



**Board Meeting Handout  
Statement 140—Transfers of Financial Assets  
July 26, 2006**

**OBJECTIVE OF THE MEETING**

At today's meeting, the Board will discuss whether to (1) redeliberate three open issues related to the transfers project and (2) address all of the issues related to the permitted activities of a qualifying special-purpose entity (QSPE) together, including the issues on rollovers of beneficial interests, servicer discretion, and the limits on derivatives that may be held by a QSPE.

**BACKGROUND**

At the June 7, 2006 Board meeting, the Board decided to proceed with the transfers project and redeliberate certain issues related to that project. However, the Board deferred making decisions on whether to redeliberate the following three issues until all Board members were present and could participate in those decisions:

1. Rollovers of beneficial interests
2. Participating interests (paragraph 8(a))
3. Transferability requirements (paragraph 9(b)).

**ROLLOVERS OF BENEFICIAL INTERESTS**

The staff will ask the Board whether it wants to:

1. Reaffirm its decisions on the issue without modification.
2. Remove the issue from the scope of this project.
3. Discuss the issue further in redeliberations.

The staff recommends that the Board redeliberate the proposed guidance on rollovers of beneficial interests and determine whether to:

1. Disallow rollovers.
2. Clarify the meaning of "more-than-trivial incremental benefit."
3. Provide examples of acceptable and unacceptable combinations of involvements by a single party.
4. Clarify the guidance for beneficial interests issued by a master trust.
5. Consider other alternatives.

**PERMITTED ACTIVITIES OF A QSPE**

The Board also will discuss whether it wants to combine discussions and decisions related to servicer discretion (currently a separate project on the Board's agenda) along with the transfers project, or if certain issues related to the permitted assets and activities of a QSPE should be reassigned to the separate servicer discretion project. The decisions on whether a QSPE may rollover beneficial interests may be

affected by the Board's discussions on servicer discretion. This is because the staff on both projects has been asked to analyze whether the ability of a QSPE to rollover beneficial interests and to engage in certain servicing activities are consistent with the requirement in paragraph 35(b) of FASB Statement No.140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, that the activities of a QSPE must be "significantly limited" and "entirely specified." The following issues in the transfers and servicer discretion projects involve the permitted activities of a QSPE:

1. Rollovers of beneficial interests
2. Equity investments in a QSPE
3. Servicer discretion in:
  - a. Waiving a due-on-sale provision
  - b. Substituting collateral with respect to a loan held by a QSPE
  - c. Connection with the potential foreclosure and sale of real estate temporarily held by a QSPE
4. Limitations on derivatives in a QSPE

The staff recommends that the Board address issues pertaining to the permitted activities of a QSPE jointly for efficiency and to ensure that consistent guidance is provided for those related issues.

The staff also will ask the Board whether it wishes to reconsider the decision it made at the June 7, 2006 Board meeting to drop consideration of the limits on the QSPE's ability to hold passive derivative financial instruments that pertain to a transferor's beneficial interests.

Regarding a QSPE's ability to hold passive derivative financial instruments that pertain to a transferor's beneficial interests, the staff will ask the Board whether it wants to:

1. Reaffirm its decisions on the issue without modification.
2. Remove the issue from the scope of this project.
3. Discuss the issue further in redeliberations.

The staff recommends that the Board discuss this issue further in redeliberations.

## **PARTICIPATING INTERESTS AND TRANSFERABILITY REQUIREMENTS**

The staff recommends that the Board defer making a decision about when a QSPE is required until the Board has completed its redeliberations on (1) permitted activities of a QSPE and (2) the effects of continuing involvements on isolation. For participating interests and transferability requirements, the staff will ask the Board whether it wants to:

1. Reaffirm its decisions on the issue without modification.
2. Remove the issue from the scope of this project.
3. Discuss the issue further in redeliberations.
4. Defer its decision until completion of redeliberations on permitted activities of a QSPE and the effects of continuing involvements on isolation.



## Board Meeting Handout

### POSTRETIREMENT BENEFIT OBLIGATIONS INCLUDING PENSIONS

July 26, 2006

#### PURPOSE

At today's meeting, the Board will discuss matters related to:

1. Whether the proposed effective date of fiscal years ended after December 15, 2006, for recognition provisions should be retained for some or all entities.
2. Whether to incorporate into the final Statement the definition of a public entity in FASB proposed FSP FAS 126-a, "Revision to the Definition of a Public Entity to Include an Obligor for Conduit Debt Securities"
3. Whether to require plan assets and obligations to be measured as of the date of the sponsor's financial statements, or retain the existing provision in FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, which permits a measurement date of up to three months before the balance sheet date
4. Whether to supersede the illustrations included in Statement 87, FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and Statement 106, as proposed in the Exposure Draft.

#### ITEM 1: EFFECTIVE DATE FOR RECOGNITION PROVISIONS

The Exposure Draft, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, proposed that all entities (both public and nonpublic) adopt the requirement to recognize the funded status of a defined benefit postretirement plan and the related disclosure requirements in their fiscal year ending after December 15, 2006.

#### Alternatives

1. For public entities:
  - a. Retain the effective date as fiscal years ending after December 15, 2006.
  - b. Delay the effective date to fiscal years beginning after December 15, 2006, or some other date.
2. For nonpublic entities:
  - a. Retain the effective date as fiscal years ending after December 15, 2006.
  - b. Grant an impracticability exemption for entities that are unable to adjust contractual arrangements by the December 15, 2006 effective date. That exemption would allow nonpublic entities that qualify for the exemption to delay the effective date to fiscal years ending after June 15, 2007. Entities would be required to disclose in a footnote the reasons contractual arrangements could not be adjusted prior to the effective date.

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The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

- c. Delay the effective date to fiscal years ending after June 15, 2007, for entities that do not have debt or equity securities trading in a public market, as defined by FASB Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*.
- d. Delay the effective date to fiscal years ending after June 15, 2007, for entities that do not have equity securities trading in a public market, as defined by FASB Statement No. 123 (revised 2004), *Share-based Payment*.

### **Staff Recommendation**

The staff recommends Alternatives 1(a) and 2(d).

### ***Do Board members agree with the staff's recommendation?***

### **ITEM 2: CONFORM THE DEFINITION OF A PUBLIC ENTITY TO THE DEFINITION INCLUDED IN PROPOSED FSP FAS 126-A**

Proposed FSP FAS 126-a clarifies the definition of a public entity in certain FASB standards to include an entity that is an obligor in a conduit municipal bond in which the debt securities are traded in a public market, including over-the-counter markets. Proposed FSP FAS 126-a indicates that the definition of a public entity in the Board's final Statement on employers' accounting for defined benefit pension and other postretirement plans would conform to the definition of a public entity included in that FSP.

### **Alternatives**

- 1. Conform the definition of a public entity included in the final Statement on postretirement benefits to the definition of a public entity that is included in proposed FSP FAS 126-a.
- 2. Do not conform the definition of a public entity included in the final Statement on postretirement benefits to the definition of a public entity that is included in proposed FSP FAS 126-a.

### **Staff Recommendation**

The staff recommends Alternative 2. This is based on the staff's recommendation in Item 1 above.

### ***Do Board members agree with the staff's recommendation?***

### **ITEM 3: MEASUREMENT DATE PROVISIONS**

FASB Exposure Draft, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, proposes that plan assets and benefit obligations be measured as of the date of the employer's statement of financial position.

### **Alternatives – Measurement Date**

- 1. Include measurement date provisions in the scope of Phase 2.
- 2. Include measurement date provisions in the scope of Phase 1.
  - a. Affirm the requirement in the Exposure Draft.
  - b. Change the requirement in the Exposure Draft.

- (1) Reduce the allowable earlier measurement provision from three months to one month.
- (2) Retain the current provisions that permit measurements to be up to three months prior to the reporting date, but require measurements to be performed as close to year-end as is practicable.
- (3) Retain the current provisions that permit measurements to be up to three months prior to the reporting date, but encourage measurements to be performed as close to year-end as is practicable.
- (4) Adopt provisions similar to IAS 19, *Employee Benefits*, that require amounts recognized not to be materially different than if they had been determined as of the date of the employer's statement of financial position.
- (5) Require enhanced footnote disclosure of significant changes in plan assets and benefit obligations between the measurement date and fiscal year-end.

#### **Alternatives – Transition to a fiscal year-end measurement date**

1. Affirm the transition requirements in the Exposure Draft.
2. Select the “15-month” alternative.

(For example, a calendar-year company currently using a September 30, 2006 measurement date would measure the assets and liabilities at September 30, 2006, for the December 31, 2006 financial statements (per the Exposure Draft). The September 30, 2006 measurement would also be used to determine net benefit cost for the following 15 months (from September 30, 2006 through December 31, 2007). The first three months' net benefit cost would be an adjustment to retained earnings as of the effective date of the measurement date provisions, and the next 12 months' net benefit cost would be 2007 expense. The next measurement, at December 31, 2007, would be used for the December 31, 2007 financial statements and the 2008 expense.)

#### **Alternatives – Effective Date for a change in the measurement date**

1. Affirm the effective date requirement in the Exposure Draft.
2. Change the effective date for public and nonpublic entities to:
  - a. Years ending after December 15, 2007
  - b. Years ending after December 15, 2008.

#### **Staff Recommendation**

Most of the staff recommends Alternative 1 for measurement date. (If this alternative is selected, the transition and effective date alternatives would not need to be considered.)

#### ***Do Board members agree with the staff's recommendation?***

#### **ITEM 4: WHETHER ILLUSTRATIONS SHOULD BE AMENDED AND RETAINED OR BE SUPERSEDED**

The Exposure Draft proposes that when Statements 87, 88, and 106 were issued, they represented fundamental changes in the accounting for defined benefit postretirement plans. Examples were included in those Statements to illustrate the application of certain accounting

and disclosure requirements. As stated in the Exposure Draft, the Board concluded that the need for examples about how to apply Statements 87, 88, and 106 has diminished over the many years since those Statements were first issued.

**Alternatives**

1. Supersede all illustrations.
2. Amend relevant illustrations in the final Statement.
3. Amend relevant illustrations for FARS, FASB Loose-leaf Service, *Current Text*, and *Original Pronouncements* after the final Statement is issued.

**Staff Recommendation**

The staff recommends Alternative 3.

*Do Board members agree with the staff's recommendation?*



**Board Meeting Handout**  
**Proposed FSP, Measurement of Certain**  
**Nonfinancial Assets and Nonfinancial Liabilities**

**July 26, 2006**

The Board will discuss alternatives to address the diversity in practice that has arisen with respect to the use of an entity's own assumptions, rather than market-participant assumptions, to measure the fair value of nonfinancial assets and nonfinancial liabilities.

**1. BACKGROUND**

A number of reviewers of a draft of the final Statement on fair value measurements expressed concern that the application of the market participant approach in the draft Statement to nonfinancial assets and nonfinancial liabilities would change the existing measurement approach under FASB Statements No. 141, *Business Combinations*, No. 142, *Goodwill and Other Intangible Assets*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Moreover, those reviewers believe the application of the market-participant approach would fail to provide relevant and representationally faithful information about the reporting entity's financial position, and they expressed significant concerns about the operationality of the guidance for identifying market participants.

Although these comments were received in connection with the draft Statement, the requirement to use market-participant assumptions is currently specified in Statements 141, 142, and 144. However, that existing requirement may not be expressed as clearly as the Board had intended. Statements 141, 142 and 144 (and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*) specify that, if a present value technique is used to measure fair value, estimates of future cash flows used in the technique shall incorporate assumptions that market participants would use in their estimates of fair value. If that information is not available without undue cost and effort, an entity may use its own assumptions. Statement 142 also specifies that when cash flows are used to estimate fair value, those cash flows should be consistent with the most recent budgets and plans approved by management, which is an entity-specific notion. As a result, diversity in practice has arisen in the development of fair value measurements required under Statements 141, 142, and 144.

## **2. ISSUES AND ALTERNATIVE SOLUTIONS**

### **Proposed Guidance**

#### **Use of an Entity's Own Assumptions in a Fair-Value-Based Measurement**

The Board will discuss the guidance to be provided by a proposed FASB Staff Position (FSP) that would:

- a. Identify circumstances where an entity may use its own assumptions in fair-value-based measurements of nonfinancial assets or nonfinancial liabilities, regardless of whether market-participant assumptions are available without undue cost and effort.
- b. Explicitly state that the use of an entity's own assumptions in fair-value-based measurements of nonfinancial assets or nonfinancial liabilities is not intended to permit an entity to assume that the asset or liability should be measured at zero.
- c. Clarify that, depending on the nature of the entity's own assumptions versus market-participant assumptions with respect to a particular nonfinancial asset or nonfinancial liability, a fair-value-based measurement using an entity's own assumptions could be less than, equal to, or greater than a fair value measurement of the asset or liability.
- d. Contain examples illustrating the use of an entity's own assumptions in fair-value-based measurements.

#### **Level of Inputs That Would Preclude the Use of an Entity's Own Assumptions**

The Board will discuss whether the guidance in the proposed FSP should permit the reporting entity to use its own assumptions, without demonstrating that information about market-participant assumptions is not available without undue cost and effort, only if a fair value measurement of the nonfinancial asset or nonfinancial liability would involve significant unobservable inputs. Alternatively, the reporting entity may be permitted to use its own assumptions only if a quoted market price for an identical asset or liability is not available.

#### **Guidance on Subsequent Measurements**

The Board also will discuss whether the proposed FSP should provide guidance on subsequent measurements, such as the unit of account in subsequent impairment tests involving assets it intends to abandon.

## **Scope**

### **Use of an Entity's Own Assumptions Permitted in Business Combinations (and Similar Transactions) and Impairment Tests**

The Board will discuss whether the fair-value-based measurement alternative that would be permitted by the proposed FSP should apply to nonfinancial assets and nonfinancial liabilities that otherwise would be required to be measured at fair value in a business combination accounted for under Statement 141 or in an impairment evaluation performed under Statements 142 or 144. The Board also will discuss whether the proposed FSP should apply to fair value measurements of nonfinancial assets and nonfinancial liabilities in several circumstances that require a new basis of accounting similar to a business combination.

### **Use of an Entity's Own Assumptions Not Permitted for Certain Nonfinancial Assets and Nonfinancial Liabilities**

The Board will discuss whether the use of an entity's own assumptions should be prohibited for measurements of the following items:

- a. Nonfinancial assets classified as held for sale
- b. Nonfinancial liabilities recognized under FASB Statement No. 143, *Accounting for Asset Retirement Obligations*
- c. Nonfinancial liabilities recognized under FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*
- d. Mining assets measured at fair value in a business combination or in an impairment evaluation under EITF Issue No. 04-3, "Mining Assets: Impairment and Business Combinations."

### **Other Circumstances Where Nonfinancial Assets and Nonfinancial Liabilities Are Required to Be Measured at Fair Value**

The Board will discuss whether the proposed FSP should apply to all measurements of nonfinancial assets and nonfinancial liabilities that are otherwise required to be measured at fair value (for example, nonmonetary transactions), except for those assets and liabilities that are explicitly excluded from its scope (for example, assets held for sale and liabilities for asset retirement obligations).

### **Application of the Guidance in the Proposed FSP**

The Board will discuss the period over which the guidance in the proposed FSP should remain effective. The staff has identified the following two alternatives:

- a. Until an entity adopts the guidance in the draft Statement on fair value measurements
- b. Indefinitely (that is, until such time as measurement attributes might be reconsidered in other projects such as the business combinations project or a future project on impairments).

### **Disclosures**

The Board will discuss whether the proposed FSP should require, for fair-value-based measurements that use an entity's own assumptions, the reporting entity to provide the disclosures that will apply under the draft Statement for fair value measurements using significant unobservable inputs.

### **Comment Period**

The Board will discuss the comment period for the proposed FSP.

### **3. Fair Value Measurements Statement**

The Board will discuss whether the release of a final statement on fair value measurements should be delayed to coincide with the issuance of this FSP.



**Board Meeting Handout  
Conceptual Framework**

**July 26, 2006**

The Board will further discuss the elements phase of the joint IASB/FASB conceptual framework project. The Board will consider the proposed working definition of an asset and amplifying text. A range of examples will be analyzed to ensure that the definition works for the most obvious situations as well as those demonstrating issues at the margins. Following is an overview of the issues to be discussed.

**Definition of an Asset**

1. An *asset* is a present economic resource to which an entity has a present right or other privileged access.
2. An asset of an entity has three essential characteristics:
  - a. There is an economic resource.
  - b. The entity has rights or other privileged access to the economic resource.
  - c. The economic resource and the rights or other privileged access both exist at the financial statement date.

All three characteristics must be met for an item to meet the definition of an asset. That is, each characteristic is a **necessary condition** and, collectively, they constitute a **sufficient condition** for an item to be an asset.

**The Board will be asked to:**

1. Discuss the proposed working definition, including each of the three essential characteristics and application of the definition to certain examples.
2. Consider approving the proposed working definition of an asset and amplifying text as a working draft for use in moving forward with other aspects of Phase B of the conceptual framework project.

3. Comment on the staff's latest working draft of the definition of a liability, but no decisions will be requested.



## Board Meeting Handout

July 26, 2006

### Joint Revenue Recognition Project

#### BACKGROUND

In March 2006, the Board discussed two revenue recognition methods. Under the extinguishment-based method (EBM), revenue is recognized when the obligation to provide goods, services, or other rights is extinguished. Under the performance-based method (PBM), revenue is recognized as the entity's production process creates or enhances assets for customers. In April 2006, the Board continued to discuss revenue recognition methods and agreed that the notion of *customer acceptance* is important in determining when performance has occurred (and, thus, when revenue should be recognized). The Board further decided that customer acceptance means that the entity has obtained an unconditional right to at least some consideration (and, correspondingly, that the customer has incurred an unconditional obligation for at least some consideration) for performance to date. That unconditional right might arise under the contract terms or the operation of the relevant contract law.

The Board instructed the staff to explore revenue recognition based on the following criterion:

Revenue should be recognized if the customer must accept performance to date. That is, the contract's legal remedy for breach is, or is like, specific performance or in the event of customer cancellation, the customer is obligated to pay damages reflecting performance to date.

#### PURPOSE OF TODAY'S DISCUSSION

The objective of today's meeting is to further discuss the Board's decision that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for performance to date. The Board will consider how that decision would be applied to certain revenue contracts.

#### CRITERIA FOR REVENUE RECOGNITION

The Board's decision has been trifurcated into three criteria for revenue recognition. That is, revenue should be recognized for the reporting entity's performance to date when either (a) the

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contract's legal remedy in the event of breach is specific performance, (b) in the event of customer breach, the customer is obligated to pay monetary damages reflecting performance to date, or (c) the contract contains explicit customer acceptance provisions that unconditionally obligate the customer to compensate the reporting entity for performance to date.

**Criterion 1: The Contract's Legal Remedy In The Event Of Breach Is Specific Performance.**

The legal remedy of specific performance requires the parties to fully perform as promised under the contract. The seller will perform by providing goods, services, or other rights to the buyer and, in exchange, the buyer will perform by paying consideration to the seller. In other words, in all cases (including breach), the contract will be physically settled in full ('full physical settlement'). Specific performance is awarded when monetary damages are inappropriate or inadequate.

**Criterion 2: In the Event of Customer Breach, the Customer Is Obligated to Pay Monetary Damages Reflecting Performance to Date**

Most contracts do not require a remedy of specific performance. Rather, the common remedy in the event of breach is monetary damages. Generally, the objective of monetary damages is to place the aggrieved party in as good a position as it would have been in if the contract had been performed fully as promised.

Criterion 2 is bifurcated into two sub-criteria.

**Subcriterion A: The customer is required to pay a net cash settlement amount**

Subcriterion A represents a one-way flow (of cash) from the buyer to the seller. If the buyer breaches a contract for the sale of a good prior to delivery, the seller may, in making an attempt to mitigate damages, resell the good and recover from the buyer the difference between the contract price and the price at which the seller was able to resell the good (if that resale price is less than the contract price), together with any incidental damages, less any costs avoided because of the buyer's breach.

**Subcriterion B: The parties to the contract physically settle it in part (‘partial physical settlement’)**

Subcriterion B represents a two-way flow of resources. That is, this remedy requires the customer to pay an amount that reimburses the reporting entity for the costs incurred for production to date plus a profit margin (either on production to date or on the entire contract). In exchange for paying those damages, the customer obtains the work in process and the title to it. In other words, the parties physically settle the **finished** portion of the contract.

**Criterion 3: The Contract Contains Explicit Customer Acceptance Provisions**

Some contracts contain explicit customer acceptance provisions that unconditionally obligate the customer to compensate the reporting entity for performance to date at certain points during the contract term. Thus, at those points, the reporting entity obtains an unconditional right to at least some consideration from the customer.

At this meeting, the Board will focus on Criterion 1 (the contract’s legal remedy in the event of breach is specific performance) and Criterion 2, Subcriterion B (in the event of customer breach, the parties physically settle the contract **in part**). The appendixes to this handout include preliminary explorations of Criterion 2, Subcriterion A and Criterion 3.

**ILLUSTRATIVE EXAMPLE**

The following example illustrates the application of the Board’s decision on the meaning of performance to certain contracts.

**Example Facts**

In Period 1, Company and Customer enter into a contract for a single Product that Company is to produce for \$100,000. Company’s expected and actual cost to produce the Product will be \$60,000. Delivery cost will be zero because Customer will pick up Product at Company’s production facility.

Production is 60 percent complete at end of Period 1 and 100 percent complete at the end of Period 2. Customer picks up the Product and pays for it at the beginning of Period 3.

**Example 1:** The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

**Example 2:** In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

Two scenarios are illustrated for each example:

**Scenario A:** Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.

**Scenario B:** Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.



**Example 1: The contract’s legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.**

	<b>Scenario A:</b> Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	<b>Scenario B:</b> Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
<b>Summary of Account Balances— End of Period 1</b>	<u>Balance Sheet</u>	<u>Balance Sheet</u>
	Claim against Customer \$40,000	Claim against Customer \$100,000
	Consideration receivable 60,000	
	Contract liability \$40,000	Contract liability \$100,000
		Less: Production asset <u>(60,000)</u> \$40,000
	Accounts payable 36,000	Accounts payable 36,000
Retained earnings \$24,000	Retained earnings \$24,000	
<u>Income Statement</u>	<u>Income Statement</u>	
Contract revenue \$60,000	Contract revenue \$60,000	
Contract expense \$36,000	Contract expense \$36,000	
	<b>Staff note:</b> The claim against Customer reflects the contract amount that is attributable to the <b>unfinished</b> portion of the contract. That amount is not due until Company performs. Correspondingly, the contract liability reflects Company’s remaining liability to perform the unfinished portion of the contract.	<b>Staff note:</b> At the end of Period 1, the sum of Company’s assets (the claim against Customer and the production asset) is \$160,000, which exceeds the contract amount (\$100,000). As a possible resolution, the staff offsets the contract liability with the production asset because, in all cases, that asset will be used to satisfy the liability upon delivery.
	In contrast, the consideration receivable reflects the contract amount that is attributable to the <b>finished</b> portion of the contract that has been transferred to Customer.	

**Example 1: The contract’s legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.**

	<b>Scenario A:</b> Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	<b>Scenario B:</b> Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.																																																						
<u>End of period 2</u> To recognize revenue and costs associated with Company’s performance to date; production is 100% complete.	<table border="0"> <tr> <td>Production asset</td> <td>\$40,000</td> <td></td> </tr> <tr> <td>Contract revenue</td> <td></td> <td>\$40,000</td> </tr> <tr> <td>(\$100,000 × 100% – 60,000)</td> <td></td> <td></td> </tr> <tr> <td>Contract expense</td> <td>\$24,000</td> <td></td> </tr> <tr> <td>Accounts payable</td> <td></td> <td>\$24,000</td> </tr> <tr> <td>(\$60,000 × 100% – 36,000)</td> <td></td> <td></td> </tr> <tr> <td>Contract liability</td> <td>\$40,000</td> <td></td> </tr> <tr> <td>Claim against Customer</td> <td></td> <td>\$40,000</td> </tr> <tr> <td>Consideration receivable</td> <td>\$40,000</td> <td></td> </tr> <tr> <td>Production asset</td> <td></td> <td>\$40,000</td> </tr> </table>	Production asset	\$40,000		Contract revenue		\$40,000	(\$100,000 × 100% – 60,000)			Contract expense	\$24,000		Accounts payable		\$24,000	(\$60,000 × 100% – 36,000)			Contract liability	\$40,000		Claim against Customer		\$40,000	Consideration receivable	\$40,000		Production asset		\$40,000	<table border="0"> <tr> <td>Production asset</td> <td>\$40,000</td> <td></td> </tr> <tr> <td>Contract revenue</td> <td></td> <td>\$40,000</td> </tr> <tr> <td>(\$100,000 × 100% – 60,000)</td> <td></td> <td></td> </tr> <tr> <td>Contract expense</td> <td>\$24,000</td> <td></td> </tr> <tr> <td>Accounts payable</td> <td></td> <td>\$24,000</td> </tr> <tr> <td>(\$60,000 × 100% – 36,000)</td> <td></td> <td></td> </tr> <tr> <td>Consideration receivable</td> <td>\$100,000</td> <td></td> </tr> <tr> <td>Claim against Customer</td> <td></td> <td>\$100,000</td> </tr> </table>	Production asset	\$40,000		Contract revenue		\$40,000	(\$100,000 × 100% – 60,000)			Contract expense	\$24,000		Accounts payable		\$24,000	(\$60,000 × 100% – 36,000)			Consideration receivable	\$100,000		Claim against Customer		\$100,000
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**Example 1: The contract’s legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.**

	<p><b>Scenario A:</b> Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.</p>	<p><b>Scenario B:</b> Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.</p>												
<p><b>Summary of Account Balances— End of Period 3</b></p>	<table style="width: 100%; border-collapse: collapse;"> <tr> <td colspan="2" style="text-align: center;"><u>Balance Sheet</u></td> </tr> <tr> <td style="width: 60%;">Cash</td> <td style="text-align: right;">\$100,000</td> </tr> <tr> <td>Accounts payable</td> <td style="text-align: right;">\$60,000</td> </tr> <tr> <td>Retained earnings (\$100,000 – 60,000)</td> <td style="text-align: right;">\$40,000</td> </tr> <tr> <td colspan="2" style="text-align: center;"><u>Income Statement</u></td> </tr> <tr> <td colspan="2" style="text-align: center;">No activity</td> </tr> </table>		<u>Balance Sheet</u>		Cash	\$100,000	Accounts payable	\$60,000	Retained earnings (\$100,000 – 60,000)	\$40,000	<u>Income Statement</u>		No activity	
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**Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.**

	<b>Scenario A:</b> Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	<b>Scenario B:</b> Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.																																										
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	<p><b>Staff note:</b> The accounting for performance in this contract generally parallels the accounting illustrated in Example 1 for a contract that requires specific performance. That is because this contract will result in physical settlement of the finished portion of the contract; therefore, Customer is required in all cases to accept the work in process (and compensate the reporting entity for it).</p> <p>Under Scenario B, the production asset and title to it has not been transferred to Customer; therefore, it remains on Company's balance sheet. However, because the finished portion of the contract will be physically settled, Company has a liability to transfer Product to Customer and an unconditional right to receive consideration for it.</p>																																											

**Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.**

	<b>Scenario A:</b> Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	<b>Scenario B:</b> Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
<b>Summary of Account Balances— End of Period 1</b>	<u>Balance Sheet</u>	<u>Balance Sheet</u>
	Consideration receivable \$60,000	Consideration receivable \$60,000
		Contract liability \$60,000
		Less: Production asset (60,000) -----
	Accounts payable \$36,000	Accounts payable \$36,000
	Retained earnings \$24,000 (\$60,000 – 36,000)	Retained earnings \$24,000 (\$60,000 – 36,000)
	<u>Income Statement</u>	<u>Income Statement</u>
Contract revenue \$60,000	Contract revenue \$60,000	
Contract expense \$36,000	Contract expense \$36,000	
	<p><b>Staff note:</b> The account balances for the <b>performed</b> portion of the contract are almost identical to the account balances in Example 1. The only difference is in Scenario B. In this example, Company has a receivable from Customer for the finished portion of the contract because that portion of the contract could be physically settled. In contrast, under specific performance, the entire contract would be physically settled; therefore, Company must complete Product before it has a receivable from Customer (Company has a claim against Customer until then).</p> <p>The accounting for the <b>unperformed</b> portion of this contract is different from Example 1. That is because the unit of account for the unperformed portion of this contract is the contract as a whole (consistent with the unit of account at the wholly executory stage). That is, the liability to produce the remaining 40 percent of Product and the claim against Customer for that future performance continue to be recognized ‘net’ (and have a net measurement of zero).</p>	

**Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.**

	<b>Scenario A:</b> Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	<b>Scenario B:</b> Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.																																				
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<u>Beginning of Period 3</u> Customer picks up the completed Product and pays for it.	Cash \$100,000 Consideration receivable \$100,000	Contract liability \$100,000 Production asset \$100,000  Cash \$100,000 Consideration receivable \$100,000						
<b>Summary of Account Balances— End of Period 3</b>	<p style="text-align: center;"><u>Balance Sheet</u></p> <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; text-align: right;">Cash</td> <td style="width: 50%; text-align: right;">\$100,000</td> </tr> <tr> <td style="text-align: right;">Accounts payable</td> <td style="text-align: right;">\$60,000</td> </tr> <tr> <td style="text-align: right;">Retained earnings (\$100,000 – 60,000)</td> <td style="text-align: right;">\$40,000</td> </tr> </table> <p style="text-align: center;"><u>Income Statement</u> No activity</p>		Cash	\$100,000	Accounts payable	\$60,000	Retained earnings (\$100,000 – 60,000)	\$40,000
Cash	\$100,000							
Accounts payable	\$60,000							
Retained earnings (\$100,000 – 60,000)	\$40,000							

## **APPENDIX A**

### **Preliminary Exploration: Application of the Board's Decision on Performance to Contracts That, in the Event of Customer Breach, Require a Remedy of *Net Cash Settlement***

The Board agreed that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. Moreover, the Board agreed that the reporting entity obtains such an unconditional right for its performance to date if, in the event of customer breach, the customer is required to compensate the reporting entity for that performance.

There may be different views on how to apply that decision to contracts that, in the event of customer breach, require a legal remedy of net cash settlement.

#### **Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date**

Under Alternative A, revenue should be recognized over the production period as performance occurs. That is because, in all cases (including customer breach), the reporting entity will ultimately receive the contract amount. If the contract is fully performed by both parties, the reporting entity will collect the contract amount from the customer. If the customer breaches, the reporting entity will resell the product to another customer and will have the right to collect from the original customer the difference between the contract amount and the amount at which the product was resold.

#### **Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract**

Under Alternative B, the reporting entity is not viewed as having an unconditional right to any consideration until the contract is completed or the customer breaches the contract. Until that time, the reporting entity's right to consideration is conditioned upon either the completion of the contract **or** the customer's breach. Until either of those events occurs, the entity has not obtained any right to consideration; therefore, revenue should not be recognized until either one of those events occur.

### **Illustrative Example**

The following example illustrates how the Board's decision could be applied to a contract that requires a remedy of net cash settlement. The example facts are the same as the preceding two examples (refer to page 3). Additional facts are as follows:

#### **Additional Example Facts**

In the event of customer breach, Customer would be required to pay monetary damages in an amount that reimburses Company for its 'lost expectations' on the contract; that is, Customer must pay damages in an amount sufficient to place Company in as good a position as it would have been in had the contract been performed.

Product is fungible; therefore, Company thinks that it could resell Product if Customer breaches. However, if Customer breaches and Company has to resell Product, Company may not be able to collect \$100,000 from the substitute customer. In that case, consistent with the remedy of monetary damages, Customer would be required to pay the difference between the contract price and the price at which Product was resold.

**Example 3: In the event of customer breach, Customer would be required to pay monetary damages in an amount that reimburses Company for its ‘lost expectations’ on the contract; that is, Customer must pay damages in an amount sufficient to place Company in as good a position as it would have been if the contract had been performed.**

	<b>Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date</b>	<b>Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract</b>
<u>Contract inception</u>	No entry	No entry
<u>End of Period 1</u> To recognize Company’s performance to date; production is 60% complete.	Production asset/Claim against Customer \$60,000 Contract revenue \$60,000 (\$100,000 × 60%)  Contract expense \$36,000 Accounts payable \$36,000 (\$60,000 × 60%)	Production asset \$36,000 Accounts payable \$36,000 (\$60,000 × 60%)
<b>Summary of Account Balances—End of Period 1</b>	<u>Balance Sheet</u> Production asset/Claim against Customer \$60,000  Accounts payable \$36,000  Retained earnings \$24,000  <u>Income Statement</u> Contract revenue \$60,000 Contract expense \$36,000	<u>Balance Sheet</u> Production asset \$36,000  Accounts payable \$36,000  Retained earnings -----  <u>Income Statement</u> No activity
<u>End of period 2</u> To recognize Company’s performance to date; production is 100% complete.	Production asset/Claim against Customer \$40,000 Contract revenue \$40,000 (\$100,000 × 100% – 60,000)  Contract expense \$24,000 Accounts payable \$24,000 (\$60,000 × 100% – 36,000)	Production asset \$24,000 Accounts payable \$24,000 (\$60,000 × 100% – 36,000)



## **APPENDIX B**

### **Preliminary Exploration: Application of the Board's Decision on Performance to Contracts that have *Contractually Stated Customer Acceptance Provisions***

The Board agreed that revenue should be recognized if the customer accepts performance to date—*acceptance* meaning that the entity has obtained an unconditional right to consideration from the customer. In a contract in which acceptance arises at discrete points (and assuming no other legal remedies), an unconditional right to consideration only will arise at those discrete acceptance points.

#### **Illustrative Example**

The following example illustrates how the Board's decision should be applied to a contract that has contractually stated customer acceptance provisions. The example facts are the same as the preceding three examples (refer to page 3). Additional facts are as follows:

#### **Example Facts**

Production of the Product consists of two distinct phases; thus, there are two customer acceptance points. The first acceptance point is at the end of the first phase when the contract is 75 percent complete and the second customer acceptance point is upon delivery. At those points, Customer is obliged to accept Company's performance to date and becomes unconditionally obligated to pay for that performance. At each acceptance point, title to the work in process transfers to Customer.

The payment attributable to Company's performance in the first phase (that is, up to the first customer acceptance point) cannot subsequently be recovered by Customer if Company fails to complete Product.

As noted, assume that no additional legal remedies are available to Company if Customer breaches.

**Example 4: Customer is unconditionally obligated to pay Company only at contractually stated acceptance points.**

	Title of Product transfers to Customer on acceptance of each phase. That is, Customer has legal ownership of the work in process.		
<u>Contract inception</u>	No entry		
<u>End of Period 1</u> To recognize Company's performance to date; production is 60% complete but Customer <b>has not</b> accepted it.	Production asset	\$36,000	
	Accounts payable ( $\$60,000 \times 60\%$ )		\$36,000
<b>Summary of Account Balances— End of Period 1</b>	<u>Balance Sheet</u>		
	Production asset		\$36,000
	Accounts payable		\$36,000
	Retained earnings		-----
	<u>Income Statement</u> No activity		
<u>Period 2—up to point of Customer's acceptance</u>  To recognize completion of phase 1; production is 75% complete and Customer <b>has</b> accepted it.	Production asset	\$9,000	
	Accounts payable ( $\$60,000 \times 75\% - 36,000$ )		\$9,000
	Consideration receivable	\$75,000	
	Contract revenue ( $\$100,000 \times 75\%$ )		\$75,000
	Contract expense	\$45,000	
	Production asset ( $\$36,000 + 9,000$ )		\$45,000
<u>Period 2—from point of Customer's acceptance to contract completion</u> To recognize Company's performance; production is 100% complete but Customer has accepted only 75%.	Production asset	\$15,000	
	Accounts payable ( $\$60,000 \times 100\% - 45,000$ )		\$15,000
<b>Summary of Account Balances— End of Period 2</b>	<u>Balance Sheet</u>		
	Production asset		\$15,000
	Consideration receivable		\$75,000
	Accounts payable		\$60,000
	Retained earnings		\$30,000
	<u>Income Statement</u> Contract revenue		
	Contract expense		\$75,000
			\$45,000

**Example 4: Customer is unconditionally obligated to pay Company only at contractually stated acceptance points.**

	Title of Product transfers to Customer on acceptance of each phase. That is, Customer has legal ownership of the work in process.																					
<u>Beginning of Period 3</u> Customer accepts and picks up Product and pays for it.	<table> <tr> <td>Consideration receivable</td> <td>\$25,000</td> <td></td> </tr> <tr> <td>Contract revenue</td> <td></td> <td>\$25,000</td> </tr> <tr> <td>(<math>100,000 \times 100\% - 75,000</math>)</td> <td></td> <td></td> </tr> <tr> <td>Contract expense</td> <td>\$15,000</td> <td></td> </tr> <tr> <td>Production asset</td> <td></td> <td>\$15,000</td> </tr> <tr> <td>Cash</td> <td>\$100,000</td> <td></td> </tr> <tr> <td>Consideration receivable</td> <td></td> <td>\$100,000</td> </tr> </table>	Consideration receivable	\$25,000		Contract revenue		\$25,000	( $100,000 \times 100\% - 75,000$ )			Contract expense	\$15,000		Production asset		\$15,000	Cash	\$100,000		Consideration receivable		\$100,000
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<b>Summary of Account Balances— End of Period 3</b>	<table> <tr> <td colspan="2"><u>Balance Sheet</u></td> </tr> <tr> <td>Cash</td> <td>\$100,000</td> </tr> <tr> <td>Accounts payable</td> <td>\$60,000</td> </tr> <tr> <td>Retained earnings (<math>100,000 - 60,000</math>)</td> <td>\$40,000</td> </tr> <tr> <td colspan="2"><u>Income Statement</u></td> </tr> <tr> <td>Contract revenue</td> <td>\$25,000</td> </tr> <tr> <td>Contract expense</td> <td>\$15,000</td> </tr> </table>	<u>Balance Sheet</u>		Cash	\$100,000	Accounts payable	\$60,000	Retained earnings ( $100,000 - 60,000$ )	\$40,000	<u>Income Statement</u>		Contract revenue	\$25,000	Contract expense	\$15,000							
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## **Board Meeting Handout**

### **Technical Corrections of FASB Statement No. 123 (revised 2004), *Share-Based Payment***

**July 26, 2006**

#### **OBJECTIVE**

The purpose of this Board meeting is for the Board to approve for issuance a proposed FASB Staff Position to address certain technical corrections of FASB Statement No. 123 (revised 2004), *Share-Based Payment*.

#### **BACKGROUND – DISCLOSURE REQUIREMENTS FOR NONPUBLIC ENTITIES**

Paragraph A240(d)(2) of Statement 123(R) explicitly exempts nonpublic entities from having to disclose the aggregate intrinsic value of currently exercisable (or convertible) fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position. However, paragraph A240(d)(1) does not exempt nonpublic entities from disclosing the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest.

By requiring a nonpublic entity to provide the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest at the date of the latest statement of financial position (paragraph A240(d)(1)), a nonpublic entity would be required to determine the fair value of its underlying equity at each reporting date.

#### **BACKGROUND – AMENDMENT OF ILLUSTRATION 4(b)**

Illustration 4(b) provides an example of the accounting for an award with a graded vesting schedule, including computation of the minimum compensation cost required to be recognized when using the straight-line method and the entity has determined a specific value for each separately vesting portion of the award. The last sentence in paragraph A102 changes one of the assumptions used in the example and recomputes the floor amount based on the revised assumption. The revised computation is not consistent with the recognition provisions established in paragraph 42 of Statement 123(R) because it (a) fails to take into consideration the change in the aggregate value of the award that would result from the change to a front-loaded vesting schedule and (b) implies the use of an average value per award based on the aggregate award value, despite the fact that the example utilizes specific value information for each separately vesting portion of the award that is vested as of the date of the computation.

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The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

## **BACKGROUND – AMENDMENT OF ILLUSTRATION 13(e)**

Illustration 13(e) in Appendix A of Statement 123(R) provides an illustration of an improbable to probable modification (Type III modification). Part of that illustration assumes that the original award is probable of vesting until the entity decides to close the plant where all of the award holders are employed. At the point when the entity decides to close the plant and terminate the employees, and, as a result, the awards are no longer probable of vesting, the entity should have reversed any previously recognized compensation cost. However, rather than indicating that the previously recognized compensation cost should be reversed at the date the awards were no longer probable of vesting, the illustration indicates that the compensation cost should be reversed on June 30, 20X8 (the date the award is subsequently modified to accelerate the vesting terms of the award).

**The Board will be asked whether it approves of the issuance of a proposed FSP to address certain technical corrections of Statement 123(R).**

## **COMMENT PERIOD AND TRANSITION**

The staff recommends the proposed FSP should be exposed for a 30-day comment period. The effective date should be the first reporting period beginning after the final FSP is posted to the website. If in applying Statement 123(R) an entity did so in a manner consistent with the provisions of this FSP, then that entity would continue to apply the provisions in this FSP to prior periods. However, if an entity did not apply Statement 123(R) in a manner consistent with the provisions of this FSP, then that entity would be required to retrospectively apply the provisions in this FSP to prior periods when those periods' financial statements are included for comparative purposes with current-period financial statements. Early application of this FSP is permitted in periods for which financial statements have not yet been issued.

**The Board will be asked whether it agrees with the comment period and proposed transition requirements.**