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June 30, 2015

VIA EMAIL TO: director@FASB.org

Technical Director
File Reference No. 2015-250
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update, *Identifying Performance Obligations and Licensing*

To Whom It May Concern:

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions. We are writing to provide comments on the FASB's Proposed Accounting Standards Update, *Identifying Performance Obligations and Licensing* (the "ED").

We commend the FASB for being open to improving upon the guidance issued in ASU 2014-09, *Revenue from Contracts with Customers.* We believe that making improvements before the new guidance is adopted will help to ensure a smooth and effective transition. We believe that the guidance on Identifying Performance Obligations and Licensing are two areas in which improvements can be made to along these lines. However, we believe that certain of the proposed changes to Topic 606 are unnecessary, and could in fact be detrimental to the application of generally accepted accounting principles. We explain these views later in this letter as we respond to each of the Questions for Respondents posed in the ED.

Convergence

We are also concerned about the effect of the proposed modifications on convergence between US GAAP and International Financial Reporting Standards. The ED states that the FASB "…does not expect that the amendments in this proposed Update would result in financial reporting outcomes that are significantly different from those reported under IFRS for similar transactions." We don't know what level of different outcomes the Board would consider significant, but we believe it is unlikely that significantly different words, which would result from the proposals now being pursued by the Board and the IASB, would not lead to different accounting conclusions in some instances. The Board and the IASB worked very hard during the deliberations leading up to the issuance of ASU 2014-09 and IFRS 15 to keep the wording almost exactly the same. To lose

that in a significant way now would be very disappointing, especially because the views on these topics expressed by members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition were similar between US and non-US members.

It is even more disappointing because the areas in which the proposals in the ED differ most significantly from the IASB's proposals to address similar issues involve either 1) areas in which the Board seems to be trying to address issues which are better addressed in other ways (see our responses to Questions 2 and 3 below), and 2) a decision by the Board to deviate from the core principle of Topic 606, which the IASB has refused to do (see our response to Question 5 below).

Reponses to Questions for Respondents

Question 1: *Paragraphs 606-10-25-14(b) through 25-15 include guidance on accounting for a series of distinct goods or services as a single performance obligation. Should the Board change this requirement to an optional practical expedient? What would be the potential consequences of the series guidance being optional?*

We understand that the Board included the guidance on accounting for a series of distinct goods or services as a single performance obligation because it believed that doing so would be simpler than accounting for each of those goods or services as separate performance obligations. We observe that under Topic 605 (current GAAP), the types of goods or services that would be scoped into the guidance in ASC 606-10-25-14(b) and 25-15 are generally accounted for as a single deliverable or unit of account. We believe that this is primarily because vendors in these situations don't view themselves as selling one service repetitively, but instead as selling a service of outsourcing an activity. In that regard, the payroll processor doesn't believe it has 52 deliverables, one for each weekly payroll run, but instead a single deliverable of a year of payroll processing. The guidance in ASC 606-10-25-14(b) logically provides that this treatment should continue. While the Summary to the ED suggests that some TRG members noted that in some instances, this provision may actually make the guidance more difficult to apply, we are not aware of those situations. As such, at this point, we do not see a need to make this guidance optional.

Question 2: *Paragraph 606-10-25-16A specifies that an entity is not required to identify goods or services promised to a customer that are immaterial in the context of the contract. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.*

The question posed has only one logical answer. Of course, not accounting for something is simpler and cheaper than accounting for it, and, of course, allowing an entity to avoid accounting for something without a full materiality analysis makes the standard simpler and cheaper to apply.

But the question posed is the wrong question. The issue that proposed paragraph 606-10-25-16A seeks to address arises because of the way practice (in particular, auditing practice) has developed in regard to so-called "accounting conventions", in which a company knowingly deviates from GAAP because it believes that doing so will not result in a material misstatement in the financial statements. In practice, instead of accepting a qualitative analysis that supports the conclusion that the accounting convention will not result in a material misstatement, auditors have requested that preparers quantify the misstatement for reporting to the audit committee, believing that this quantification and reporting is expected by the Public Company Accounting Oversight Board (PCAOB). The expectation is that similar treatment will occur under Topic 606 if preparers

elect to ignore certain promises in contract with customers, resulting in non-value-added work to quantify immaterial differences.

We agree that the practice that has developed is inefficient and that something should be done to relieve the burden of quantifying misstatements which are qualitatively analyzed as being immaterial. However, we do not believe that the issue should be addressed by the FASB on a topic-by-topic basis by declaring *certain* accounting conventions to not be errors at all. We also note that TRG members generally did not believe that changes to Topic 606 were necessary to address this issue. Addressing the matter in this fashion is extremely inefficient and risks complicating GAAP.

Instead, the issue should be addressed in a more comprehensive fashion, perhaps through changes in audit practice to allow auditors to accept, as they did for many decades, qualitative support that accounting conventions would not result in material misstatements. Alternatively, the issue of whether the application of accounting conventions should be thought of misstatements at all could be addressed broadly.

If the Board does decide to add the guidance proposed in ASC 606-10-25-16A, we believe that the exception should not describe the promised goods or services that can be omitted from accounting as "immaterial in the context of the contract". Using the word "material" and the concept of "materiality" in multiple ways in financial reporting creates confusion. We believe the Board should reserve the use of the word "material" to situations pertaining to the financial statements, not an individual contract, and that the Board should use other terms when the analysis is to be limited to a contract. There is already precedence for this in Topic 606, in regards to identifying financing components. In ASC 606-10-32-16, financing components that must be accounted for are described as those that are "significant to the contract" – the word "material" is not used. Similarly, ASC 606-10-25-16A should not refer to those promises that may be ignored as being "immaterial" to the contract, thereby adding further confusion to the meaning of the term.

Question 3: *Paragraph 606-10-25-18A permits an election to account for shipping and handling as an activity to fulfill a promise to transfer a good if the shipping and handling activities are performed after a customer has obtained control of the good. Would the proposed amendment reduce the cost and complexity of applying Topic 606? If not, please explain why.*

Similar to the previous question, the way the question is asked has only one answer. Of course it is simpler and cheaper to not account for a promise to a customer than to account for it.

Also similar to the previous question, we believe that the Board is with this proposal attempting to resolve a practice question in a way that is inappropriate. Under Topic 605 (current GAAP), shipping and handling activities handled by the seller when title to the products transfers upon shipment (i.e., the goods are shipped "FOB shipping point") sometimes result in a conclusion that revenue should not be recognized until the goods have reached the customer, despite the earlier transfer of title, because the risks and rewards of ownership have not transferred due to the seller being responsible for shipping and handling. Generally, this conclusion is reached if shipping the goods is an activity that carries with it significant risks, due to complexity, time, risk of physical loss during shipment, etc. Under Topic 606, such risks will not necessarily cause a conclusion that control of the goods has not transferred, and therefore revenue might well be recognized for the transfer of the goods before shipping occurs.

We do not believe any modification is necessary related to this issue. Practitioners have asked for relief from the need to consider shipping activities to be a separate performance obligation in large part because of the need to quantify the effects of something that will usually be immaterial, just as in the previous question. When an entity is paid to move another entity's goods, that activity is clearly a performance obligation to a customer. That the goods were only recently transferred to the customer by the vendor does not change the nature of the activity – the vendor is still being paid to physically move its customers' goods. If the shipping activity is simple, its fair value will not be significantly larger than its cost, and therefore the difference between accounting for the activity as a performance obligation and accounting for it as a fulfillment cost (or indeed not accounting for it at all until it occurs) will be insignificant, and therefore it simply falls into the category of an accounting convention which, if the Board continues with its tentative conclusion, will be covered by ASC 606-10-25-16A, or, if our recommendation is followed, will be addressed in a more comprehensive manner.

If, however, shipping and handling is a significant effort because of special conditions needed to keep the goods safe, regulatory matters, unavailability of suitable transport mechanisms, or other matters, the Board's proposal in this area could result in material risks not being reflected in the financial statements. If shipping the goods is a significant undertaking, and the vendor has promised to provide that shipping, revenue properly allocable to shipping should not be recognized until that promise has been fulfilled.

Question 4: *Would the revisions to paragraph 606-10-25-21 and the related examples improve the operability of Topic 606 by better articulating the separately identifiable principle and better linking the factors to that principle? If not, what alternatives do you suggest and why?*

Yes. We believe these revisions and additional examples are helpful for the reasons described in the basis for conclusions.

Question 5: *Would the revisions to paragraphs 606-10-55-54 through 55-64, as well as the revisions and additions to the related examples, improve the operability of the implementation guidance about determining the nature of an entity's promise in granting a license? That is, would the revisions clarify when the nature of an entity's promise is to provide a right to access the entity's intellectual property or to provide a right to use the entity's intellectual property as it exists at the point in time the license is granted? If not, what alternatives do you suggest and why?*

We believe that improvements to the guidance in Topic 606 regarding determining the nature of an entity's promise in granting a license can and should be made. We believe that the changes being proposed that describe "functional" intellectual property and explain that a promise to grant a license to functional intellectual property will generally be satisfied at the beginning of the license term are appropriate. We believe an important part of the proposed guidance related to functional intellectual property is the need to evaluate ongoing activities of the vendor to determine whether the effect of those activities on the licensed intellectual property indicates that the promise to grant the license is satisfied over time instead of at the beginning of the license term.

ASC 606-10-25-23 states the core principle that revenue should be recognized "when (or as) the entity satisfies a performance obligation by transferring a promised good or service…to a customer." This clearly focuses on the activities of the vendor. In regards to licenses to "symbolic" intellectual property, however, the ED proposes to require recognition of revenue over

the license term whether the entity continues to perform any activities or not, thereby changing the principle from one focusing on the activities of the vendor to one focusing on the nature of the underlying intellectual property.

We agree that, in most cases, a vendor's continuing activities will affect the value of a license to symbolic intellectual property because such intellectual property derives its value from its association with the licensor. However, as acknowledged in draft paragraph ASC 606-10-55-59(b), that value could be "derived from its association with the entity's past or ongoing activities…" When the value of the symbolic property relates only to the entity's ***past*** activities (for example, because there are no ongoing activities related to that intellectual property), we believe the vendor has satisfied its performance obligation at the beginning of the license term. We believe that licensors should consider whether the value of the license to symbolic intellectual property will be affected by ongoing activities, similar to the requirement to consider such activities in relation to functional intellectual property.

Question 6: *The revisions to paragraph 606-10-55-57 that state an entity should consider the nature of its promise in granting a license of intellectual property when accounting for a single performance obligation. Does this revision clarify the scope and applicability of the licensing implementation guidance? If not, why?*

The proposed revisions correct what was likely an unintended consequence of the original drafting of Topic 606 that seemed to indicate that consideration of the nature of the license was not required if the license was combined with another good or service in a single performance obligation. As currently drafted, however, the paragraph in the ED doesn't make reference to licenses that are distinct and are therefore performance obligations in and of themselves. We would therefore suggest that the paragraph be changed to state:

> An entity should consider the nature of its promise in granting a license (see paragraphs 606-10-55-59 through 55-64) when accounting for a <u>license of intellectual property that is distinct from other promised goods and services and when accounting for a single performance obligation that includes a</u> license of intellectual property and one or more other goods or services (that is, to apply paragraphs 606-10-25-23 through 25-37).

Question 7: *Would the revisions to paragraph 606-10-55-64 adequately communicate the Board's intent (a) that restrictions of time, geographical region, or use in a license of intellectual property are attributes of the license (and, therefore, do not affect the nature of an entity's promise in granting a license or its assessment of the goods or services promised in a contract with a customer) and (b) about determining when a contractual provision is a restriction of the customer's right to use or right to access the entity's intellectual property? If not, what alternatives do you suggest and why?*

The revisions to paragraph 606-10-55-64 seem to be clear in communicating that restrictions of time, geography, or use do not impact the nature of the promise or the number of promises.

However, the second half of paragraph BC39 confuses the issue by noting that certain restrictions of time do affect the number of promised goods or services. That guidance references a situation in which there is a gap in the licensee's right to use and the ability of the licensor to license the intellectual property to others during the gap. However, that discussion leaves open:

- Whether it is important that the license is exclusive during the periods in which the licensee does have the right to use the property (seemingly an implicit assumption in the example, but unstated)
- Why a gap should cause the license to be looked at as multiple promises, considering that the licensor need take no further actions to fulfill its obligations
- What situations other than a gap in which rights revert to the licensor might lead to a conclusion that the license includes multiple promises
- How the substance of a gap is to be evaluated. For example, if a license to exhibit a film on television allows exhibiting once every year, but only in December, is the 11-month gap substantive because it is compared to the 1 month exhibition period? Or is the gap non-substantive because the television operator likely wouldn't show the film more than once per year anyways?

As drafted, we believe the second half of paragraph BC39 throws into question how restrictions on time, geographical region or use should be evaluated. Overall, we believe it preferable to simply state that such restrictions do not cause a license to be evaluated as multiple promises. If the Board believes there are situations in which such restrictions do impact the number of promised goods or service, a better explanation is needed.

Question 8: *Would paragraphs 606-10-55-65 through 55-65B and the related example clarify the scope and applicability of the guidance on sales-based and usage-based royalties promised in exchange for a license of intellectual property? If not, what alternatives do you suggest and why?*

Yes. While we would prefer that variable payments that are sales-based or usage-based be accounted for similarly no matter what the promised goods or services are, we believe the proposed amendments in these paragraphs will clarify when the exception applies.

Summary

We developed the views expressed in this letter as we were following the Board's deliberations of the issues addressed by the TRG. Obviously, we do not agree with several of the decisions reached by the Board. Upon reading the ED, we noted that our views are very consistent with the alternative views expressed by Messrs. Linsmeier and Siegel in paragraphs BC64 through BC75. Application of those alternative views would also limit the divergence between US GAAP and IFRS, which would, as we note above, also be beneficial.

Once again we appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Identifying Performance Obligations and Licensing*. If there are any questions, please contact Scott A. Taub at 312-345-9105.

Sincerely,

Financial Reporting Advisors, LLC

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