

Private Company Financial Reporting Committee

401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116
e-mail: jhodell@fasb.org

203-956-5218
Fax: 203-849-9714



JUDITH H. O'DELL
Chair

June 30, 2009

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: Revenue Recognition Preliminary Views

Dear Mr. Herz:

The Private Company Financial Reporting Committee (“PCFRC” or “committee”) offers its recommendations and comments below on the FASB’s Preliminary Views, *Revenue Recognition*. In addition to drawing upon the experience and knowledge of its own members, the PCFRC reached out to its Resource Group and key organizations about the Preliminary Views. In particular the committee discussed the FASB’s proposed revenue recognition standard with representatives from the Construction Financial Management Association (“CFMA”) and the Associated General Contractors of America (“AGC”). Their viewpoints were especially valuable given that the proposals in the Preliminary Views would significantly affect the accounting for long-term construction contracts and that the vast majority of construction contractors are private companies.

Key Points

The PCFRC’s key comments relate to how the proposed revenue recognition standard will affect the accounting for long-term contracts.

- Private company financial statement users, including lenders and sureties, have the following concerns:
 - The proposed guidance in the Preliminary Views will cause existing revenue recognition patterns to change unnecessarily, which will needlessly impair comparability and analysis. Additionally, the proposed guidance appears capable of creating diversity in application, further impairing comparability.
 - Lacking the current body of long-term contract accounting literature, the proposed revenue recognition principles could make the

manipulation and structuring of long-term contracts easier, as part of efforts to understate or overstate revenue, and could lead to abuse. For example, users are more comfortable working with a long-term contract that utilizes one gross profit margin throughout the term of the contract (as currently done) and less comfortable working with a contract that may have more than one gross profit margin applied to different phases of the contract (as may be done under the proposed model).

- The decision-usefulness of financial information may be weakened if the current percentage-of-completion based accounting model is replaced by the proposals in the Preliminary Views. Allowing different gross profit percentages for various performance obligations in a contract, combined with the fact that one does not adjust for changes in cost estimates unless a contract is deemed “onerous” will result in users not being able to estimate the remaining cost to complete a contract and related revenue to be recognized.
- The proposed revenue recognition guidance in the Preliminary Views has generated considerable concern within the construction industry. The PCFRC refers you to the comment letters issued by CFMA and AGC. Their letters commendably articulate the concerns of private company construction contractors and the issues they will face under the proposed revenue recognition guidance. Many years of work by standard setters and the accounting profession have crafted the existing standards and guidance on accounting for construction contracts. This existing literature is well-known and understood by private company financial statement users, preparers, and CPA practitioners. Although existing guidance needs to be updated to address developments within the construction industry, it generates a high level of consistent financial reporting and generally reflects the underlying economics relating to the complicated and dynamic nature of contracts often found in the construction industry. The Preliminary Views does not appear to provide an adequate level of guidance to deal with the complexities inherent in accounting for construction contracts and other long-term contracts. As such, the PCFRC recommends that the FASB carefully consider the need to provide additional guidance on accounting for long-term contracts with differing characteristics and performance obligations.
- Some of the examples in the Preliminary Views, especially those related to construction contracts, are too simplistic and do not reflect the complex and dynamic reality of long-term contracts. The PCRFC recommends that the FASB utilize real-life, practical examples of long-term contracts that private companies encounter in the construction industry and other industries and apply the proposed revenue recognition model to those

examples. In doing so, the FASB will be better able to determine whether the proposed model is operational and effective at handling the unique aspects of recognizing revenue on long-term contracts. Applying the proposed model to real-life examples will also indicate whether the proposed guidance is effective at generating consistent financial information that is decision useful for private company users.

- Private companies involved with long-term contracts will face major difficulties and challenges in applying the concepts of transferring control, the continuous transfer of control, and identifying separate performance obligations. These concepts are in need of significant clarification and development

Specific Responses to Questions Asked in the Preliminary Views

Q1) 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?

The PCFRC believes that a single contract-based principle is a good starting point in addressing revenue recognition, but a number of “what-ifs” and issues arise beyond that starting point. The Committee cannot definitively answer this question until questions and concerns about long-term contract accounting, such as the definition and applicability of the concepts of control, continuously transferring control, and identifying separate performance obligations, are resolved. The PCFRC recommends that the FASB apply the proposed revenue recognition model to real-life, practical examples of long-term contracts that exist in the private company sector. Such an exercise will provide a useful analysis of how operational the proposed model will be and how relevant and informative the financial information on revenue recognition will be to private company financial reporting users. The PCFRC also refers the FASB to the comment letter developed by CFMA, which captures the concerns of the construction industry well.

Nevertheless, the creation of an overarching single document about revenue recognition, that would eliminate the myriad number of standards and guidance currently existing, may prove to be a positive outcome of this project. The contract based approach is logical and may be operational with the addition of significantly improved guidance about long-term contract accounting and the areas referred to above. However, some PCFRC members caution that the complicated nature of revenue recognition across many varied industries may necessitate the sizeable amount of revenue recognition guidance that currently exists. PCFRC members are concerned about whether users of private company financial statements will accept one overarching revenue recognition

standard and an absence of specific industry guidance. The Preliminary Views notes possible scope exceptions for areas such as insurance contracts and financial instruments. The PCFRC encourages the FASB to explore the advisability of these scope exceptions as well as others, such as accounting for construction contracts.

The simplifying assumptions in the proposed model are a positive development in some cases as is convergence with the IASB on this key accounting subject. However, the simplifying assumptions may not prove to be an improvement in industries where long-term contracts are prevalent, like construction and manufacturing.

The proposals in the Discussion Paper appear to represent a major improvement to the financial accounting and reporting for multi-element service contracts. The current ratable approach to accounting and reporting for those contracts can fail to capture the economic reality of the arrangements in some cases. The proposed revenue recognition model would remedy that situation. As such, the proposed model will prove to be a positive development for the software industry and other service areas, with the exception of the proposed accounting for statutory/implied warranties (see the PCFRC's answer to question number 4).

Q2) 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?

The PCFRC is concerned and unclear about the accounting for long-term construction contracts and the loss of the percentage-of-completion method under the proposed model. Much of this concern and lack of clarity is related to the concept of transferring control of an asset to a customer and identifying separate performance obligations. The economics of these long-term arrangements generally indicate a continuous transfer of assets.

The construction contract examples in the Preliminary Views are too simplistic compared to the complicated and dynamic real-life long-term contracts that are common in the construction industry and other industries. Private company constituents working with long-term contracts will find it challenging to comprehend the concept of transferring control of an asset as enumerated in the Preliminary Views. For example, construction companies incur costs as assets are added to a job. These assets may not be on the project site or in the customer's possession. Determining when control is transferred may prove difficult and may lead to inconsistent financial reporting within an industry, without clearer guidelines. See the PCFRC's answer to Question 8 below.

Q3) 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.

Yes, the FASB's definition of a contract seems reasonable and operational. However, concern exists in the construction industry that the definition may be incomplete and fail to take into account items such as change orders and amendments to the original contract.

Q4) 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.

The proposed accounting for warranties appears problematical. The approach proposed in the model for accounting for statutory/implied warranties may be too onerous and create unnecessary bookkeeping expense for private companies. The PCFRC believes that purchased warranties are different from statutory/implied warranties. As a practical expedient then, the PCFRC suggests that the FASB consider the merits of only identifying a separate performance obligation for purchased warranties and treating statutory/implied warranties as expenses.

Also, the proposed definition of a performance obligation is not sufficient in helping to identify separate performance obligations and identifying when control transfers in long-term contract accounting.

Q5) 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?

Separating performance obligations in a contract on the basis of when an entity transfers the promised assets to the customer appears to be the correct approach. However the concept of transferring control of an asset, as discussed in the Preliminary Views, is problematical. In cases involving long-term contracts (such as manufacturing and construction), the proposed approach may often be impractical and not provide decision-useful information to private company financial statement users.

Currently when a private company is accounting for a long-term contract, the entity develops an original estimate of the gross profit on the contract and updates it during the term of the contract. The entity assesses the performance of the contract in its entirety and does not examine it in a component-by-

component manner. Having an entity assess their gross profit on individual components such as mobilization, engineering, electrical, plumbing and many other areas would not be practical or operational. As such, the proposed separation of performance obligations needs to be simplified. Private companies involved with long-term contracts do not tend to break out the various components of the contract in the way that the proposed model would require to recognize revenue. An over-stratification of gross profit margins based on a separation of performance obligations would only place a burden on private companies without providing any benefit to financial statement users.

Q6) 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?

The proposed accounting for rights of return seems problematical. The PCFRC believes that rights of return are part of the cost of doing business and the current approach to accounting for them works effectively in the private company sector. A return is the unwinding of a sale. Considering return obligations to be performance obligations would add unnecessary complexity, especially considering the possible difficulty in measuring a performance obligation associated with a right of return. Moreover, the proposed guidance would not provide any significant benefit to the users of private company financial statements. For example, lenders often build in a "dilution" factor when working with a customer engaged in a business that has the possibility of significant returns. As such the lender is taking into consideration the possibility of returns and the proposed change in accounting for returns would not offer additional useful information to the lender.

► Q7) 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?

The PCFRC views discounts as different from free goods and services and customer loyalty programs. Discounts reduce revenue. In considering discounts on future sales, the PCFRC had differing opinions. For example, grocery stores often grant a coupon to a customer at the point of sale that entitles that customer to a certain dollar amount off on his or her next purchase. The PCFRC could not agree on whether this represented a performance obligation. The FASB should consider utilizing the series of existing EITF guidance on sales incentives, which seems to address the accounting for sales incentives well.

► Q8) 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.

The definition and discussion of control in the Preliminary Views is in need of further clarification and development. This includes the idea of continuously transferring control. The Preliminary Views is unclear about whether a company needs to identify milestones or events that signify the transfer of control to a customer. The PCFRC has reservations about whether the control concept, as enumerated in the Preliminary Views, can be operational in certain areas of the private company sector and how it would apply to transactions involving construction, the development of intellectual property, design engineering, upgrading and maintaining software, providing attorney services, auditing services, and marketing services, among other transactions.

When providing services, one may assume that there is a continual transfer of control to the customer, which facilitates the recognition of revenue under the proposed model. However the concept of continuous transfer of control is not as clear when accounting for long term contracts..

Below are some examples of the problematical nature of the Preliminary View's concept of control in the private company sector:

1. A company is in the preliminary design phase of a project. The company has a meeting with its customer at which time the customer accepts the design and instructs the company to proceed with the next phase. Has the customer taken control of an asset at that point?
2. A company signs an eighteen month design and build contract and receives specifications from the customer. The company incurs cost in designing a working engineering model. At that point nothing has been transferred to the customer. Currently, the company uses the percentage-of-completion method and receives milestone payments from the customer. Under the proposed model, revenue recognition for this design and build contract would change creating a "saw-tooth" effect on revenue in the company's financial statements. This would lead to issues with lenders and related loan covenants. In addition, if the company has a profit-sharing plan, the ability to tie employees' productivity on a contract to the related revenue stream would be lost under the proposed model.
3. In the case of a customer purchasing a software update, does control transfer when the customer receives the right to download the software or when the customer actually downloads the software? In some cases, a company may not be able to determine if a customer has downloaded the software.
4. A company sells a software license with a subscription and support services. At the time of the sale, the company planned on releasing one

- more version of the software during the subscription period. Based on the proposed model, the company would allocate a value to each of the three elements (or maybe two elements depending on one's point of view). Under the proposed model, revenue for the initial delivery of code would be recognized and the revenue for subscription and support services would be spread out over the contract period as in SOP 97-2 based upon assessment of the performance obligation each month.
- a. What would happen, if subsequent to the sale, the company decided not to release the additional version during the subscription period? Would the company accelerate the revenue and recognize that portion immediately for that period's financial statement?
 - b. What would happen, if after the release of the financial statements, the company decided to release the new version of the software and grandfather the customers that were left out? Is this a change in accounting estimate or a change in accounting policy? Does the company restate its financial statements or not?
5. How would the model apply to a contract in which the buyer is obligated to pay for work performed and therefore owns certain aspects of the work but doesn't necessarily control it?
 6. In the case of a construction contract in which the customer, although having the right to cancel a contract, is responsible for payment of costs incurred by a company to date plus a profit margin, when is the company allowed to recognize revenue in those cases, even though the asset has not transferred to the customer? Currently, as a company incurs cost, it recognizes revenue yet no control has passed. Even though it may be 14 months before a project is finished, should a company recognize revenue under the proposed model before then because they are entitled to payment for their costs plus a profit margin? If not, is economic reality properly reflected?

Recognizing revenue based on the concept of control as outlined in the Preliminary Views could have a profound effect on certain private companies' financial statements, and on the analytical processes of the users of those financial statements. Moreover, financial ratios could change a great deal and could vacillate from year to year as a result of the proposed revenue recognition model. This would be an important issue because licensing requirements in many states are partially based on financial ratios as are loan covenants.

Q9) 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.

Significantly more clarification and guidance is needed on how and when performance obligations are satisfied, and how and when control is transferred to a customer. In the absence of that clarification and guidance, private company constituents will encounter problems with the proposed model. The FASB may find it useful to consider whether different revenue recognition models are required for products and services.

Q10) 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?

(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?

(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.

(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

Q10 (a) - Yes. This is operational, and well understood by private company financial statement preparers and users.

Q10 (b) - Yes. To not remeasure the performance obligation when deemed onerous would fail to recognize the true economics of the changing circumstances that caused the performance obligation to become onerous.

Q10 (c) – Yes, the proposed model may not be appropriate for financial service/insurance contracts and long-term contracts like construction contracts.

Q10(d) – Given the nature of long-term contracts, remeasurement should be permitted for reasons other than when a performance obligation is deemed onerous. Long-term contracts often undergo positive and negative changes throughout their term due to changes in estimated profitability, cost trends, change orders, and other reasons.

► **Q11)** *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?

(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.

Q11 (a) – The PFRC believes that including the amounts that an entity charges a customer to recover the costs of obtaining a contract in the initial measurement of the entity's performance obligation depends upon the circumstances and further study and clarification by the FASB is needed in this area. The PCFRC refers the FASB to the CFMA's comment addressing this question.

Q11 (b) – The PCFRC believes that contract origination costs should only be capitalized if they qualify for capitalization under other existing GAAP.

Q12) 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?

Generally yes, but see the concerns expressed in the answer to question 13.

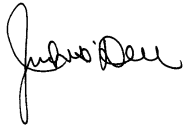
► **Q13)** *Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?*

Yes, but in some cases and industries, especially those involving long-term contracts, a reasonable basis to estimate a standalone selling price may not be available. As such, estimating a standalone selling price may not be operational for certain long-term contracts depending upon the circumstances. As noted in the CFMA comment on this question, the percentage-of-completion method, utilizing a cost-to-cost approach, may be the more operational model for the construction industry.

Private Company Financial Reporting Committee
Comment Letter – Revenue Recognition Preliminary Views

The PCFRC appreciates the FASB's consideration of these comments and recommendations. As we receive additional input from our constituents, we will work with that information and provide the FASB with additional feedback, as appropriate. Please feel free to contact me if you have any questions or comments.

Sincerely,

A handwritten signature in black ink, appearing to read "Judith H. O'Dell". The signature is fluid and cursive, with a prominent loop at the end.

Judith H. O'Dell
Chair
Private Company Financial Reporting Committee