

October 11, 2010
Technical Director
Financial Accounting Standards Board
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Re: Exposure Draft: Revenue Recognition (Topic 605) *Revenue from 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 the proposed accounting standard update.

The AP&AS Committee is the senior technical committee of the 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.

Following are the Committee’s responses to the ED for your consideration.

The Committee applauds the efforts of the Boards in this comprehensive and complex project. The Committee agrees with the basic framework proposed by the Boards. However, the Committee believes a departure from the “conceptual purity” that the Boards tried to maintain is warranted in accounting for sales incentives and for warranties, and clarification is needed in the accounting for contracts under which there is a continuous transfer of goods or services. This is further discussed below.

Recognition of revenue (paragraphs 8–33)

Paragraph 11 states that a contract does not exist for the purpose of applying the proposed guidance if either party can terminate a wholly unperformed contract without penalty. The Committee questions this aspect of the definition of a contract. In a single contract document, there may be portions that cannot be cancelled without penalty, and portions that can be cancelled without penalty. The Committee suggests the exclusion be limited to the unperformed portion of a contract, rather than the entire contract.

Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

The Committee agrees with the proposed principle.

The Committee suggests an additional indicator of interdependence in paragraph 13: “payment of individual contracts is dependent on performance of all of the contracts”

Paragraph 20 is overly dependent on the Implementation Guidance in conveying the types of performance obligations that should be considered, and it would be helpful to include the contents of paragraph IG4 immediately after paragraph 20.

Question 2: The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

The Committee agrees with the proposed principle.

Question 3: Do you think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

The Committee agrees with the proposed guidance and does not propose any additional guidance. However, it believes the application of transfer of control when there is a continuous transfer of goods or services discussed in paragraphs 32 and 33 needs clarification in situations where the rights and obligation of the buyer and seller are set forth in a contract.

In the Committee’s view, 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 control the subject of the contract while under production. Changes generally require joint resolution by the parties. Transfer of physical control and/ or 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. Thus, the ability of the customer to direct the use of, and receive the benefit from, the good or service (paragraph 26) is generally defined in the contract and met by the seller’s performance under the contract. The wording in the proposed standard seems to accommodate the Committee’s view. We recommend that the Committee’s view be included in implementation guidance, and replace the implementation guidance in paragraphs IG64 and IG65.

The implementation guidance at IG64, IG65 and IG66 and Example 15, Scenario 2 define “control” in a manner that is narrower than the requirements of paragraphs 25 through 31 of the

proposed standard. It points to an ability of the customer to direct the use of, and receive benefit from, the work in process as the basis for the seller to recognize revenue; those words are from paragraph 26. However, paragraph 30 of the proposed standard provides guidance on how paragraph 26 is to be interpreted, and IG65 and IG65 ignore paragraph 30, and come to an incorrect conclusion. The customer's ability to direct the use of, and receive benefit from, the work in process is basically the ability to require the seller to complete the contract; the implication that it is more than that, and is somehow physical use of the work in progress, simply ignores the reality of construction-type and production-type contracts.

Example 15, Scenario 2, point out as factors indicating the customer does not obtain control factors such as lack of involvement in design, lack of managerial involvement throughout the contract, and not taking possession before delivery; these are not necessarily relevant or conclusive under paragraph 30 of the proposed standard, and their use in the example could well lead to users to place excessive reliance on those factors and reach incorrect conclusions. The Committee believes that the seller's ability to sell the equipment to another customer is a single factor that by itself conclusively indicates that the customer has not obtained control, so it does not disagree with the conclusion in the example. However, because the example can be misinterpreted, the Committee suggests the example be deleted, or if not deleted, clarified to make the discussion consistent with the proposed standard.

Example 11 at paragraph IG43 should be clarified. The Committee does not take exception to how the contract is segmented in the example; the Committee believes it would be useful to point out that revenue should be recognized as performance obligations are satisfied under one of the methods specified in paragraph 33.

Measurement of revenue (paragraphs 34–53)

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price. Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

The Committee agrees with the Boards' proposal. It has several questions and comments which may serve to clarify the proposal:

- Paragraph 38 may impose too high a hurdle in a situation where the entity or other entities has no experience, but the transaction price is fixed and there is no uncertainty as to collectability. This could happen with a newly invented and revolutionary product or service.
- Does the reference in paragraph 40 to the "above factors" refer to paragraph 39, or to both paragraphs 38 and 39. We believe it should clearly refer to both, which would accommodate the preceding situation.

Question 5: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

The Committee was evenly split on this issue. Some of the Committee agrees with the Boards' proposal. Others believe that the amount recorded as a sale is a matter of what is in the contract, and the credit risk should be accounted for as a separate cost of doing business; also, the Boards' proposal would be hard to implement and the result not sufficiently objective to audit reliably.

Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

The Committee agrees with the Boards' proposal.

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

The Committee agrees with the Boards' proposal.

However, the Committee does 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.

Contract costs (paragraphs 57–63)

Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, *Intangible Assets*), an entity should recognize an asset only if those costs meet specified criteria. Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

The Committee disagrees with the Boards' proposal with respect to costs of obtaining a contract. The Committee believes that costs of obtaining a contract should be accounted for as an asset if they result in the successful acquisition of a contract.

The Committee notes the inconsistency between the accounting proposed for precontract costs and the accounting for similar costs in other industries such as insurance and financing. It sees little conceptual differences between the transactions giving rise to the costs, and suggests the

Boards seek consistent accounting for similar costs, regardless of the industry, and that those costs be capitalized on a “successful efforts” basis.

Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation. Do you agree with the costs specified? If not, what costs would you include or exclude and why?

The Committee agrees with the Boards’ proposal, except that precontract costs should be capitalized on a successful efforts basis; please refer to response to Question 8.

Disclosure (paragraphs 69–83)

Question 10: The objective of the Boards’ proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

The Committee believes that the totality of the proposed disclosure requirements go far beyond what is appropriate for general purpose financial statements. Users of financial statements of non-public entities seldom need the information, and if they do want it, can usually get it on request. They might be of use in larger public entities, but the disclosures proposed, on top of what is already required by other standards, will aggravate the overload in footnotes that render financial statements of those entities unreadable to any but the most sophisticated accountant, and beyond the comprehension of many sophisticated investors.

The Committee recommends that disclosures beyond what is currently required be required only as supplemental information for large public entities.

Question 11: The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

While the information might be useful for users of financial statements of entities affected, the Committee reiterates the concerns and recommendation made in response to Question 10.

Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

See the Committee’s response to Question 10. This disclosure should be limited to entities required to report segment data.

Effective date and transition (paragraphs 84 and 85)

Question 13: Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

The Committee does not object to retrospective application.

Implementation guidance (paragraphs IG1–IG96)

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

The Committee finds the Implementation Guidance to be helpful in making the proposals operational. However, it recommends the following corrections or clarifications:

- IG2, Example 1: It is unclear why Product A and Product B are not accounted for as separate contracts. Each appears to be a separate deliverable, and the transaction price can be allocated pursuant to paragraphs 50 through 52.
- IG13 through IG 17, and Example 4 all deal with warranty claims that are satisfied by an exchange of the product sold, but do not deal with warranty claims for which the customer has no right to return the product, but only to have it repaired. As stated below in the response to Question 15, if the customer has only the right to have the product repaired, the seller should accrue the cost of repairs at the time of sale, but should not defer any revenue.

It is unclear why Example 4 described the warranty as not being a performance obligation, when the accounting it describes has revenue deferred related to future performance, i.e., the delivery of replacement products.

- IG34 and IG39: Licensing and rights to use: The Committee disagrees with the conclusions in the examples; see response to Question 16 below.
- IG43 and Example 11: See the Committee's comment on Question 3.
- IG52 and Example 14: A 50% probability that the asset will be returned might properly cause some to question whether revenue should be recognized at all under paragraphs 38 through 41. The Committee suggests use of a lower probability of return.
- IG63 through IG66 and Example 15, Scenario 2: See the Committee's comment on Question 3.
- IG87 and Examples 26 and 26: As stated above, the Committee believes that programs such as these should not 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.

Question 15: The Boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

The Committee finds the proposed approach useful, but that it finds that the Boards' proposal on warranties is complex and confusing. The Committee believes that quality assurance warranties (i.e., coverage for latent defects) under which a product can only be repaired and not returned for exchange or refund should not be accounted for as a performance obligation. However, it is unclear from the text and examples how the Boards intend these to be accounted for. The Committee believes it is simply a future cost to be accrued at the time of sale. Manufacturers do not view quality assurance warranty service as a profit generating activity, but a cost of the product sold, and they have the obligation to incur that cost.

In simple terms, the warranty is either a right to receive a repair only, or a right to exchange the product for another one without a defect; the former should give rise to a cost accrual for the repair, the latter to a revenue deferral for the right of return, which is a performance obligation. For example, defects in automobiles are repaired (excluding infrequent returns under "lemon laws"), but small consumer appliances that have defects are usually exchanged for one that is not defective.

A warranty covering faults that arise after the product is transferred to the customer does give rise to a performance obligation. The Committee is unsure how this obligation can be separated from a warranty for latent defects, particularly if the seller does not, or cannot, distinguish whether the defect was latent or arose after the sale transaction. An example might be useful.

Question 16: The Boards propose the following if a license is not considered to be a sale of intellectual property:

- (a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and
- (b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

The Committee does not agree with the Boards' proposal. The Committee fails to see a basis for different accounting based on whether the non-controlling rights granted are exclusive or non-exclusive. The seller's obligation is the same in both instances: to transfer rights to use. And, in both cases, it has the continuing obligation to provide peaceful use of the license and usually to protect the user from those who might infringe on such peaceful use; but, under IG38, that is not a performance obligation. So, as to the rights granted, the seller has no obligation to the buyer as to those rights once they have been transferred, whether the rights are exclusive or non-exclusive, and so the Committee believes revenue should be recorded at the time of transfer in both cases.

Consequential amendments

Question 17: The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

The Committee agrees with the Boards' proposal.

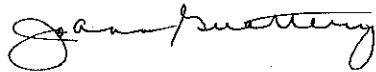
Nonpublic entities

Question 18: Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Yes. Please refer to the Committee's responses to Questions 10, 11 and 12.

We would be glad to discuss our comments further should you have any questions or require additional information.

Very truly yours,



JoAnn Guattery, Chair
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