

Private Company Financial Reporting Committee

401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

443-480-5800

e-mail: judyodell@dmv.com



Judith H. O'Dell CPA CVA
Chair

October 29, 2010

Ms. Leslie Seidman
Acting Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: Proposed Accounting Standards Update, *Revenue from Contracts with Customers* (“proposed ASU”)

Dear Ms. Seidman:

The Private Company Financial Reporting Committee has reviewed the proposed ASU and is pleased to offer its recommendations below. The Committee appreciates the extensive and challenging work performed by the FASB and its staff in attempting to improve the accounting standards related to revenue recognition. In accordance with its unique mission, the PCFRC assessed whether the proposed ASU would improve financial reporting by better meeting the needs of private company financial statement users and whether any improvements are worth the additional costs of complying with the proposed ASU.

The Committee presents its recommendations by first addressing those areas that could prove most problematic for private companies. The key areas of concern are:

- The potential loss of the percentage-of-completion accounting method and the resulting impact on the construction industry and other industries with multi-element and long-term contracts;
- Lack of clarity for determining when control of a promised good or service has been transferred to a customer and the implementation problems that could arise in the software industry;
- Requiring a private company to reduce the amount of promised consideration to reflect a customer’s credit risk; and,
- The proposed changes to warranty accounting.

Also, the PCFRC suggests that the proposed ASU should not be finalized until the FASB's Accounting for Financial Instruments proposed ASU is finalized. Otherwise, confusion and disparity of practice may result in the private company sector.

The PCFRC may send the FASB supplemental input on the proposed ASU as the committee is still discussing several questions.

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

Construction Industry/Percentage-of-Completion Accounting

Most construction companies (which overwhelmingly use the percentage-of-completion accounting method) are privately held. Over a period of many years construction companies, sureties, taxing authorities and bankers have come to an understanding on the use of the percentage-of-completion method of recognizing revenue. The proposed ASU will cause substantial change to those long-held construction accounting principles. Such change will impose additional costs on an industry suffering economic hardships. Moreover, the proposed ASU could open the door to the manipulation of revenue, depending on how a contractor decides to allocate revenue to a performance obligation.

Key private company constituent organizations within the construction industry are seriously concerned about the proposed ASU and have submitted their concerns and objections to the FASB. The PCFRC, therefore, will not repeat those issues in this letter. While the PCFRC realizes that one of the goals of the proposed ASU is to provide a common framework that applies across all industries, the PCFRC strongly recommends that the FASB maintain the percentage-of-completion method, as we now know it for construction contractors. It appears that there is room within the proposed model to do so. Not to do so would entail costly changes to accounting systems at construction contractors and the possibility that sureties and lenders would still want to see the percentage-of-completion schedule and management would still manage the company using this method. In addition, this is a required tax accounting method. The proposed revenue recognition standard would require construction contractors to maintain two separate systems.

Dissenting Viewpoint of PCFRC Practitioner Member: Maintaining the percentage-of-completion method would be a separate, industry-based carve out, which would defeat the purpose of the proposed ASU. The application of the proposed ASU to the construction industry is unclear. More detailed guidance about the continuous transfer of assets and selection of input/output methods is needed to avoid wide diversity in practice.

Customer Credit Risk

Requiring the entity to reduce the amount of promised consideration to reflect a customer's credit risk could be costly and unnecessarily complex for private companies and provide little benefit to their financial statement users. Currently, accounts receivable agings are reviewed periodically and an allowance is provided for doubtful accounts. The change in the allowance is recorded as a bad debt expense. The PCFRC believes that showing the amount of bad debt expense provides better information about how a company manages its credit policies than reducing revenue by the probability-weighted amount of consideration the entity expects to receive. In effect, this results in netting some bad debt expense against revenue. Such a presentation could actually impair a financial statement user's ability to assess credit risk at a company. In addition, the proposed requirements would prove very costly to many private companies because they would need to employ the services of outside businesses to help calculate the probabilities of default.

Also important to point out is the fact that many rental contracts for retail stores and other types of contracts that private companies enter into are based in part on sales. The PCFRC recommends that paragraph 43 of the proposed ASU not be applicable to private companies and that private companies be permitted to continue the current practice of recording an allowance for bad debts.

Rights of Return

The proposed accounting for rights of return (paragraphs IG5-IG12 of the proposed ASU) will also be costly and complex for private companies to implement as it would require complex estimates. Similar to the allowance for doubtful accounts, most private companies provide an allowance for sales returns or record actual sales returns as a contra-income item. Sales returns and allowances are usually disclosed on the face of the income statement and gives the user some indication of whether the company is experiencing difficulties with its products. The PCFRC recommends that the current practice of accounting for rights of return be maintained.

Disclosures

See answers to Respondent Questions 10, 11 and 12 below.

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

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

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

PCFRC Response: The PCFRC agrees with the proposed price interdependence principle, with the recommendation that a materiality factor should be introduced into the principle.

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

PCFRC Response: The PCFRC agrees with the principle that an entity should account for a promise of a good or service as a separate performance obligation only if that good or service is distinct. However, the PCFRC understands that construction industry companies, their auditors, and those who use their financial statements have significant concerns about identifying performance obligations within construction contracts. We refer you to the comment letters submitted by those parties and the discussion in the first part of this letter. In addition, the PCFRC believes that these same concerns will be present in other industries with multi-element and long-term contracts.

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

PCFRC Response: The Committee does not believe that the guidance in the proposed ASU is sufficient for determining when control of a promised good or service has been transferred to a customer. In the software industry, a number of subsequent deliverables may not occur despite being completed and ready for pickup by the customer. In those cases, the PCFRC recommends that the guidance on recognizing revenue be clearer. For example, a software company sells XYZ software (Version 1) with subscription rights entitling the customer to one year of future software upgrades. Customer A purchases a contract in January and receives Version 1 with the one-year upgrade subscription. Customer B purchases a contract in April and receives Version 2 with the one-year upgrade subscription. If Customer A does not download the new version of software (Version 2), what impact would that have on revenue recognition?

The PCFRC understands that private company constituents in the construction industry have serious concerns about the transference of control of a good or service to a

customer and the related impact on revenue recognition. The PCFRC refers the FASB to the comment letters submitted by construction industry constituents and recommends, as stated above, that a way to be found within the model to maintain the percentage-of-completion method.

Also, the PCFRC recommends that the FASB make clear whether each contract must be analyzed individually or whether contracts can be aggregated by type.

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

PCFRC Response: The PCFRC agrees that revenue should only be recognized if the transaction price can be reasonably estimated. Also, the proposed criteria in paragraph 38 of the proposed ASU appears to be useful in determining the transaction price.

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

PCFRC Response: The PCFRC does not agree. See the PCFRC's response to Question 18 under the header "Customer Credit Risk". In addition, the Committee believes it is not cost effective at an individual (small) contract value to determine collectability based on customer credit risk without aggregating customers into risk groups. The proposed ASU does not allow for customer credit risk to be cost-effectively evaluated by private companies. The most effective way to assess credit risk allowances is on a regular basis and not on a transactional basis. Assessing credit risk on a transaction basis would prove too costly for all but the larger companies.

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

PCFRC Response: Adjusting the amount of promised consideration to reflect the time value of money if the contract includes a material financing component appears to be generally reasonable. However, private company constituents within the construction industry may have concerns over the incorporation of risk components (like the time value of money) into the transaction price. We refer the FASB to the comment letters submitted by those constituents.

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

PCFRC Response: The PCFRC agrees that generally the transaction price should be allocated to all separate performance obligations in a contract in proportion to the standalone selling price of the good or service underlying the performance obligations. However, we are concerned that this approach may be problematic in the construction industry and refer the FASB to the comment letters submitted by constituents in that industry for further consideration. In addition, the PCFRC believes that these same concerns will be present in other industries with multi-element and long-term contracts.

Respondent Questions 8 and 9
The PCFRC is not responding to these at this time.

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

PCFRC Response: The PCFRC is of the opinion that some of the proposed disclosure requirements will help users of private company financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. However, the information provided by the proposed reconciliations of contract balances and onerous performance obligations, as well as the tabular disclosure in paragraph 79 of the proposed ASU, does not appear to be of sufficient value to private company financial statement users to justify the compliance costs that would be incurred by financial statement preparers and auditors. As such, the PCFRC recommends that private companies be exempted from those reconciliation and tabular disclosure requirements.

Respondent Question 11: *The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you*

agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

PCFRC Response: The PCFRC does not agree that a company should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Private company financial statement users do not appear to have a significant need for such information. The PCFRC also notes that the accounting software industry may not have the ability to incorporate these requirements into their accounting products in a timely fashion depending on the effect date of the ASU.

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

PCFRC Response: The PCFRC does not agree that a company should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Such information does not appear to be of significant benefit to private company financial statement users.

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

PCFRC Response: The Committee disagrees with retrospective application of the proposed ASU. While consistency of presentation is an important aspect of financial reporting, private company constituents will find it more cost effective to apply changes prospectively based on contract date. In addition retrospective application would entail a significant amount of time in implementing the standard.

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

PCFRC Response: Overall, extensive application guidance is needed for private companies, given the wide array of revenue generating activities that exist in the sector. As such, the Committee recommends the inclusion of wide-ranging application guidance and examples in the final standard such as those included in the exposure draft. Application guidance and examples related to the healthcare industry would be

valuable. Also, the PCFRC recommends that additional guidance be provided on when the control of a good or service has been transferred to a customer, especially in multi-element arrangements where delivery of contract items /elements may be completed and deliverable but not accepted by the customer.

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

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

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

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

PCFRC Response: The PCFRC does not agree with the proposed accounting for product warranties. The manner in which warranty obligations are currently accounted for (as an estimated liability and corresponding expense) is much easier to apply and more conceptually sound for the private company sector. Providing a warranty is more of a cost of sale item than a revenue producing item. A product backed by a warranty is an incentive for a customer to purchase that product. Accordingly, the PCFRC recommends that the current method of accounting for warranties be maintained for private companies in that the related liabilities should be recognized separately from revenue recognition.

Dissenting Viewpoint of PCFRC Practitioner Member: One member agreed with the proposed accounting for product warranties and the proposed distinction between the types of product warranties.

Beyond that recommendation, the Committee recommends that the FASB better clarify the distinction between the two types of warranties to avoid disparate application. Also, more clarification is needed when both types of warranty elements are present. If a warranty covers defects in the product at the time of sale and also defects that occur after the sale, criteria would be needed for bifurcating the costs/performance obligations of each element.

Respondent Question 16- *The PCFRC is not commenting on this at this time.*

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

PCFRC Response: The PCFRC agrees that a company should apply the recognition and measurement principles of the proposed ASU in accounting for the gain or loss on the sale of some nonfinancial assets.

The PCFRC appreciates the FASB's consideration of these recommendations. Please feel free to contact me if you have any questions or comments. As stated above, the PCFRC may issue a supplement to this letter after the November 4th joint FASB/IASB roundtable meeting on the proposed ASU.

Sincerely,



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