liabilities are recorded or carried at fair value, we do not believe the approach would provide decision-useful information. In addition, we share the Boards' concern stated in paragraph 5.89 about trying to apply the allocated transaction price approach to insurance contracts.

We do not believe the contracts referred to in paragraph 5.90(a) and (b) require another measurement approach; measurement of these long-term potentially highly variable contracts is difficult now and is likely to be difficult under any approach. As stated previously, the long-term contracts referred to in paragraph 5.90(c) should continue to be accounted for under SOP 81-1, and that would obviate the concern expressed.

Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose

that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

Yes. The costs incurred, and the charges to the customer do not reduce the entity's performance obligation under the contract.

(b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

We do not believe there are many specific instances where recognizing contract origination costs as expenses as they are incurred would not provide decision-useful information about an entity's financial position and financial performance, and further believe a consistent approach for all industries in accounting for contract origination costs is appropriate.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Yes. It is the best measure of the performance obligations satisfied and those remaining to be satisfied.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Yes. Use of estimates will give the best measure of the performance obligations satisfied and those remaining to be satisfied, notwithstanding the fact that estimates are subject to some inherent uncertainty. The residual method does not provide as good decision-useful information; it may be more objective, but it is less relevant, and we believe relevance is more important than objectivity. The deferral of revenue for delivered items if there is no vendor-specific objective evidence of selling prices for undelivered items may or may not be more objective than the residual method, but is even less relevant than the residual method.

Potential Effects on Current Practice

Potential Effect on cash-based revenue recognition, paragraphs 6.11 through 6.13

We agree that the basic model needs to be examined in view of collectibility issues. For many of these issues, a provision for doubtful collection is adequate, and consistent with the preponderance of practice today. Departures from the basic model should be rare, and

limited to situations where the uncertainty causes substantial uncertainty whether the assets transferred by the customer to the entity will be converted to cash. In some cases, it may be done on a transaction basis, as with FAS 66 for real estate sales. Other cases may be more judgmental based on the nature of the transaction or the customer.

The Boards should evaluate this issue further. In addition, it is necessary to consider whether the issue is whether the transaction price should be adjusted, or recognition of the entire transaction deferred because the “sale” may be nothing more than an option. We believe that if collectibility issues are severe, the transaction price should not be adjusted, but the “sale” treated as executory, in effect, an option.

Potential effect on accounting for inventory in the absence of an option, paragraphs 6.15 and 6.16

The Boards should reject inclusion in revenue increases in the value of goods produced, such as agricultural products and real estate. These are fair value measurements, and if it desirable to permit or require them, the revaluations from cost should be excluded from revenue and net income, and included in Other Comprehensive Income.

Potential effect on accounting for inventory under contract, paragraphs 6.17 through 6.21

As stated above, we believe the Boards should exclude contracts currently covered by SOP 81-1. They have not followed the “delivery” model required in most other revenue recognition rules, and the scope of SOP 81-1 is well understood, and there is no call, or apparent need, for elimination.

Revenue recognition as construction progresses has been a recognized exception to conventional revenue recognition principles, and has been in the U.S. accounting standards since at least as far back as 1942. The basic reason for its use is to achieve a better measure of periodic income results than would be achieved under other methods that required delivery. The accounting standards for construction contracts have evolved over the years, always around a basic principle of revenue recognition as construction progresses. The last major accounting standard was SOP 81-1 issued in 1981; it is a very robust standard and has been well accepted in practice.

The Boards state in paragraph 6.20 that the proposed contract-based revenue recognition principle is consistent with the basis for recognizing revenue in SOP 81-1, and cites paragraph 22 of SOP 81-1. The Boards’ statement is simply not true.

While a transfer of title to work-in-progress may occur, and does occur in many contracts, it is not a requirement to the use of percentage of completion accounting under SOP 81-1. SOP 81-1, in paragraph 23, only requires that contracts normally include provisions that clearly specify the enforceable rights regarding goods and services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement, and that the buyer and the contractor can be expected to satisfy their obligations under the contract. Passage of ownership to the buyer is not a criterion.

Further, revenue recognized under various methods of calculating the percentage-of-completion may differ from revenue based on the cost-based work-in-progress as proposed by the Boards if the contractor has segmented the contract, is using measurement of progress toward completion inputs other than cost, or output measures based on units

produced, contract milestones or value added. Thus, even for contracts where the entity's construction activities continuously transfer assets to a customer, there would be a significant change in practice under the Boards' proposal.

While we agree that for most sales of goods or services, revenue should reflect the transfer of the promised goods and services to the customer because that is a meaningful and objective point, it is not the only way to satisfy a performance obligation, and SOP 81-1 provided another accounting model to deal with a unique class of transactions and should be retained.

Sales incentives, paragraphs 6.30 through 6.33

The analysis in these paragraphs seems to be limited to free or substantially free goods and services. See our response to Question 7, above, where we state that we do not believe they should be accounted for as performance obligations. Also, it is unclear whether the Boards see a change from current practice for discounted goods or services where the seller will still recognize a positive gross margin at the discounted price.

Segmentation of a construction contract, paragraphs 6.34 and 6.35

See our comment above on the potential effect on accounting for inventory under contract. While we agree with the Boards' analysis in paragraphs 6.34 and 6.35, we believe the Boards should exclude contracts currently covered by SOP 81-1.

Use of estimates, paragraphs 6.36 through 6.42

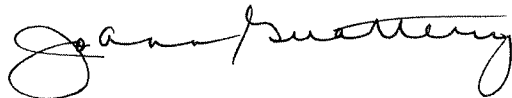
We agree with the Boards' analysis, and believe the use of estimates will be an improvement over current U.S. GAAP.

Example 3: Sale of a good with a warranty

Paragraph A23 of this example raises a question that may not have been considered by the Boards: how is the obligation to provide warranty service satisfied? The example says revenue is recognized continuously during 20X1. This implies a straight-line amortization. However, the obligation is satisfied only as the warranty services are provided, so the revenue should only be recorded as the service is provided, and, further, it may be necessary to increase or decrease the obligation based on actual vs. estimated warranty claims.

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Very truly yours,

A handwritten signature in black ink, appearing to read "JoAnn Guattery". The signature is written in a cursive style with a large initial "J" and "G".

JoAnn Guattery, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants