

October 22, 2010

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Re: Comment Letter on Revenue from Contracts with Customers

Dear Sir David and Ms. Seidman,

The CFA Institute,¹ in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the joint Exposure Draft (“ED”): International Accounting Standards Board’s (“IASB”) Exposure Draft (“IASB Exposure Draft” or “IASB ED”), *Revenue from Contracts with Customers* and Financial Accounting Standards Board’s (“FASB”) Proposed Accounting Standards Update, *Revenue from Contracts with Customers (Topic 605)*, (“FASB Proposed Update” or “FASB Update”). The IASB and FASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

¹ With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

IMPORTANCE OF IMPROVED REVENUE RECOGNITION PRINCIPLES TO INVESTORS

Reported revenue is one of the most important metrics for investors for the following reasons:

- It is the starting point of financial analysis of a firm and is used to generate earnings forecasts, make future cash flow estimates and perform valuations for the purpose of making investment decisions.
- It is used in valuation models for certain industries, usually for companies that are growing rapidly but are not yet profitable.
- It has been a primary source of restatements and earnings management. These restatements have had an adverse impact on investor confidence.

The following reasons support the need for an improvement in the revenue recognition requirements in existing U.S. Generally Accepted Accounting Standards (“U.S. GAAP”) and International Financial Reporting Standards (“IFRS”):

- The FASB’s Conceptual Framework states that revenues must be earned and realized/realizable (i.e. the earnings process³) and revenue is defined in terms of changes in assets and liabilities that arise from activities with customers. FASB Statement of Financial Accounting Concepts No.5 (“SFAC #5”), *Recognition and Measurement in Financial Statements of Business Enterprises*, with the FASB’s Conceptual Framework defines revenues in terms of the earnings process and SFAC #6, *Elements of Financial Statements*, defines revenues in terms of assets and liabilities. However, the FASB’s Conceptual Framework fails to adequately and precisely define the criteria for determining the earnings process⁴ and thereafter linking it to the definition of assets and liabilities.
- A noted shortcoming of relying on the earnings process as a primary determinant when recognizing revenue is that it has resulted in the proliferation of industry and transaction specific literature under U.S. GAAP. There are 100+ U.S. GAAP related pieces of literature addressing revenue recognition. The variation of accounting approaches across industries arises because an entity’s earning process is dictated by its business model and, as noted above, there is no precise definition of an earnings process. Hence, revenue recognition is inconsistent and widely divergent across industries (e.g. software, film, casino, airlines and construction) and across transactions (e.g. leasing, intellectual property, insurance, and financial instrument transactions). The ongoing emergence of new and complex business models is further likely to result in new earnings processes and, thereafter, the need for another set of bespoke revenue recognition requirements. In this vein, the current revenue

³ FASB Statement of Financial Accounting Concepts No. 5 states that the earnings process is complete, and revenue is recognized, when the selling firm has provided the goods or services and the buying party has accepted the goods or services and agreed to pay. Further substantiating the application of this principle, the SEC Staff Accounting Bulletin (SAB) 104, states that the SEC staff believes that revenue is generally realized or realizable and earned when all of the following criteria are met: 1) persuasive evidence of an arrangement exists; 2) delivery has occurred or services have been rendered; 3) the seller’s price to the buyer is fixed or determinable; and 4) collectability is reasonably assured. (i.e. These four criteria were first discussed in SFAC # 5).

⁴ Schipper.K., Schrand.C., Shelvin.T, and Wilks.T; *Reconsidering Revenue Recognition*; Accounting Horizons; 2009, Vol.23, No.1, pp 55-68.

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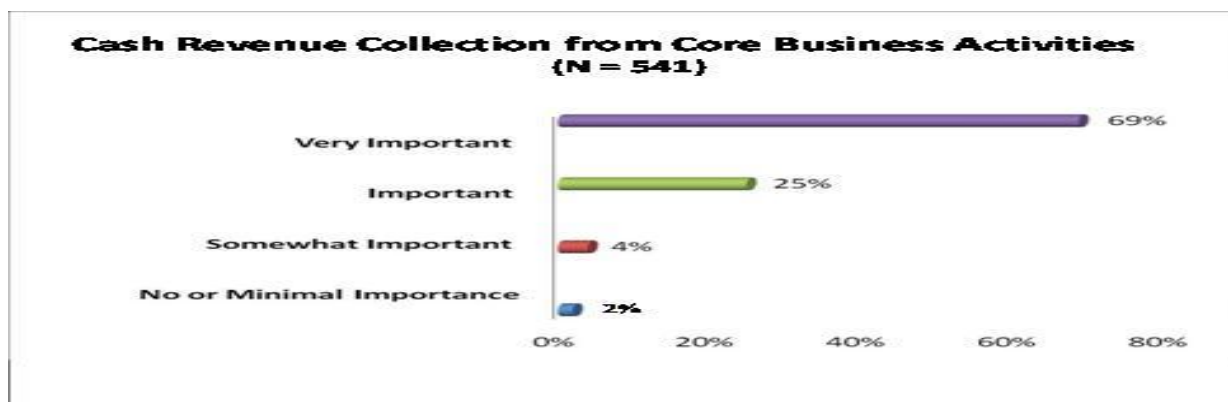
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recognition approach contributes to the complexity, inconsistency and limited comparability of reported performance across industries.

- Under IFRS, there are conceptual inconsistencies and vagueness in the requirements across its very limited (i.e. two) revenue recognition standards (IAS 18, *Revenue*, and IAS 11, *Construction Contracts*) and four interpretative releases (IFRIC 13, *Customer Loyalty Programs*; IFRIC 15, *Agreements for the Construction of Real Estate*; IFRIC 18, *Transfers of Assets from Customers*, and SIC 31, *Revenue-Barter Transactions Involving Advertising Services*). Further, IFRS standards do not adequately deal with separation of deliverables and allocation of revenues in multiple element arrangements and linkage of two or more contracts with a customer among other elements of revenue recognition. IAS 11 focuses on whether the different parts of a contract have been negotiated separately but IAS 18 is largely silent on when and how to sub-divide contracts for revenue recognition purposes.
- Under both U.S. GAAP and IFRS there are inadequate, highly aggregated disclosures and poor presentation of revenue information. The reported revenue amount, which is a highly important performance measure, typically tends to have the least informative accompanying disclosures.
- Under both U.S. GAAP and IFRS there is little guidance for service activities, financial instruments, and intellectual property transactions, despite the increasing importance of these industries given their being among the fastest growing sectors in major economies.

Overall, an enhanced revenue recognition standard would facilitate the convergence of U.S. GAAP and IFRS by providing investors with a more comprehensive revenue recognition model that includes robust disclosures regarding an entity's earnings activities. It is of utmost importance to investors to be able to see how revenue recognition connects with the cash collection activities of the organization and, as we describe later, the direct cash flow method should be an integral part of the presentation of financial information. The ability of an organization to convert its revenue recognition activities to cash, and for investors to see this occur, is essential to the valuation of the enterprise. In our July 2009 Cash Flow Survey we asked members to rate the importance of certain key cash flow measures. From the chart below you can see that 94% of the 541 respondents believe obtaining cash flows related to revenue as either important or very important:



GENERAL COMMENTS

Background and Context to Our Comments

As noted in the previous section, investors are best served when: (1) reported earnings reflect the pattern of wealth creation; and (2) reported revenues (and accompanying disclosures) are useful for making forecasts of future revenues, cash flows, earnings, etc. **Hence, the primary question for investors related to this ED is to what extent does this proposed model strengthen or weaken the association between reported revenues and the pattern of economic wealth creation manifested by realized future generated free cash flows.**

Need for Development of the Underlying Conceptual Framework

Despite the espoused objective of laying a conceptual foundation that can allow the consistent accounting of economically similar transactions across different industries, we do not believe that the purported objectives of this project can be fully attained in the absence of a more robust Conceptual Framework related to the recognition and measurement of assets, liabilities and revenue for both U.S. GAAP and IFRS. Because of the lack of Conceptual Framework, there is the risk that this revenue recognition model will simply compound the extant complexity and inconsistency in the methods of recognition and measurement of assets and liabilities because of limitations in scope and inconsistencies with other projects currently under consideration by the Boards.

Scope

The exclusion from scope and separate treatment of items such as executory contracts, insurance contracts, mining, biological, agricultural assets, financial instruments and lessors, makes it more difficult to achieve a conceptually robust model and limits the extent to which this model can be seen by investors as a universal model. The exclusion of the aforementioned items is unfortunate, because many of the performance obligations and contractual assets and liabilities resulting from transactions in the excluded items have characteristics in common with included industries and transactions.

Cross Cutting Issues with Other Projects Currently Under Development

These risks associated with complexity and inconsistency are compounded by the fact that the Boards have significant projects underway on most of the excluded items and the exclusions will result in incomplete accounting standards in critical industries and or contract types that are growing in importance. Examples include executory contracts, insurance, and both tangible and intellectual property lessor arrangements. It is important for the Boards to promulgate asset and liability recognition and measurement standards for insurance contracts and lessors that are consistent with this revenue recognition ED.

Need For Application or Implementation Guidance Addressing Real World Complexities and Certain Key Industry Issues

We realize and support the imperative of having a converged revenue recognition standard by 2011; however, we believe the proposed standard still requires further development, especially as far as delineating impacts on various industries. We view this project as a first step towards the purported goal of creating a unified revenue recognition framework and expect that the Boards will have to further develop revenue recognition principles in a fashion that will result in consistency in accounting across all type of contracts.

We do not believe that the ED has fully addressed all the areas of improvement that are necessary to inform investors about the effects – improvements and not just changes – that the proposed approach will have on revenue recognition, and correspondingly valuation. The ED provides numerous helpful illustrative examples on the application of the conceptual principles of separating and satisfying performance obligation. However, these relatively simple examples do not inform on the anticipated effects of this new model across the key industries, where this approach will likely result in a significant departure from existing revenue recognition patterns. There has been ongoing and extensive commentary questioning the impact of this new approach on a number of key industries⁵ and we anticipate that primary differences will arise in long-duration contracts with multiple elements and industries that deliver bespoke goods or services. We believe the final standard and its basis for conclusions can be significantly strengthened by supplementing the guidance with a substantially more detailed analysis of the nature and characteristics of information that will be available to investors upon implementation of this approach.

Estimates, Judgements, & Subjectivity – Impact on Reliability and Comparability

Unquestionably, existing U.S. GAAP and IFRS related to revenue recognition requires a significant amount of management judgement and subjectivity in arriving at the estimates used to recognize revenue. Our view is, however, that this standard – given the subjectivity and significant level of judgment associated with various building blocks of recognition and measurement of revenue (i.e. identifying contract boundaries; determining and separating distinct performance obligations; evaluating whether control has been transferred to customers; estimating selling prices of standalone performance obligations to allocate transaction price; and estimating variable customer consideration) – requires even greater management judgement. Further, with the removal of industry specific guidance under U.S. GAAP we believe the principles-based nature of the standard increases the subjectivity and may decrease the reliability and comparability of revenue recognition patterns across companies and industries. Further, the ability to utilize profit margins in the identification of separate performance obligations and the ability to utilize estimated selling prices – without reference to market observable evidence – increases, in our estimation, the ability to manage earnings.

⁵ Many raise concerns regarding the need for industry specific guidance in the following industries: a) Construction Industry (i.e. Will percentage of completion continue to be allowed?); b) Telecommunication Industry (i.e. Will revenue be heavily weighted to the front end based on issuance of device?); c) Software Industry (i.e. Will the use of estimated selling price result in front ending of revenues?); d) Pharmaceutical and Life Sciences; e) Engineering and Construction; and f) Entertainment and Media

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Overview and Organization of Our Response

As we articulated previously, reported revenue is one of the most important metrics for investors and a comprehensive standard which results in convergence between U.S. GAAP and IFRS is something that investors unequivocally support, in principle. That said, this ED includes revenue recognition and measurement standards which are very principles-based and involve a great deal of management judgement and estimation – without reference to market based information in many cases – which cause investors to consider whether this ED is an improvement over the significant U.S. GAAP literature that includes more detailed and industry specific guidance. Given the limited guidance in IFRS, this ED would be an improvement over existing IFRS.

The scope of the ED does not include revenue producing activities that are being covered by other projects of the Boards and which are not necessarily coming to consistent conclusions. This lack of consistency highlights the need for an underlying conceptual framework as we described previously. We believe that, for the ED to be operational further application or implementation guidance which considers industry-specific issues needs to be developed and that field testing is essential. Investors, like preparers and auditors, have no appetite for a standard which is likely to result in frequent restatements.

Because of the principles-based nature of the ED and our belief that it will result in increased subjectivity and estimation, we have organized our response to address our views on the disclosure provisions of the ED first as we believe comprehensive disclosures will be essential for management to communicate to investors and other users the nature and extent of the decisions which they have made in arriving at the recognized revenue amounts. The disclosures have not been a substantial focus of discussion by the Boards nor a formal topic of discussion in the roundtables. Our view is that disclosures should not be an afterthought in the creation of this new standard, but an integral part of the creation of the final standard.

In the next section we provide our responses to the IASB's Exposure Draft and the FASB's Proposed Update related to revenue recognition in the following order:

- Disclosures
- Recognition
- Measurement
- Cost Recognition
- Transition & Effective Date
- Application or Implementation Guidance
- Other Matters

The **Appendix** to this letter contains a more detailed explanation of our views on all of these subjects.

Disclosures

As noted previously, disclosures should not be a secondary consideration in the development of this proposed standard. They need to be paramount because of their importance in describing and illustrating the judgements and estimates made by management in arriving at their recognized revenue amounts. Because of this, we provide our comments on disclosures first in the ordering of our response to the questions posed in the ED. We ask that the final standard give disclosures equal prominence to recognition and measurement.

Some may characterise these additional disclosures as burdensome as that they will increase the volume of disclosures. However, none of these disclosures would provide information that falls outside the sphere of the measurement of revenue under the new model and the design of these disclosures is fully cogent with the accounting model. In other words, managers will simply be conveying how they are recognizing, measuring and collecting revenue. If preparers adhere to the spirit of meaningful and comprehensive communication, these revenue disclosures have the capacity to increase user understanding and comfort with the reliability and relevance of reported revenue and operating results.

Revenue reported under the proposed standard would contain both inherent economic and accounting uncertainty and only a robust disclosure regime that complements recognition and measurement, can help investors to assess the association between reported revenues and related cash flows. It is essential that revenue disclosures communicate the relationship between revenue recognition patterns and cash flow collections as these are critical to enterprise valuation.

We believe that reporting cash flows by type of revenue in a direct method statement of cash flows would allow investors to understand the linkage between revenue recognition patterns and cash flow collections. Enterprise valuation requires confirmation that revenue recognized is ultimately converted to cash, and knowledge regarding the timing of the conversion. Our historical advocacy for the direct cash flow method stems from the importance to investors of this need to connect revenue and cash measurements. Under the indirect method, users cannot directly see the connection between revenue and the related cash collection of such revenues. Attempts to estimate direct method cash flows generally prove fruitless given the level of aggregation as well as the impact of foreign currency and business combinations.

The proposed disclosures represent a significant improvement from current revenue disclosures which are highly inadequate under both U.S. GAAP and IFRS. We strongly support all of these proposed disclosures which we believe will significantly enhance transparency regarding revenue recognition practices and help users to link revenues with cash flow patterns. **Our review of the disclosures, however, suggests certain important disclosures have been omitted from the ED – most specifically disclosures regarding the judgements made in the determination of the recognition and measurement of revenue and costs.** In the **Appendix** we provide additional details regarding disclosures which we believe have been omitted from the ED including:

- 1) *Qualitative and Quantitative Information Regarding Significant Judgements & Estimates* – We believe the final standard should include disclosures regarding significant judgements and estimates related to:
 - a. identifying contract boundaries;

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- b. determining and separating distinct performance obligations;
- c. evaluating whether control has been transferred to customers;
- d. estimating selling prices of stand-alone performance obligations to allocate transaction price;
and
- e. estimating variable customer consideration;

as we believe these are essential to understanding the revenue recognition and measurement decisions made by management. In addition to making such qualitative disclosures, we also believe it is important to emphasize that these qualitative disclosures regarding such judgments and estimates should be made in sufficient detail and with sufficient specificity (i.e. not boilerplate disclosures) and quantitative detail that investors and other users can determine how such decisions correlate with the revenue recognition measurements included in the financial statements. We urge the Boards to consider the quality of the disclosures associated with judgments and estimates provided by entities that have early adopted new U.S. GAAP related to multiple-element arrangements and software-enabled devices. We also recommend the Boards consult with the SEC and PCAOB staff regarding their experience with the adoption of these standards and the resulting disclosures.

- 2) *Revenue Measurement* – In the **Appendix**, we set forth additional disclosures regarding measurement of revenues in connection with: variable consideration, credit risk, the time value of money; the use of estimated selling price for measurement of separate performance obligations; changes in transaction price; and onerous performance obligations which we believe are necessary to a full understanding of revenue measurement by investors.
- 3) *Cost Recognition* – The ED excludes disclosure requirements associated with costs recognized as expense or capitalized in accordance with the provisions of the proposed standard. We find this to be a substantial omission in the proposed standard. This exclusion is particularly unfortunate given that several U.S. entities have worked hard to provide comprehensive disclosures explaining their position with respect to cost deferral and subsequent recognition (amortisation) in response to SAB 104 and the growth of the software as a service industry. We believe disclosures related to cost capitalisation; allocation to performance obligations; amortization of costs; and a rollforward/reconciliation of capitalized costs should be included in any final standard.
- 4) *Level of Disaggregation – Disclosure vs. Presentation* – Due to the deferral of the Financial Statement Presentation (FSP) Project, which would have increased the disaggregation of revenue on the income statement, we urge the Boards to include the provisions of Paragraph 74 of the ED within the Presentation section of the ED rather than the Disclosure section of this ED.
- 5) *Performance Obligation vs. Contract Assets & Liabilities* – We do not think the ED adequately articulates the connection between performance obligations and contract assets and contract liabilities. In particular, it is not clear whether a performance obligation (as that term is defined in the ED) always meets the definition of a financial statement element (specifically, a liability). Further, we do not think the ED is clear in describing how a performance obligation is different from a contract liability. While this distinction might be clear to the most technically inclined accountants, we are not convinced that the conceptual nuance will register with users of financial statements. Our ability to evaluate the completeness of the disclosures related to contract balances versus performance obligations is contingent upon greater clarity on this issue.
- 6) *Reconciliation of Contract Balances* – The ED provides for the inclusion of a reconciliation of contract balances. We are fully supportive of the inclusion of such a reconciliation; however, we highlight several issues we observe related to the decision-usefulness of the rollforward in our comments in the **Appendix**.

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- 7) *Other Disclosures* – We provide additional remarks regarding disclosures associated with: the maturity analysis of performance obligations; presentation of information in a tabular format; warranties; and backlogs & unsigned contracts in the **Appendix**.

Presentation

Paragraphs 64 through 68 of the ED describe the boards' proposed presentation of assets and liabilities that arise in contracts with customers. The discussion of the presentation of financial statement elements is limited to the face of the statement of financial position. We note that there is no discussion in the Standard section of the ED that addresses the presentation of revenue on the face of either the statement of comprehensive income or the statement of cash flows. We also note that the boards did not solicit feedback (in their respective Invitations to Comment) on the presentation of information on the face of the financial statements. However, in the light of the boards' joint decision to postpone work on their project to overhaul financial statement presentation we think that it is critical that the boards address in the revenue recognition project the following presentation issues:

- *Presentation of Revenue on the Face of the Statement of Comprehensive Income:* Our comments can be divided into two categories:
 1. disaggregation of revenue; and
 2. display of that disaggregated information on the face of the statement of comprehensive income versus disclosure of it in the notes.

Current practice generally results in the presentation of revenue as a single aggregate number on the face of the statement of comprehensive income. Given the fact that analysts and investors expend considerable effort to understand reported revenue, we think that it is essential that the final revenue recognition standard include a requirement to disaggregate revenue on the face of the statement of comprehensive income by **both** nature and function.

We believe that disclosure is not a substitute for the presentation of information on the face of the financial statements and we believe that the Boards have asserted this principle as well.

Given the importance of revenue as an input to an investor's capital allocation decision, we think the boards should elevate the disclosure requirements in Paragraph 74 to presentation on the face of the statement of comprehensive income. Further, we think that the requirements in Paragraph 74 should be expanded to include a requirement to disaggregate revenue by time horizon (e.g. performance obligations associated with short term versus long-term contracts should be separately presented).

- *Net Presentation of Contract Assets and Contract Liabilities in the Statement of Financial Position:* The boards propose to require the net presentation of contract assets and contract liabilities on the face of the statement of financial position. The result is that a company will display a net contract asset or a net contract liability depending on the performance of the parties to the contract. We think that additional implementation guidance should be developed that explains how the net contract asset or net contract liability is determined. In particular, we would like to understand how the "netting" proposed in the revenue recognition project relates to (or will be influenced by) the boards' joint project to develop common requirements on the offsetting (a.k.a. netting) of financial assets and financial liabilities in the statement of financial position.⁶ It is the CFA's position that, generally, gross presentation is preferable to net presentation in the statement of financial position.

⁶ In particular, we would be interested to know whether the contract asset or contract liability that results from the application of the proposed revenue recognition model meets the definition of (and is thereby also considered to be) a financial asset or a financial liability, respectively.

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- *Presentation of Warranties, Returns, Refunds and Credit Risk Adjustments:* While we understand the measurement of the net contract position proposed in the ED, we think that adjustments to contract amounts (specifically, warranties, returns, refunds and credit risk adjustments) should be separately presented on the face of the statement of financial position through linked presentation. Said differently, each item proposed to be presented separately in the roll-forward disclosure of the net contract position should also be presented separately on the face of the statement of financial position. Further, we think that a company should be required to disclose the amount of each adjustment that is actually recognized in revenue during a reporting period—that is, the amount of revenue (or its reduction) that is attributable to warranties, returns, refunds and credit risk adjustments.
- *Performance Obligations versus Contract Balances:* As previously noted in our comments on the proposed disclosures, we think that greater clarity is needed on how a performance obligation differs from a contract asset and a contract liability. In Paragraph 68 of the ED, the boards propose to require the separate presentation of onerous performance obligations on the face of the statement of financial position. As currently written, the ED implies that performance obligations do not become financial statement elements (i.e. contract assets or contract liabilities) until either party to the contract performs. In other words, performance in accordance with the contract triggers the recognition of a contract asset or a contract liability. However, Paragraph 68 suggests that an onerous performance obligation could be recognized in the statement of financial position before either party to the contract has performed—that is, before the performance obligation becomes a contract asset or a contract liability.

Recognition

As it relates to revenue recognition and measurement we believe that the criteria for determining distinctive performance obligation and the indicators of control should be enhanced to ensure consistency of application and we are concerned by the use of profit margins to determine distinct performance obligations and estimated selling price to allocate transaction price. We expect the reliance on management estimates unfettered by market-based evidence in the use of profit margins and estimated selling prices to result in a significant increase in the inclusion of future products and services in multiple-element contracts. The ability to use management estimates of selling prices for future (as-yet undeveloped) performance obligations will contribute to front loading of revenue due to the ability to allocate desired amounts of transaction price to delivered and extant products and services. This front loading will be accompanied by little or no substantive required disclosure of the costs of developing promised future performance obligations. **Because the proposed model relies heavily on these management estimates of profit margins and estimated selling prices without reference to market observable data, we believe there is substantial subjectivity in their determination which could lead to front loading of revenue and/or earnings management.** In the **Appendix** we more specifically address the following aspects of the ED's recognition provisions:

Contract Definition

We agree with the objective in the ED to better define the manner in which contracts are combined, segmented or modified. However, we believe this combination and segmentation should be done based on functional interdependence as well as price interdependence. We are supportive of contract definition as described in the ED, as we understand the elements provided to equate to a constructive obligation; however, we recommend the explicit articulation of the contract being a constructive obligation, so that there is no confusion on whether it need only be a legal obligation. Constructive obligation is the only meaningful measure for investor analytical purposes as it corresponds to the economic liability.

Identifying Separate Performance Obligations

The ED proposes that entities account for promised goods or services as separate obligations only if they are distinct. In principle, we support the notion of identifying separate performance obligation as a basis of recognition for multiple-element revenue contracts. However, we are concerned about the rudimentary criteria proposed in the ED to determine the separation of the performance obligations within these contracts. As it relates to the proposed principles of distinctiveness, we foresee issues related to separating performance obligations based upon differences in profit margin and differences in the timing of satisfaction of performance obligations.

In addition, we have concerns regarding the exhaustiveness of the criteria articulated in the ED and the difficulties in applying these distinctiveness principles to long-term contracts. Given the rudimentary and broad or general nature of these articulated principles of distinctiveness, they will most likely not preempt the emergence of industry specific practices. The development of industry specific practices will likely negate one of the objectives of this ED – namely to create a unified revenue recognition approach. By not adequately articulating distinctiveness criteria and illustrating unbundling applications, the ED does not provide investors with sufficient evidence to enable them to make an informed judgment on whether the approach will enhance the informativeness of reported earnings and revenues.

Satisfaction of Performance Obligations (Transfer of Control)

The proposed recognition approach places an emphasis on control or transfer of assets, through the definition of a contracts-based performance obligation, as a basis for recognizing revenue. **We support the notion of revenue recognition based on the satisfaction of performance obligations, via transfer of goods or services to the customer.** We are supportive of control being seen from the perspective of the customer, as opposed to from the entity perspective. This approach is internally consistent with measurement being based on customer consideration and also corresponds to the notion of wealth creation being based on fulfilling obligations to the customer. We believe that it is decision-useful for reporting entities to convey the pattern of transfer of assets as a depiction of its economic activities. We also agree with the satisfaction of performance obligations being evaluated based on transfer of control to the customer. **However, we propose the integration of a risk and rewards assessment as an indicator of control.** We also believe additional indicators of control particularly as it relates to services industries and the transfer of intangible assets are necessary and we suggest that additional illustrations of the evaluative judgments regarding the transfer of control using a range of real world, complex industries is necessary. We also believe here is need to ensure consistency in the control definition across accounting standard projects currently under development.

Distinguishing Between Performance Obligations and Contract Assets & Liabilities

In our analysis of the ED's proposed disclosures in the **Appendix**, we highlight our concerns regarding users' ability to distinguish between the definition of performance obligations and contract assets and liabilities as set forth in the ED. Only the most technically inclined accountants can discern these differences. We do not believe that users will understand the accounting distinction applied to the economics of the rights and obligations associated with a contract. While included within our disclosure discussion, this issue is really one of when assets and liabilities are recognized within the financial statements and, as such, we reiterate it here. We think the ED is not clear on this issue and that the Boards are not consistent across projects in their distinction regarding when a performance obligation is recognized as an asset or liability in the financial statements.

Measurement

Overview of Our Perspective on a Customer Consideration Model Versus Exit Value Model

As opposed to the customer consideration model proposed by the ED, we would have preferred the exit price approach to revenue measurement because we believe it can provide relevant and timely information to users and investors. Unlike an exit price notion, we do not believe an entry price approach, as required by the proposed customer consideration model, yields the most decision-useful information or always reflects the underlying economics of the sale of goods and services. An exit price approach captures the fact that agreed customer consideration may also cover delivery of pre-contract goods or services as well as the contract stipulated performance obligations, yet the proposed recognition approach precludes the recognition of gains or losses associated any such pre-contract performance components. We believe it is relevant and decision-useful to depict day one profits or gains, whenever the aggregate market value of performance obligations does not equate to the promised customer consideration. Only an exit value approach would allow the faithful representation of any profit or loss associated with the customer consideration from day one.

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Specific Considerations Regarding a Customer Consideration Model

Regarding the proposed approach of measuring revenue (i.e. customer consideration model), we are supportive of the various building blocks proposed that deal with variable consideration, consideration of credit risk (i.e. customer credit risk) and the time value of money where there is a material financing component. We provide our specific views on each of these aspects in the **Appendix**.

Use of Estimated Selling Price for Measurement of Separate Performance Obligations

As noted previously, we are concerned with the subjectivity and earnings management (e.g. front loading of revenues) which will likely result from the latitude available with the use of estimating selling prices particularly when such latitude is coupled with the loosely defined principles of separation of distinct performance obligations (e.g. through profit margin differences). We are concerned by the lack of reliability of estimated selling prices for new products or components of products where there is little or no correlation between costs and sales prices when such products are not sold separately. This concern also applies to services, technology, and intellectual property performance obligations. We contend that it is very difficult to estimate selling prices until substantial standalone sales are achieved.

Further, our experience in the United States has been that the disclosures related to the use of estimated selling price per EITF 08-1, *Revenue Arrangements with Multiple Deliverables*, and EITF 09-3, *Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements* – two standards that mirror the proposals in this ED – are usually uninformative. Our reservations are compounded by the expectation that preparers might be reluctant to disclose the confidential information used to model estimated selling prices. Our experience with disclosures by early adopters of these two EITFs leaves us unconvinced that auditors will demand or be able to enforce required disclosures. **We strongly recommend that concurrent with allowing managers to use estimate selling price, there should be a hierarchy with respect to the determination of this estimated selling price, and that disclosures should be significantly improved.** This hierarchy and additional disclosures are more fully described in the **Appendix**.

Cost Recognition

We commend the Boards on the guidance regarding cost recognition and are supportive of these proposed criteria for distinguishing when to expense versus capitalise contract costs. We believe capitalising of costs directly related to fulfilling a contract is appropriate. It is also appropriate to expense the cost of obtaining new business as it is a sunk cost. For costs to qualify for capitalisation we favour a high threshold. However, we foresee interpretations and questions (“grey areas”) arising regarding some of the costs identified as being related directly to the contract.

We observe that the issue of cost recognition, or cost capitalization, exists across various projects currently under considerations by the Boards – insurance, leases, revenue recognition, financial instruments – and that inconsistencies in recognition and presentation persist and should be resolved by the Boards.

As noted above, the ED contains no disclosure requirements related to cost recognition. We find this to be a substantial omission from the ED and we have articulated above the disclosures related to cost recognition which we believe should be included in a final standard.

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Transition & Effective Date

A smooth transition is essential to market assimilation of the changes proposed in the ED. Transition should be fully retrospective in nature and optional adoption on a prospective basis should not be allowed. Users of financial statements need three years of data to ensure they understand trends. We are not averse to an extension in the effective date to ensure an appropriate transition. We are surprised by the lack of transition guidance provided as we can foresee issues arising during transition which do not yet appear to have been addressed.

Implementation & Application Guidance

The ED provides application guidance with some helpful illustrative examples regarding the application of the conceptual principles in the ED including separating and determining satisfaction of performance obligations. However, as noted earlier in the general comments, more needs to be done to reflect real world complexities and to illustrate certain key industry specific issues. Further, we believe these examples or application guidance should be a part of the authoritative U.S. GAAP and IFRS literature – not separate guidance which is not of the same authoritative stature as the remainder of the ED. This guidance should be developed simultaneously with the completion of the ED to ensure they are consistent.

Other Matters

In the **Appendix** we set forth our view on the treatment for warranties, licensing of intellectual property, consequential amendments and application to non-public entities.

DETAILED COMMENTS

See **Appendix** for detailed comments and answers to specific questions posed in the ED.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, PhD, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/ Gerald I. White

Gerald I. White, CFA

Chair

Corporate Disclosure Policy Council

/s/ Sandra J. Peters

Sandra J. Peters, CPA, CFA

Head, Financial Reporting Policy Group

Standards and Financial Market Integrity Division

cc: Corporate Disclosure Policy Council

RESPONSES TO SPECIFIC QUESTIONS

In this Appendix we respond to the specific questions raised in the ED pertaining to key aspects of the proposed revenue recognition and measurement model. Our responses are organized as follows commencing with disclosures requirements for the reasons articulated in the body of our letter:

- Disclosure Requirements
- Revenue Recognition –
 - Contract Definition
 - Identifying Separate Performance Obligations
 - Satisfaction of Performance Obligations
- Revenue Measurement –
 - Customer Consideration Model
 - Use of Estimated Selling Price for Measurement of Separate Performance Obligations
 - Subsequent Measurement
- Cost Recognition
- Transition and Effective Date
- Application or Implementation Guidance
- Warranties
- Licensing of Intellectual Property
- Consequential Amendments
- Application to Non-Public Entities

Disclosure Requirements (FASB and IASB Questions #10, #11 and #12)

Paragraphs 69 to 83 of the ED propose a package of disclosures including:

- Disaggregation of revenue (e.g. by good or service, geography, customer and type of contract) (Paragraph 74);
- Roll-forward reconciliations of contract assets or contract liabilities (Paragraphs 75-76);
- Details of performance obligations including goods and services; significant payment terms; when the performance obligation is typically satisfied; obligations for returns, refunds and similar obligations; types of warranties and related obligations (Paragraph 77); and a maturity analysis of performance obligations (Paragraph 78);
- The existence of onerous performance obligations including a roll-forward/reconciliation; details of why performance obligations have become onerous and when the liability will be satisfied (Paragraphs 79 – 80);
- Significant judgements used in: a) determining the timing of satisfaction of performance obligations which are satisfied continuously (Paragraph 82); and b) determining the transaction price and allocating it to performance obligation. This includes the basis of estimating selling prices of separate performance obligations; the measurement of obligations for returns, refunds and similar obligations; and the measurement of liabilities for onerous contracts (Paragraph 83).

Some may characterise these additional disclosures as burdensome as they will increase the volume of disclosures. However, none of these disclosures would provide information that falls outside the sphere of the measurement of revenue under the new model and the design of these disclosures is fully cogent with the accounting model. In other words, managers will simply be conveying how they are recognizing, measuring and collecting revenue.

The objective of managers should be to communicate to users through disclosures the company's method of recognizing revenue and not to engage in a tick-the-box compliance exercise that produces generic disclosures or to provide fragments of information that leave users uninformed on how management is carrying out their economic activities. **The required disclosures, which must be company specific, rather than boilerplate, would provide a useful framework for preparers to communicate how their business generates revenue, operating profits, and cash flows.**

Given the significant level of judgment associated with the various building blocks of recognition and measurement of revenue (i.e. identifying contract boundaries; determining and separating distinct performance obligations; evaluating whether control has been transferred to customers; estimating selling prices of standalone performance obligations to allocate transaction price; and estimating variable customer consideration), the ED proposes disclosures that we consider to be complementary to the recognition and measurement model; **however, we believe that there are certain critical disclosures – particularly associated with key judgements and estimates used in the revenue recognition and measurement process – which have been omitted. We set forth below additions we believe would better articulate such estimates and judgements.**

Revenue reported under the proposed standard would contain both inherent economic and accounting uncertainty and only a robust disclosure regime that complements recognition and measurement, can help investors to assess the association between reported revenues and related cash flows from these revenues. **It is essential that revenue disclosures communicate the relationship between revenue recognition patterns and cash flow collections as these are critical to the enterprise valuation. We believe that reporting cash flows by type of revenue in a direct method statement of cash flows would allow**

investors to understand the linkage between revenue recognition patterns and cash flow collections. Enterprise valuation requires confirmation that revenue recognized is ultimately converted to cash, and knowledge regarding the timing of the conversion. Our historical advocacy for the direct cash flow method stems from the importance to investors of this need to connect revenue and cash measurements. Under the indirect cash flow method, users cannot directly see the connection between revenue and the related cash collection of such revenues. Attempts to estimate direct method cash flows generally prove fruitless given the level of aggregation as well as the impact of foreign currency and business combinations.

The proposed disclosures represent a significant improvement from current revenue disclosures which are highly inadequate under both U.S. GAAP and IFRS. We strongly support all of these proposed disclosures which we believe will significantly enhance transparency regarding revenue recognition practices and help users link revenues with cash flow patterns. **Our review of the disclosures, however, suggests certain important disclosures have been omitted from the ED – most specifically disclosures regarding the judgements made in the determination of the recognition and measurement of revenue and costs.** Set forth below are additional disclosures which we believe would ensure a complete communication of the recognition and measurement of revenues and related costs:

- *Contract Definitions:* While Paragraphs 73 and 80 of the ED propose disclosures related to contracts with customers and Paragraphs 81 to 83 of the ED require disclosures of significant judgments and estimates related to the timing of the satisfaction of continuous performance obligations, and in determining the transaction price and allocating it to performance obligations, the ED does not require disclosures regarding the definition of contracts or the basis for combining or segmenting contracts. **We are strongly supportive of disclosures that shed light on the definition of contracts and we believe such criteria for combining, segmenting or modifying contracts should be explicitly required for disclosure.**
- *Identifying Separate Performance Obligations:* The ED does not explicitly require disclosures regarding the basis for identifying and unbundling separate performance obligations. Given the significance of these judgments and estimates to the revenue recognition model and process, **we believe disclosures of these judgments and estimates should be made in the financial statements and should be included in a final standard.**
- *Satisfaction of Performance Obligations (Transfer of Control):* The satisfaction of performance obligations is premised on transfer of control in the ED; however, other than disclosures regarding timing of the satisfaction of performance obligations which are satisfied continuously, there are no disclosures required in the ED to communicate to investors the preparer's judgments regarding the appropriate timing for the recognition of revenue. **It is essential that users have disclosures regarding the judgments associated with the determination of when transfer of control to customers occurs. Further, given that exposure to risks and rewards is not part of the definition of control we believe that the risks unique to various performance obligations should be disclosed as clearly and as objectively as possible.**
- *Revenue Measurement:* Paragraph 83 of the ED provides the only guidance in the ED regarding disclosures associated with the measurement of revenues. Paragraph 83 requires disclosures regarding the methods, inputs and assumptions used to determine transaction price; estimate stand-alone selling prices; measure obligations for returns, refunds and similar obligations; and measure the liability for onerous contracts. However, we recommend additional disclosures regarding measurement of revenues in the following areas:
 - *Variable Consideration:* **If material, we believe disclosures regarding variable consideration should be required including disclosures of the number of outcomes**

considered, the estimated variable consideration initially included in the transaction price and a range around the expected outcome. Additionally, we believe disclosures of significant changes in estimates of variable consideration are instructive to users of financial statements and should be a required disclosure.

- *Credit Risk:* **We believe the final standard should include separate disclosures of initial expectations of credit losses as well as subsequent changes in expectations.** These disclosures are necessary to enable users to evaluate credit losses relative to revenue. Further, we believe a rollforward of credit losses (allowances) should be provided within the notes to the financial statements. Such rollforward should include beginning and ending allowances for credit losses, estimates of expected credit losses on new revenue, revisions to expectations of credit losses, and adjustments related to foreign currency, business combinations, etc.
- *Time Value of Money:* The ED does not include provisions for disclosure of the discount rate or the impact of the time value of money. **The basis of discount rate determination – along with the discount rate – should be included in disclosure requirements.** Further, the “unwind” of the discount rate should be reflected as interest expense or income and be separately presented in the income statement, or at a minimum be disclosed in footnotes to the financial statements.
- *Use of Estimated Selling Price for Measurement of Separate Performance Obligations:* Paragraph 83 provides very generic guidance regarding the need to disclose the methods, inputs and assumptions used to estimate stand-alone selling prices. **We believe more robust disclosures are required regarding the basis of determination of estimated selling price as we describe more fully below. We strongly recommend that concurrent with allowing managers to use estimate selling price, there should be a hierarchy with respect to the determination of this estimated selling price.** This hierarchy should prioritize the application of available market evidence and it should also necessitate higher levels of disclosure, including the basis of estimation of these selling prices, for any management estimates that are not based on objective evidence. See the suggested hierarchy in our response to Question #7 which follows.
- *Changes in Transaction Price:* The ED does not include provisions for disclosures regarding changes in transaction price. While revenue from allocating changes in transaction price to performance obligations satisfied in previous reporting periods is included in the contract assets or liability rollforward, there are no disclosures required regarding total changes in transaction price. **We believe total changes in transaction price should be disclosed.**
- *Onerous Performance Obligations:* We note that Paragraphs 79 and 80 of the ED provide disclosures regarding onerous performance obligations and that separate presentation of such onerous performance obligations is required. Further to the disclosures already required for onerous contracts, it would be useful if there were disclosures of contracts near to becoming onerous (i.e. a “watch list”). Also, we believe it is important for preparers to analyze the cause of performance obligations which have become onerous and evaluate whether the onerous nature of the obligations results from a misallocation of revenues at that inception of the contract.

- *Cost Recognition:* The ED excludes disclosures associated with costs recognized as expense or capitalized in accordance with the provisions of the proposed standard. We find this to be a glaring omission in the proposed standard. We believe the following disclosures should be added to any final standard:
 - *Costs Capitalized:* **Preparers should disclose the nature and amounts of costs capitalized during the period and the basis for capitalizing such costs.**
 - *Allocation to Performance Obligations and Amortization:* **The method by which costs have been allocated to various performance obligations and, accordingly, the amortization pattern of recognizing such costs as expense should be disclosed.**
 - *Rollforwards or Reconciliations:* **As with contract assets and contract liabilities, there should be a rollforward or reconciliation of the contract related capitalized costs** including prior period and current period balances, costs capitalized, costs amortized and the impacts of foreign currency fluctuations and business combinations.
 - *Expected Run-off of Capitalized Costs:* Consistent with the disclosure in Paragraph 78 related to revenues associated with performance obligations to be satisfied in future periods, **we believe a similar “run-off” schedule associated with capitalized costs would be useful to allow investors and analysts to compare the run-off of expenses with the related revenue.**
- *Warranties:* The ED does not include a requirement to disclose separately the provision (performance obligation) associated with warranties. **If such amounts are material, we believe separate disclosure of such warranty obligations – and their impact on reported revenue and expense amounts – should be disclosed.** Similarly, we believe disclosures of returns, refunds and other similar obligations should be separately disclosed in the notes to the financial statements as each impacts the revenue recognition pattern of the company.
- *Backlogs & Unsigned Contracts:* **Where backlogs exist, and are meaningful predictors of future revenue, we believe disclosures of such backlogs should be included in the notes to the financial statements.** Additionally, the extent to which current period revenue represents amounts included in prior period backlogs would also be useful to investors. Further, if the entity has substantial contracts which are deferred for signature – or performance – until the inception of the next accounting period, we believe disclosures of such information would be useful to investors.
- *Qualitative and Quantitative Aspects to Significant Judgments and Estimates:* Paragraphs 82 and 83 of the ED require disclosures regarding certain significant judgments and estimates. However, as we note previously, the ED fails to include a requirement to disclose other key judgments and estimates which we believe are essential to understanding the revenue recognition and measurement decisions made by management. **In addition, we believe it is important that the disclosures regarding such judgments and estimates be made in sufficient detail and with sufficient specificity (i.e. not boilerplate disclosures) that investors can determine how such decisions correlate with the revenue recognition measurements included in the financial statements.** This would include more than just a qualitative description of the decisions and judgments. Such qualitative decisions should be connected with quantitative measurements or revenue included within the financial statements.
- *Level of Disaggregation – Disclosure vs. Presentation:* Paragraph 70 and 74 address the level of disaggregation associated with the disclosure of revenues as proposed in the ED. Due to the deferral of the Financial Statement Presentation (FSP) Project – which would have increased the disaggregation of revenue on the income statement – the disaggregation of revenue will only occur in the notes to the financial statements – rather than within the financial statements themselves – and will not be required by function and by nature (See Paragraph BC 175). **Given the importance of revenue to the decision-usefulness of the financial statements, we believe the Boards should include the provisions of Paragraph 74 within the Presentation section of the ED rather than**

the Disclosure section of this ED. Further, we believe that the requirements in Paragraph 74 should be expanded to include disaggregation by revenue recognition pattern associated with the nature of the performance obligation (e.g. performance obligations associated with short term vs. long-term contracts).

- *Performance Obligation vs. Contract Assets & Liabilities:* We do not think the ED adequately articulates the connection between performance obligations and contract assets and contract liabilities. In particular, it is not clear whether a performance obligation (as that term is defined in the ED) always meets the definition of a financial statement element (specifically, a liability). Further, we do not think the ED is clear in describing how a performance obligation is different from a contract liability. **While this distinction might be clear to the most technically inclined accountants, we are not convinced that the conceptual nuance will register with users of financial statements.** Said differently, binding contracts entered into by two parties will not be reflected as a liability in a company's balance sheet if neither party has moved to perform in accordance with the contract (i.e. neither party has crossed the "performance threshold" that triggers recognition of a financial statement element (i.e. a contract asset or a contract liability)).

We do not think users of the financial statements will be able to make the conceptual distinction between a performance obligation and a contract liability. Yet, preparers may have performance obligations that either:

- do not meet the definition of a liability; or
- are not recognized in the financial statements simply because neither party to the contract has performed.

It is not clear whether the disclosures about performance obligations proposed in Paragraphs 77 and 78 would require the disclosure of information about a company's performance obligations that have not yet given rise to contract assets or contract liabilities. Further, it is not clear that the performance obligations proposed to be disclosed in accordance with Paragraphs 77 and 78 would be the same (i.e. tie to) the aggregate of the roll-forwards proposed in Paragraphs 75 and 76.

Further, we note that the revenue recognition exposure draft and the leases exposure draft contain different proposals for the recognition and presentation of rights and obligations that arise in a contract. Specifically, the proposed revenue recognition model would require the recognition of a financial statement element (either a contract asset or a contract liability) in the balance sheet on a net basis only after either party to a contract has performed. The performance obligation approach to lessor accounting (proposed in the leases exposure draft) would require the recognition of financial statement elements (a receivable, an underlying asset and a liability) in the balance sheet on a gross basis at the date of commencement of the contract. It is not clear that the requirement to perform described in the revenue recognition model would result in the same timing of asset and liability recognition that could result if the contract was accounted for in accordance with the proposed lessor accounting model (the performance obligation approach). Said differently, we think that a company (specifically, a lessor) would be required to recognize assets and liabilities in accordance with the proposed lessor accounting model sooner than it would be required to if the same contract was accounted for in accordance with the proposed revenue recognition model.

- *Reconciliation of Contract Balances:* Paragraph 75 of the ED provides for the inclusion of a reconciliation of contract balances. **We are fully supportive of the inclusion of such a reconciliation and we have several observations regarding the contents** of such reconciliations:
 - *Performance Obligations.* Without clearer distinction between contract liabilities and performance obligations it is difficult to discern the completeness of the disclosures required by Paragraphs 75 – 78. The extent to which performance obligations are contract liabilities, or become contract liabilities from one accounting period to the next, will impact the nature and extent of what will be disclosed about each based upon the disclosures proposed in the ED. **For example, if an enterprise has significant performance obligations – which are not yet contract liabilities – users of the financial statements will not be provided with the amount of such performance obligations** (i.e. As Paragraph 77 only requires a description of the performance obligation and Paragraph 78 only requires disclosure of the amounts over one year) nor will a “rollforward” of such performance obligations from the beginning of the accounting period to the end of the accounting period be required. We think greater clarification regarding the distinction between performance obligation and contract liability would facilitate an understanding of the disclosures and allow us to more thoughtfully comment on their completeness.
 - *Elements of Contract Balance Reconciliation:* We have the following observations regarding the elements of the contract balance reconciliation:
 - *Contract Liabilities:* As we considered the elements of the reconciliation in Paragraph 75 we noted that there is no element which results in the recognition of a liability for the performance obligation. Only upon the receipt of cash or the unconditional right to receive cash will a contract liability be created. Further, when we consider Example 29 in Paragraph B9, the first entry on January 31 of Scenario 2 results in the creation of receivable (i.e. not a contract asset) and a contract liability; however, when you consider the elements of reconciliation as described in Paragraph 75, none appear to encompass the results of this journal entry. Said differently, the contract liability would be in the ending balance at January 31, but not in the rollforward based upon the criteria defined.
 - *Foreign Currency:* We observe that based upon Paragraph 75(a)(iv), the element of the reconciliation related to effects of foreign exchange differences does not distinguish between foreign currency transaction gains and losses (included in net income) and foreign currency translation gains and losses (included in other comprehensive income). We believe these foreign currency exchange differences should be presented separately.
- *Maturity Analysis of Performance Obligations:* We agree with the disclosures in Paragraph 78 related to the presentation of a maturity analysis of performance obligations with durations of more than one year, but we believe that even those with a duration of only one year should be included.
- *Tabular Format:* **We believe the ED should include a requirement that all reconciliations/rollforwards and other disclosures which can be presented in a tabular format be required to presented in such a manner.** Tabular presentation will greatly increase the clarity and usefulness of the information to investors.

Revenue Recognition – Contract Definition (FASB and IASB Question #1)

Linkage of Contracts: The ED proposes that for contract definition purposes, and in situations that require the combination, segmentation or modification of standalone contracts, this should be done based on **price interdependence**. The determination of price interdependence takes into consideration whether the contracts are initiated at or near the same time, and whether the contracts are negotiated as a package. Price interdependence will lead to contract combination, while price independence will lead to contract segmentation. We agree with this proposed principle of linking or separating contracts based on price interdependence. However, contract accounting should also reflect **functional interdependence** of product form and features of either goods or services when determining the linkage or distinctiveness of contracts. The following two examples illustrate this point:

- Consider a contract to convert a lending library card catalogue into an electronic database, followed by a subsequent contract to develop a computer-based record of all books borrowed by library patrons with the ability to send an email reminder of the due date for returns and subsequently calculate fines for late returns. The functional interdependence in this case stems from the linkage of the electronic database to the record of books borrowed and when they are due to be returned. A library patron would know when a copy of a specific book is available only if the two systems are linked. It is unclear that there would be price interdependence but there is functional interdependence.
- Applying these principles to a recent real-life example of a London restaurant, the first contract could call for conversion of a wine list and food-wine pairing recommendations into an electronic database, with a second contract designed to record purchases and replenish inventory by placing orders as wines are consumed by restaurant patrons. In such a circumstance there is functional interdependence.

Constructive versus Legal Obligation: We are supportive of contract definition as described in Paragraph 10 of the ED, as we understand the elements⁷ provided to equate to a constructive obligation. However, we recommend explicit articulation of the contract being a constructive obligation, so that there is no confusion on whether it is a legal obligation. Constructive obligation is the only meaningful measure for investor analytical purposes as it corresponds to the economic liability.

Contract Definition Disclosures: As noted above, we believe disclosures regarding contract definition are needed within the proposed standard. Presently, the ED lacks any requirement to make such disclosures.

⁷ Paragraph 10 of the ED defines contract as comprising the following: a) The contract has commercial substance; b) the parties to the contract have approved the contract and are committed to satisfying their respective obligations; c) the entity can identify each party's enforceable rights regarding the goods or services to be transferred; and d) the entity can identify the terms and manner of payment for those goods or services.

Revenue Recognition – Identifying Separate Performance Obligations (FASB and IASB Question #2)

This requirement pertains to multiple element revenue contract arrangements (e.g. software contracts). The ED proposes that entities account for promised goods or services as separate obligations only if they are distinct. Identification of distinct goods or services, when unbundling, occurs if:

- There is evidence that the good or service is sold separately; or
- The entity could sell the good or service separately. This determination is made if the good or service has a distinct function and it has a distinct profit margin.

However, if distinct performance obligations result in the transfer of goods or services to the customer at the same time, and also result in the same amount and timing of revenue as would be the case if the accounting had been done for a single or bundled performance obligation, then there is no need to unbundle or recognise separate performance obligations.

In principle, we support the notion of identifying separate performance obligation as a basis of recognition for multiple-element revenue contracts. However, we are concerned about the rudimentary criteria proposed in the ED to determine the separation of the performance obligations within these contracts. As it relates to the proposed principles of distinctiveness, we foresee issues related to separating performance obligations based upon:

- *Differences in Profit Margin:* The use of the concept of “different profit margins” in the proposed separation criterion (e.g. whether goods or services are distinctive and can be sold separately or have different profit margins) raises the question of whether profit margins must, or will, be defined consistently over time, across goods and services, and between competitors. Profit margins can differ across time as profit margins naturally change between when a product is initially introduced to the marketplace, when a product has established a market presence, or when a product is faced with the introduction of a competing product or service. Additionally, the term profit margin carries no formal definition in U.S. GAAP or IFRS. **Does profit margin mean gross profit margin, operating margin or net margin – and net of what?** Further, the allocation of costs across products and services may alter the meaning of the term profit margin with products with more tangible costs such as goods and services defined one way and with profit margin for licensing or intellectual property –having less tangible or direct costs – being defined differently. It is also unclear to us how changes in profit objectives and consequent margins over the life of a product would be used by different companies to separate performance obligations over the product life. Finally, the definition of profit margin may differ between competitors and their objectives in the marketplace. **Accordingly, we find the use of the term profit margin elusive and ill defined, and we believe the application of differentiated profit margin as one of the criteria for identifying distinct performance obligations provides leeway for subjectivity and earnings management. The scope for earnings management is compounded by the ability to use estimated selling price when allocating transaction price across these different performance obligations. Differentiation or separation of performance obligations by profit margin also raises the question regarding whether any company will willingly disclose useful information about this criterion given the sensitive nature of such information.**
- *Differences in Timing of Satisfaction of Performance Obligations:* The ED states that performance obligations should be separated if assets are transferred/obligations fulfilled at different times. However, the meaning of “different times” is unclear. Would separation be required if all assets are transferred/obligations fulfilled during the same quarter even if they are substantially different products and/or services? **We believe that nature of the timing of the satisfaction of the performance obligation should not be utilized as a reason not to separate performance**

obligations if financial statements users will lose decision-useful information regarding an entity's underlying distinct business activities simply because multiple assets are transferred/obligations fulfilled over similar timeframes. Said differently, a multi-element arrangement should not be presented as a single-element arrangement in the income statement simply because the differing activities are completed over a similar time period. Users are interested in the nature of the business activities distinct of their timing. It is unclear how this proposed guidance will affect presentation in the financial statements. How would a user distinguish between revenue reported for a series of multiple performance obligation contracts completed within a quarter from revenue reported for specific performance obligations in a similar contract that are satisfied over two or more quarters?

We have the following additional concerns related to separation criteria in the ED:

- *Exhaustiveness of Criteria:* The application guidance within the ED provides several examples of unbundling of separate performance obligations. However, the proposed criterion of determining distinctiveness is not exhaustive in nature. For example, the ED does not address whether the obligation not to do something (e.g. promise not to compete during the term of contract), is in itself a performance obligation. If there is a 10-year contract and there is an agreement not to compete for a 3-year period within the terms of the contract, would the obligation not to compete be considered to be, and would it be reported as, a performance obligation? Would any portion of the transaction price be allocated to such a performance obligation?
- *Long-Term Contracts:* There are difficulties in applying these distinctiveness principles to long-term contracts. For example, a product could be delivered immediately but the return, warranty right/obligation, and lack of obsolescence promises may last for different periods of time. In certain of these circumstances the product (or, more precisely, fulfilment of the performance obligations) may be nearly indistinguishable from the continuous delivery of a service (e.g. lack of obsolescence promise), and applying the guidance may be difficult. We have also observed an increase in contracts where a product or service is delivered at the inception of a contract with a long-term performance obligation to ensure continued use/applicability of the product or service through subsequent technological changes in the way the customer uses the product.

Given the general nature of these articulated principles of distinctiveness, they will most likely not preempt the emergence of industry specific practices. The development of industry specific practices in the absence of industry specific guidance will likely negate one of the objectives of this ED – namely to create a unified revenue recognition approach. **By not adequately articulating distinctiveness criteria and illustrating unbundling applications, the ED does not provide sufficient evidence to enable investors to make an informed judgment on whether the approach will enhance the informativeness of reported earnings and revenues.**

Identifying Separate Performance Obligations Disclosures: As noted above, we believe the ED should include disclosure requirements regarding identifying and separating performance obligations. Presently, the ED lacks any requirement to make such disclosures.

Revenue Recognition –

Satisfaction of Performance Obligations (Transfer of Control) (FASB and IASB Question #3)

We support the notion of revenue recognition based on the satisfaction of performance obligations, via transfer of goods or services to the customer. We are supportive of control being seen from the perspective of the customer, as opposed to from the entity perspective. This approach is internally consistent with measurement being based on customer consideration and also corresponds to the notion of wealth creation being based on fulfilling obligations to the customer. We believe that it is decision-useful for reporting entities to convey the pattern of transfer of assets as a depiction of its economic activities. We also agree with the satisfaction of performance obligations being evaluated based on transfer of control⁸ to the customer. The ED outlines various indicators of control. We propose the following considerations with respect to the transfer of control concept:

- *Integration of Risks and Rewards:* We would expect a control based approach of asset ownership to be consistent with a risks and rewards based assessment of transfer, in most instances. This is predicated on risks and rewards being an indicator of control. However, there are instances where a control versus risks and rewards assessment of transfer may not yield the same answer. **For this reason, we suggest that a risks and rewards assessment should be integrated as an indicator of control.**
- *Control Indicators:* Similar to the application of principles to identify separate performance obligations, there is need for illustration of the evaluative judgments regarding the transfer of control using a range of real world, complex industries. It is not clear whether the identified indicators of transfer of control provided in the ED are sufficient and which combination of these indicators need to be applied to determine transfer of control. In addition, these indicators are not sufficient to determine the transfer of control in service industries and for the transfer of intangible assets. Hence, we have concerns regarding the robustness of these articulated control principles.
- *Cross-Project Consistency:* The definition of control, or loss of control, should be consistent across accounting standard projects, specifically revenue recognition, de-recognition and leasing. For example, the proposed de-recognition model defines control based on whether or not there are restrictions on the transfer of an asset by the transferee. If the same principle were applied to sales returns, different outcomes may result between the proposed revenue recognition and de-recognition models. This is because customers may not face restrictions in transferring goods but can still return such goods. Still further an inconsistency arises because of the uncertainty regarding whether this concept of control applies to leases and sales of intellectual property.
- *Transfer of Control Disclosures:* As noted above, we believe the ED should include disclosure requirements regarding the manner in which transfer of control is achieved. Presently, the ED lacks any requirement to make disclosures based upon satisfaction of performance – other than in instances where performance obligations are satisfied continuously.

⁸ Paragraph 27 of the ED states that a customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service. Control includes the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service.

Revenue Measurement –

Customer Consideration Model (FASB and IASB Questions #4, #5, #6 and #7)

Overview of Our Perspective on a Customer Consideration Model Versus Exit Value Model: As opposed to the customer consideration model proposed by the ED, we would have preferred the exit price approach to revenue measurement. Unlike an exit price notion, we do not believe an entry price approach, as required by the proposed customer consideration model, yields the most decision-useful information or always reflects the underlying economics of the sale of goods and services. An exit price approach captures the fact that agreed customer consideration may also cover delivery of pre-contract goods or services as well as the contract stipulated performance obligations, yet the proposed recognition approach precludes the recognition of gains or losses associated any such pre-contract performance components. **We believe it is relevant and decision-useful to depict day one profits or gains, whenever the aggregate market value of performance obligations does not equate to the promised customer consideration. Only an exit value approach allows the faithful representation of any profit or loss associated with the customer consideration from day one.**

Specific Considerations Regarding a Customer Consideration Model: With respect to the customer consideration approach, we support the various building blocks proposed and we provide below our views on specific matters upon which you have requested comment:

- *Variable Consideration (FASB and IASB Question #4):* We agree with concept of determining variable consideration through the use of expected value (i.e. the probability weighted value of the transaction price). We believe more specific guidance should be provided on the use of expected value techniques, including the number of expected outcomes that should be considered and situations where outcomes may be limited. Given the increased use of expected value techniques in measuring liabilities such as insurance or IAS 37, arriving at credit impairments, and in determining leasing obligations, we think overall conceptual guidance may be useful. **Further, for material variable consideration, disclosures should be required of the number and range of outcomes considered. Additionally, we believe disclosures of material changes in estimates of variable consideration should be included in any final standard as they enable investors to understand the impact of such changes on the financial statements.**
- *Credit Risk – Collectability of Customer Consideration (FASB and IASB Question #5):* The risk of collectability will now be accounted for *by how much* revenue is recognized by adjusting the estimated transaction price, rather than *on when* to recognize revenue through the principle of realizability. Although initial collectability assumptions are reflected as a reduction in revenue, subsequent changes in these assumptions are reflected separately as an expense (or income) through profit and loss. We agree with the expected value approach that factors the uncertainty associated with collectability of consideration in the estimated transaction price estimate. **We propose that the assessment of collectability should be made at contract inception rather than as the performance obligation is satisfied.** It is critical that collectability be evaluated at inception otherwise revenue would be recognized without adequate information regarding collectability. **However, we propose that the credit impairment should be presented separately and that subsequent measurement should also be adjusted through revenue rather than separately through income or expense.** It is useful for investors to have information on the initial expectation of credit losses associated with customers as well as the change in expectations. Accordingly, separate disclosures of initial expectations of credit losses plus changes in expectations are necessary for users to have transparency into total credit losses as a percentage of revenue. **As noted previously, a rollforward of credit losses would also be helpful.**

- *Time Value of Money (FASB and IASB Question #6)*: We agree with the inclusion of the time value of money if there is a material financing component in the contract, and the payment from the customer is due significantly before or after the transfer of goods or services. The present value should be used in the determination of total consideration and in the allocation of consideration to performance obligations. Where time value is considered to be significant, the ED proposes that credit risk should be reflected in the discount rate. However, we believe discount rate should be better defined thereby providing clarity as to whose credit risk (i.e. seller versus customer) in the computation. In general, there is also a need to parse the discount rate into its sub-elements to ensure risks are accounted for only once. **The basis of discount rate determination – along with the discount rate – should be included in disclosure requirements.** Further, the “unwind” of the discount rate should be reflected as interest expense or income and be separately presented in the income statement. We observe that the issue of the appropriate discount rate is a cross cutting issue with other projects and needs to be resolved at the Conceptual Framework level.

Revenue Measurement –

Use of Estimated Selling Price for Measurement of Separate Performance Obligations (FASB and IASB Question #7)

We are concerned with the subjectivity and earnings management (e.g. front loading of revenues) which will likely result from the use of estimating selling prices, particularly when such latitude is coupled with the loosely defined principles of separation of distinct performance obligations (e.g. through profit margin differences). Unlike the previous requirement to utilize fair value evidence (i.e. vendor specific objective evidence (VSOE)) to differentiate deliverables (performance obligations) under U.S. GAAP for software transactions, the ability to utilize an estimated selling price – in the absence of an observable selling price – will allow companies to use low estimates of selling prices for future performance obligations, permitting them to front load revenues by understating the revenue attaching to future, higher-risk obligations (e.g., future performance obligations for products and services under development at the inception of the contract.). **We are concerned by the lack of reliability of estimated selling prices for new products or components of products where there is little or no correlation between costs and sales prices when such products are not sold separately. We contend that it is very difficult to estimate selling prices until substantial stand-alone sales are achieved.**

Further, our experience in the United States has been that the disclosures related to the use of estimated selling price per EITF 08-1, *Revenue Arrangements with Multiple Deliverables*, and EITF 09-3, *Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements* – two standards that mirror the proposals in this ED – are usually uninformative. **Our reservations are compounded by the expectation that preparers will be reluctant to disclose the confidential information used to model estimated selling prices.** Further, only when contracts become onerous will the inappropriate allocation of transaction price become apparent. Some suggest, however, that failure to further support such products or planned obsolescence will ensure that such contracts never become onerous. We are also concerned by the auditability of these estimated selling prices.

Estimated Selling Price Disclosures: As noted previously, Paragraph 83 provides very generic guidance regarding the disclosure of methods, inputs and assumptions used to estimate stand-alone selling prices. **We believe more robust disclosures (described below) are required regarding the basis of determination of estimated selling price. We strongly recommend that, concurrent with allowing managers to use an estimated selling price, there should be a hierarchy with respect to the determination of this estimated selling price.** This hierarchy should prioritize the application of available market evidence and it should also necessitate higher levels of disclosure, including the basis of estimation of these selling prices, for any management estimates that are not based on objective evidence. We suggest that the standard require reporting entities to apply the following hierarchy of entity-specific entry prices, from most reliable to least reliable:

- Level 1 – Current sales price charged by the entity in an active market.
- Level 2 – Current sales price of competitors in an active market.
- Level 3 – Current sales price charged by the entity in an inactive market.
- Level 4 – Current sales price charged by competitors in an inactive market.
- Level 5 – Estimates of sales prices using entity inputs that reflect the entity’s own internal assumptions.

Revenue Measurement – Subsequent Measurement

Paragraph 53 of the ED proposes that after contract inception an entity shall allocate any changes in the transaction price to all performance obligations on the same basis as at contract inception. An entity shall not reallocate the transaction price based on any changes in stand-alone selling prices after inception. Though we support an exit value notion which would include updating estimates to current market conditions each measurement period, given the decision to follow a customer consideration (i.e. entry value) notion at inception we support the Boards' decision not to reallocate the transaction price based on any changes in stand-alone selling prices after inception.

Paragraph 54 proposes that an entity shall recognize a liability and a corresponding expense if the performance obligation is onerous.⁹ We support this proposed treatment for onerous performance obligations and for changes in the transaction price.

See comments made previously regarding disclosures associated with changes in transaction price and onerous contracts.

⁹ A performance obligation is onerous if the present value of the probability weighted costs that relate directly to satisfying that performance obligation exceeds the transaction price allocated to the performance obligation.

Cost Recognition (FASB and IASB Questions #8 and #9)

The ED describes various cost recognition principles. These include:

- Paragraph 57 proposes that costs incurred in fulfilling a contract should give rise to recognized assets (inventory, property plant and equipment and intangible assets), only if: a) costs relate directly to a contract; b) generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and c) are expected to be recovered.
- Paragraph 58 proposes the costs related directly to the contract to be: a) direct labor; b) direct materials; c) allocations of costs that relate directly to the contract; d) costs that are explicitly chargeable to the customer under the contract; and e) other costs that were incurred only because the entity entered into the contract. These costs can be capitalized.
- Paragraph 59 proposes that an entity shall recognize the following costs as expenses: a) costs of obtaining a contract; b) costs that relate to satisfied performance obligations; and c) costs of abnormal amounts of materials, labor or other resources used to fulfil the contract.

We support these proposed criteria for distinguishing when to expense versus capitalise contract costs. For costs to qualify for capitalisation we favour a high threshold. We believe capitalising of costs directly related to fulfilling a contract is appropriate. It is also appropriate to expense the cost of obtaining new business as it is a sunk cost. **However, we foresee divergent interpretations and questions (“grey areas”) arising regarding some of the costs identified as being related directly to the contract.**

Cross-Project Consistency: We observe that the issue of cost capitalization exists across various projects currently under considerations by the Boards – insurance, leases, revenue recognition, financial instruments – and urge the Boards to ensure there is consistency in their conceptual treatment across all projects so that costs are reflected with financial statements uniformly. Further, we believe it is important that the Boards provide consistency in presentation of costs (e.g. presented as assets or netted against liabilities) and in the approach used to amortize such costs into income.

Cost Recognition Disclosures: As noted above, the ED contains no disclosure requirements related to cost recognition. The Disclosures section of this letter discusses the disclosures related to cost recognition that we believe should be included in any final standard.

Transition and Effective Date (FASB and IASB Question #13)

We support the full retrospective application proposed in Paragraph 85 of the ED. Users need comparable information for all prior periods presented on a consistent basis. Given the importance of revenue and cost information to the valuation of the enterprise, it is imperative that trends be provided through the communication of at least three periods of information (two prior periods and the current period). Optionality related to retrospective versus prospective adoption is entirely unacceptable to users. This would create a situation where similar enterprises could report noncomparable results that would make optimal investment decisions very difficult.

We do not object to an effective date which allows companies to plan for adoption and improve the quality of retrospective application, but even such a delay should not prevent the need for those enterprises with long-term contracts (e.g. greater than two to three years in duration) to engage in some element of retrospective application.

We are surprised by the lack of transition guidance provided in the ED. We expect that upon transition, questions will arise related to the availability of historical information and the use of hindsight in the determination of transaction prices, estimated selling prices, etc. For example, would a long-term contract which is onerous at the date of transition – but which was not expected to be onerous at inception – be considered onerous upon inception under a retrospective transition application? Similarly, would estimated selling prices which, upon inception of the contract, and the initial allocation, had not been observable, but which become observable by the date transition, utilize currently existing information to perform allocations or use then existing information?

Application or Implementation Guidance (FASB and IASB Question #14)

The ED provides application guidance with some helpful illustrative examples regarding the application of the conceptual principles in the ED including separating and determining satisfaction of performance obligations. However, as noted earlier in the general comments, more needs to be done to reflect real world complexities and to illustrate certain key industry specific issues. Further, we believe these examples or application guidance should be a part of the authoritative U.S. GAAP and IFRS literature – not separate guidance which is not of the same authoritative stature as the remainder of the ED. This guidance should be developed simultaneously with the completion of the ED to ensure they are consistent.

Warranties (FASB and IASB Question #15)

The ED proposes that warranties related to latent defects be accounted for as an unsatisfied performance obligation (i.e. failed sale) and warranties that relate to faults that arise in products after sale as separate performance obligations. We question why there is differentiated treatment between warranties pertaining to latent defects from warranties related to product faults that arise after sales to customers. We believe that legal form should not dictate accounting treatment and the overriding consideration should be economic substance. **A more meaningful distinction would be whether the warranty can be sold separately or not. As noted above, we believe separate presentation and disclosure of warranty obligations and changes in such estimates should be provided in the financial statements.**

Licensing Of Intellectual Property (FASB and IASB Question #16)

The ED proposes that if a license to use intellectual property is exclusive, then the revenue related to the performance obligation is recognized over the term of the license. If the license is non-exclusive, the revenue related to the performance obligation is satisfied when intellectual property is transferred to the customer. **As noted earlier, it is not clear how the principle of transfer of control is being**

consistently applied here. It seems counterintuitive, and inconsistent with the transfer of control notion, that the exclusive right does not result in immediate revenue recognition when a more limited transfer does.

Consequential Amendments (FASB and IASB Question #17)

We support the proposal to extend the proposed revenue recognition and measurement approach to the accounting for the gain or loss on the sale of certain non-financial assets. We believe, however, that separate presentation and disclosures should be provided.

Application to Non-Public Entities (FASB Question #18)

We strongly support a single model for recognition and measurement of revenue across both public and non-public entities. Given the needs of fixed income investors, and the growth of private equity, the line between public and non-public entities is increasingly difficult to discern.