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Comment Letter No. 15

Ms. Susan M. Cospers  
Technical Director  
File Reference No. 2015-320  
Financial Accounting Standards Board  
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Norwalk, CT 06856-5116

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**Proposed Accounting Standards Update, *Revenue from Contracts with Customers (Topic 606) – Narrow-Scope Improvements and Practical Expedients* (File Reference No. 2015-320)**

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Revenue from Contracts with Customers (Topic 606) – Narrow-Scope Improvements and Practical Expedients* (the Proposed ASU), from the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective to provide additional clarifications and examples to reduce diversity in practice when entities adopt the new revenue standard and to reduce the costs and complexity of applying the new guidance both at transition and beyond. Overall, we support the Proposed ASU because the additional clarifications would improve consistency and, in many cases, provide a practical approach to applying the new standard. We believe the proposed amendments would address many of the concerns raised by constituents about the new guidance on collectibility, presentation of sales and similar taxes, noncash consideration and transition.

We continue to support the convergence of Accounting Standards Codification (ASC) 606 with IFRS 15, *Revenue from Contracts with Customers*. Accordingly, we believe the FASB and the International Accounting Standards Board (IASB) should include the same guidance in their standards whenever possible. When the same guidance is not included in both standards, we believe it will be important for the FASB and the IASB to explain in their final standards whether those differences could result in different conclusions for entities applying ASC 606 and those applying IFRS 15.

**Assessing collectibility**

We support the proposed amendments to clarify the collectibility guidance and believe explaining that an entity should consider its ability to mitigate its credit risk in the collectibility assessment would help clarify how an entity should apply this guidance. We also believe the proposed amendment to add a third event that would trigger recognition of nonrefundable consideration received as revenue would improve the clarity and operability of the guidance.

Also, while we support the accounting result illustrated in Case A of Example 1, we believe the analysis in the example should be articulated differently to clarify why the transfer of control has not occurred. Absent further clarification, we believe there could be unintended consequences of linking the transfer of control to the existence of a contract. We discuss these issues further in Appendix A to this letter.

### **Presentation of sales taxes and other similar taxes**

We support the Board's proposal to permit an entity to elect to exclude all sales (and other similar) taxes collected from customers from the transaction price. We observe that the election could create a difference between the application of ASC 606 and IFRS 15 for entities with material sales (and other similar) taxes collected from customers. We believe that the Board should clearly acknowledge this difference with IFRS 15. While continued alignment of ASC 606 and IFRS 15 would be beneficial, we support the Board's proposal on this issue.

### **Noncash consideration**

We support clarifying the measurement date for noncash consideration. Without the amendment, there would be uncertainty and diversity in practice regarding when entities would measure the fair value of noncash consideration and include it in the transaction price. However, we also recommend that the Board consider whether measuring noncash consideration at contract inception could lead to financial reporting results that are inconsistent with the economics of certain contracts with customers. We provide our detailed observations in Appendix A. Further, we observe that the clarification of the measurement date for noncash consideration would create a difference in the language between ASC 606 and IFRS 15. We suggest that the Board clearly acknowledge this difference with IFRS 15.

We also support the Board's proposed revisions to clarify that the guidance on variable consideration applies only to variability in noncash consideration resulting from reasons other than the form of the consideration.

### **Contract modifications and completed contracts at transition**

We support the Board's proposal to add a practical expedient for accounting for contract modifications at transition. We also support the proposed clarifications to the definition of a completed contract at transition. We observe that the clarification on completed contracts at transition would create a difference between the application of ASC 606 and IFRS 15 for entities at transition. We suggest that the Board clearly acknowledge this difference with IFRS 15.

We respond to certain questions posed in the Proposed ASU in Appendix A to provide further detail about our above comments. In Appendix B, we recommend some additional clarifications to the proposed amendments.



\* \* \* \* \*

We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,

*Ernst & Young LLP*

cc: International Accounting Standards Board

**Appendix A – Responses to questions posed in the Proposed ASU, *Revenue from Contracts with Customers (Topic 606) – Narrow-Scope Improvements and Practical Expedients***

**Question 1:** Does the proposed addition of paragraphs 606-10-55-3A through 55-3C, as well as the addition of new examples, clarify the objective of the collectibility threshold? If not, why?

We support the proposed addition of paragraphs 606-10-55-3A through 55-3C. It is important to clarify that the objective of the collectibility assessment is to determine whether there is a substantive transaction and whether the customer has the intent and ability to pay the promised consideration in exchange for the goods or services that *will be* transferred to the customer.

We nevertheless expect questions to arise about how to evaluate whether it is probable that substantially all of the consideration will be collected. The proposed amendment to paragraph 606-10-25-1(e) appears to add the threshold of “substantially all” to the existing threshold of “probable” in the collectibility assessment. We believe the “substantially all” threshold is not needed to determine whether it is probable that the consideration will be collected and may introduce additional complexity in the analysis.

We support a practical approach to assessing collectibility. In Case E of Example 1, even though the entity’s history indicates that the entity expects to collect approximately 94% of the transaction price, the entity concludes it is not probable that it will collect the full transaction price. Instead, the entity determines it is probable that it will collect substantially all of the consideration. While not illustrated in the example, it appears this conclusion could have been reached if the entity performed a more detailed assessment of the probability of collecting specific amounts of promised consideration (e.g., historical collection data could indicate that an entity collects the full transaction price in 40% of transactions, 96% of the transaction price in 50% of transactions and 60% of the transaction price in 10% of transactions).

We believe it is sufficient for purposes of determining whether to account for a contract with a customer under ASC 606 to assess collectibility based on the weighted average payment percentage (i.e., 94% in Case E of Example 1) for that class of customer. Accordingly, we do not believe the new “substantially all” threshold is needed, and it should be removed. If the Board decides to retain this concept, we believe further clarification is needed to explain why collection is not probable because we expect entities in similar circumstances as those illustrated in Case E of Example 1 would conclude collection is probable.

The proposed examples would improve the operability of the implementation guidance and illustrate its application in circumstances in which questions frequently arise. We believe certain examples could be further improved, and we suggest the following clarifications:

- ▶ The implementation guidance in proposed paragraph 606-10-55-3A states the objective of the collectibility assessment is to determine whether there is a “substantive” transaction, while proposed paragraph 606-10-55-98S uses the terms “genuine” and “valid” and proposed paragraph 606-10-55-98G uses all three terms. Based on the discussion in paragraph BC10 of the Proposed ASU, we understand that the Board intends for these terms to be synonymous. We believe the use of all three terms may cause confusion about the objective of the collectibility assessment and recommend that the Board use one word consistently throughout.

- ▶ We believe that Case B of Example 1 should be clarified to explain what a “substantial period of time” means in the context of evaluating collectibility. We believe the Board’s intent may be for an entity to assess the period over which it expects the customer to pay in relation to the total period of expected performance by the entity, including the customary grace period. However, absent further clarification, we believe some stakeholders may believe that an entity should evaluate the period over which it expects the customer to pay in relation to the total contract term. Other entities may only evaluate the length of time the customer expects to pay without considering it in relation to a specific period (e.g., determining that payment for two years is a substantial period of time regardless of whether the contract term is two-and-a-half years or 10 years).

**Question 2:** Paragraph 606-10-25-7(c) was proposed to provide clarity about when revenue should be recognized for a contract that does not meet the criteria in paragraph 606-10-25-1. Does this proposed amendment improve the clarity of applying the guidance? If not, why?

We believe the proposed amendment to add a third event that triggers recognition of nonrefundable consideration received as revenue would improve the clarity and operability of the guidance. This proposed addition addresses the circumstances in which nonrefundable consideration should be recognized as revenue when the entity is no longer transferring goods or services but still may be pursuing collection from its customer for the remaining consideration in the contract.

However, we suggest that the Board clarify the language in the proposed amendment to help constituents understand how to apply the guidance. Proposed paragraph 606-10-25-7(c) says that “the entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods and services to the customer and has no obligation to transfer additional goods or services” (emphasis added). We recommend that the underlined phrase be removed because it may create confusion for stakeholders and is not needed to apply the guidance.

Specifically, some entities may interpret the underlined language to mean that, to determine the amount of consideration that relates to the goods or services, they would have to apply aspects of the full revenue model in ASC 606 to identify performance obligations, determine the transaction price and allocate the transaction price to those performance obligations. Other entities may believe that the words “goods or services to which the consideration...relates” imply that they can recognize nonrefundable consideration received for certain goods or services (because the consideration relates to those goods or services) while they continue to transfer other goods or services to the customer. Neither of these interpretations is consistent with our understanding of the Board’s intent.

We also support the accounting result illustrated in Case A of Example 1, but we believe the explanation about why transfer of control of the building has not occurred should be revised in two ways. First, we suggest removing the phrase, “because there is no contract between the parties in accordance with paragraph 606-10-25-1,” in proposed paragraph 606-10-55-98A because we believe the analysis should only focus on the indicators of the transfer of control in paragraph 606-10-25-30. In addition, the removal of this wording would eliminate questions we expect to arise because of a possible conflict in the proposed guidance. Specifically, if control of an asset cannot be transferred because there is no contract in accordance with paragraph 606-10-25-1, then an entity would not be able to apply proposed paragraph 606-10-25-7(c) since that paragraph, which is only applied when there is no contract, **requires** that control of the goods be transferred in order to recognize revenue.

Second, we recommend that the FASB include an analysis of the transfer of control indicators in paragraph 606-10-25-30 in proposed paragraph 606-10-55-98A, similar to the following:

- ▶ The entity has a present right to payment when physical possession of and legal title to the building are provided to the customer.
- ▶ The entity has transferred physical possession of, and legal title to, the building, but these factors are not substantive because the customer is not committed to perform (based on the facts in paragraph 606-10-55-97) and the entity has the right to repossess the building. Paragraph BC13 of the Proposed ASU says, "An entity's ability to repossess an asset transferred to a customer might, however, affect its assessment of when or whether control of the asset transfers to the customer in some arrangements." We believe an entity would consider its ability to repossess an asset when the customer is not committed to perform.
- ▶ The customer does not have the significant risks and rewards of ownership of the building. The customer has only paid a nonrefundable deposit of \$50,000 for a \$1 million sales price, and it could walk away and only forfeit its deposit.

We believe that this analysis would indicate that control of the building has not transferred to the customer without explicitly linking the control analysis to whether a contract exists under the standard (by meeting the criteria in 606-10-25-1).

**Question 3:** The collectibility criterion in paragraph 606-10-25-1(e) refers to collectibility being probable, which is defined in Topic 606 as "likely to occur." If the Board were, instead, to refer to collectibility being "more likely than not," which would result in a converged collectibility criterion with IFRS, would the amendment improve the collectibility guidance in Topic 606? Explain your response.

We believe the Board should continue to use "probable" as the collectibility threshold in paragraph 606-10-25-1(e). We note the threshold used in current US GAAP is that collectibility is reasonably assured, and we interpret the term "probable" in ASC 606 to be a similar threshold. We believe the current threshold in US GAAP is consistently applied and is designed to identify transactions for which the cash basis of accounting is appropriate. In our view, the "probable" threshold is likewise appropriate to determine whether a contract exists under the new model. Also, the alternative recognition model in paragraphs 606-10-25-7 and 25-8 will provide relevant financial results and information when an entity determines that it is not probable that it will collect the transaction price.

**Question 5:** Revisions to paragraph 606-10-32-21 and the related example specify that noncash consideration should be measured at contract inception. Does this proposed amendment improve the clarity of applying the guidance? If not, why?

We believe the proposed revisions to paragraph 606-10-32-21 and the example would clarify the guidance, and we agree that these changes are an improvement. However, we believe measuring noncash consideration at contract inception could lead to financial reporting results that are inconsistent with the economics of certain contracts if the consideration is not earned and received at or near contract inception. Therefore, we recommend that the Board further consider a view discussed at its 18 March 2015 meeting under which noncash consideration would be measured when the noncash consideration is received or receivable.

Measuring noncash consideration at contract inception could lead to financial reporting results that are inconsistent with the economics of the transaction because an entity accepts the risk of market volatility when it agrees to accept noncash consideration at a future date in exchange for its performance, and it considers that volatility when it determines the nature and amount of noncash consideration that it will accept. If the noncash consideration is measured at contract inception, the expected volatility inherent in the fair value of the consideration would be reflected in financial statement line items outside of revenue (e.g., in cost of sales and inventory) when presumably the entity would have negotiated contract consideration contemplating the revenue volatility. These financial reporting results are more likely to occur in longer-term contracts; however, they may occur anytime the noncash consideration is received or receivable after contract inception.

For example, an entity may agree to provide natural gas processing services to a customer over a 10-year contract term in exchange for 2% of the natural gas as it is processed. The fair value of natural gas is \$4 per unit at contract inception. In negotiating the contract, the entity considers that natural gas prices fluctuate significantly. In year 2, the price of natural gas drops to \$2 per unit. Under the proposed amendment, the entity would recognize \$4 per unit as its processing revenue and record inventory based on the \$4 per unit consideration allocated. Depending on the entity's inventory cost method (e.g., first-in first-out), the inventory units received for current-period processing services may be impaired within that same reporting period. In that case, the volatility from the contract is recognized through the cost of sales and inventory accounts rather than reflected in revenue. This would result in recording processing revenue higher than the value of the consideration received. Processing revenue would also appear to be stable, when, in fact, it is subject to market volatility.

We understand that, in deciding to require measurement of noncash consideration at contract inception, the Board was trying to make the guidance for this form of consideration consistent with the guidance in ASC 606 for determining the transaction price and for allocating the transaction price to performance obligations. However, our example highlights some challenges of measuring noncash consideration at contract inception. We support measuring noncash consideration when it is received or receivable. Under this approach, revenue recognized would include the effects of changes in the fair value of the noncash consideration until it is received or receivable. We believe this approach would align with the concepts of control by focusing on when the entity obtains control of the noncash consideration and also better reflect the value received by the entity for its performance under the contract.

## Appendix B – Other clarifications to the Proposed ASU

We recommend the following clarifications to the language in the proposal:

Proposed paragraph 606-10-25-3 explains that the guidance in ASC 606 should be applied to the duration of the contract and that an entity should assess collectibility of the consideration for goods or services that will be transferred to the customer rather than assess collectibility for all of the promised goods or services in the contract. We believe it would be helpful to clarify the interaction of these two concepts by adding to this paragraph language from paragraph BC11 of the Proposed ASU: “An entity should not apply that notion to the other aspects of Topic 606, such as identifying the performance obligations, determining the transaction price, allocating the transaction price to performance obligations, and recognizing revenue.”

Proposed paragraph 606-10-32-2A explains the election an entity may make to exclude all sales and similar taxes from the measurement of the transaction price. We suggest the following edits, consistent with paragraph BC27 of the Proposed ASU, to clarify that the election would result in the presentation of all sales taxes and other similar taxes on a net basis (i.e., excluded from both revenue and costs): “An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election (i.e., record those taxes on a net basis by excluding them from revenue and costs), and shall comply with the applicable accounting policy guidance, including the disclosure requirements, in paragraphs 235-10-50-1 through 50-6.”

Proposed paragraph 606-10-55-3A uses the term “promised consideration.” Paragraph 606-10-25-1(e) of the Proposed ASU requires an entity to evaluate whether it “will collect substantially all of the consideration to which it will be entitled” (i.e., the transaction price), as opposed to the entire price included in the contract. The contract price and transaction price may be different in some cases due to price concessions. We recommend an edit to the second sentence of proposed paragraph 606-10-55-3A to make clear that an entity should evaluate the transaction price, not the contract price: “...is based on whether the customer has the ability and intention to pay the ~~promised~~ consideration to which the entity will be entitled in exchange...”

Proposed paragraph 606-10-55-3B explains that an entity should assess collectibility of the consideration for goods or services that will be transferred to the customer rather than assessing collectibility for all of the promised goods or services in the contract. We believe the following edit should be made to the last sentence of this paragraph, “The assessment is not necessarily based on the customer’s ability and intention to pay the entire amount of consideration to which ~~the~~ the entity will be entitled for the entire duration of the contract...”

Proposed paragraph 606-10-55-3C allows an entity to evaluate its exposure to credit risk when assessing collectibility and uses the phrase “entire consideration promised in the contract.” The contract price and transaction price may be different in some cases due to price concessions. We recommend an edit to the first sentence of proposed paragraph 606-10-55-3C to make clear that an entity should evaluate the transaction price, not the contract price, “...the ~~entire~~ entire consideration promised in the contract to which it will be entitled because the entity...”

Proposed paragraph 606-10-55-98B states that the entity in Case A of Example 1 “might not conclude that a contract exists until substantially all of the consideration for the building is received.” We believe some constituents may default to deferring consideration received until substantially all of the consideration is received. However, we believe an entity should continue to reevaluate the contract criteria in accordance with paragraph 606-10-25-6. We suggest the following edit to change the order of the sentences in the paragraph to make clear that an entity should continue to reevaluate the contract: “The entity might conclude that a contract exists at some point before substantially all of the consideration for the building is received if, for example, the conditions in paragraph 606-10-55-97(a) through (b) change and the customer has established a consistent payment history under the contract. Alternatively, the entity might not conclude that a contract exists until substantially all of the consideration for the building is received. When a substantive contract is...”

Paragraph BC45 of the Proposed ASU describes the basis for the proposed clarification of the definition of a completed contract at transition. We believe it would be helpful to clarify in the basis for conclusions that accounting for elements of a contract that do not affect revenue under legacy US GAAP would be irrelevant to the assessment of whether a contract is complete.