

MINUTES



To: Board Members

From: Revenue Recognition Team
(Ham, ext. 443)

Subject: Minutes of the October 22, 2007 FASB-
IASB Joint Board Meeting: Revenue Recognition **Date:** November 9 2007

cc: FASB: Bielstein, Golden, MacDonald, Posta, T. Johnson, Revenue Recognition Team, Leasing Team, Bolash, Driscoll, Reese, Gabriele, Chookaszian, Klimek, Allen, Sutay, FASB Intranet; IASB: Leisenring, Rees, Pitman, Hickey, Upton, Clark, Peerless; AASB: Paul; GASB: Patton

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic: Revenue Recognition: Due Process, Measurement Model, Allocation Model, and Examples

Basis for Discussion: Board Memorandum Nos. 90–94

Length of Discussion: 1:45 to 3:00 p.m. and 3:30 to 5:00 p.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, L. Smith, and Young

IASB: Tweedie, Jones, Barth, Cooper, Danjou, Engström, Garnett, Gélard, Leisenring, McGregor, J. Smith, Yamada, and Zhang

Board members absent: None

Staff in charge of topic: Rees, Wilks

Other staff at Board table: FASB: Bielstein, T. Johnson, Bement, and Ham

IASB: Upton, Hickey, and Pitman

Summary of Decisions Reached:

In 2002, the Boards launched their joint project on revenue recognition. The objective of the project is to develop a single coherent asset and liability model for revenue recognition. In such a model, revenue is a function of changes in assets and liabilities and is not based on the notions of realization and the completion of an earnings process.

Throughout 2002–2006, the Boards explored a model in which the assets and liabilities would be measured at fair value (a fair value model) and a model in which the assets and liabilities would be measured by reference to the customer consideration (an allocated customer consideration model).

In October 2006, the Boards decided that instead of trying to forge a single, compromise model at this stage in the project, they should aim to get a better and more complete understanding about what both models would look like and what each would entail. They also decided that an initial due process document should explain and illustrate the two models and that this would form a basis for seeking comments from interested parties.

Therefore, over the past year, the staff and two groups of Board advocates (each drawn from both Boards) have developed two revenue recognition models. At this meeting, the staff provided a summary of each of the models together with some examples. (The summaries and the examples were included in the handout for this meeting and are available on the FASB website.)

The discussion was primarily informational and no technical decisions were reached. Board members commented on aspects of the models that they wanted to see explained more fully in subsequent meetings.

Objective of Meeting:

The objective of the meeting was to provide an overview of and seek initial feedback on the Measurement and Allocation models. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Herz opened the meeting by explaining that the staff and certain FASB and IASB Board members (Board advisory groups) have been developing two revenue recognition models. The Boards hope to publish a due process document in the near future that would contrast the two models with each other and with existing U.S. GAAP and IFRS. Mr. Upton further explained that the Board advisory groups met from December 2006 to June 2007. In July 2007, the staff was asked to articulate two coherent models based on its meetings with the Board advisory groups. After three months of drafting, the staff is prepared to present the Measurement (formerly Fair Value) and Allocation (formerly Customer Consideration) models.

2. Mr. Wilks noted that the memos on the models for this meeting are summaries. They do not provide every explanation or rationale for why decisions were reached. Instead, they highlight the key features of the models. Mr. Wilks stated that the staff welcomes feedback on aspects of the models that Board members feel are incomplete, internally inconsistent, or poorly explained. This feedback can then be addressed in the memos for the November and December FASB Board meetings, which will provide a more extensive description of the models. At that time, the Boards also will address whether either of the models represents an improvement over current practice. The goal is to have a due process document issued during the first quarter of 2008.

Due Process Document

3. Mr. J. Smith started the discussion by commenting on the names of the models. He expressed concern about the Allocation label. Mr. Yamada agreed, saying that he preferred Customer Consideration. Mr. Herz mentioned a potential problem with the Measurement label as well. Since many measurement attributes exist, the label may need to distinguish the specific measurement attribute chosen by the staff (fair value). Mr. Wilks acknowledged the Board members' opinions and stated that neither of the labels was meant to be pejorative. He also noted that the explanation and reasoning for the name change would be discussed in the next few months.

4. Mr. Tweedie asked if the staff intended to include the Boards' preliminary views in that document. Mr. Wilks stated that the staff would describe any leanings of the Boards at the end of the document. Nevertheless, the staff believes it would be helpful to describe both models for the public even if the Boards reach a preliminary view. Mr. Leisenring agreed as long as two fundamentally different models truly exist. Mr. Linsmeier noted that models should use the same words when applying the same principles in order to help evaluate whether the models are substantially different.

5. Next, Mr. McGregor asked to what extent the staff was planning to write the due process document in the context of other Board projects. Mr. Rees noted that the staff was planning to include a discussion on how the IASB's insurance project relates to both models. Mr. McGregor mentioned the Conceptual Framework project, and Ms. Seidman stated that the staff can realistically only use what is in the conceptual framework to date and provide a basis for conclusions. Mr. Wilks confirmed that the staff will provide reasoning for decisions throughout the paper, but there will be no separate section on how the paper relates to the Conceptual Framework project.

6. Mr. Garnett asked whether the staff was also planning to include the concept of production income in the document. Mr. Rees stated that there will be a brief discussion explaining that there is no preclusion to the Boards eventually deciding on a broader definition of revenue, including production income. However, the focus of this project is only on revenue arising from contracts with customers, and there will be no detailed discussion of production income.

Measurement Model

7. Mr. Rees started his presentation by discussing the contract with the customer. He explained that the combination of the rights and obligations in a contract give rise to a contract asset or a contract liability. This contract asset or liability is distinct and separate from the underlying goods and services in the contract. Mr. Rees noted that accounting for the contract with the customer in this model is done by accounting for the contract asset or liability.

8. Mr. G elard noted that in a contract that is not prepaid, an entity can have a contract liability at inception even if the contract is profitable. This would occur when the entity charges a price lower than market participants but higher than its costs to satisfy the obligations in the contract.

9. Next, Mr. Rees discussed the current exit price measurement attribute. He noted that it is important that subsequent measurements of the contract use the current exit price in order to reflect the price and circumstances that exist on a given date, not what existed at the contract inception. This remeasurement gives a more faithful depiction of the contract at the reporting date.

10. Mr. Danjou agreed that the subsequent measurement attribute should be consistent with the initial measurement attribute. However, he did not understand the logic behind reporting price changes in profit or loss. He questioned why revenue recognized due to the prior measurement was not corrected instead. Mr. Rees responded that this is mainly a display issue, but it also depends on how revenue is defined. Mr. Danjou stated that he understood the need for separate presentation because aggregating changes in measurement from both price changes and satisfaction of performance obligations could confuse users. Still, he questioned the staff's conclusion of reporting such changes as gains or losses.

11. Mr. J. Smith commented that he thought total revenue would always equal customer consideration under the Measurement model since price changes were not reported as revenue. Mr. Rees explained that while price changes are not reported as revenue, they have an effect on revenue. Therefore, total revenue would be different from customer consideration in the event of a price change.

12. Before moving on to the next topic, Mr. Tweedie stated that another issue is that the current exit price is often not immediately available. He thought the process of arriving at the current exit price measurement should be emphasized since it can be more involved than what one might initially expect.

13. Mr. Rees continued his presentation by discussing the accounting for the contract with the customer. Before contract inception, there is no revenue because there are no contractual rights or obligations. At contract inception, an entity records a contract asset or liability and a corresponding amount of revenue for obtaining the contract. Mr. Rees noted that this does not mean there is a corresponding amount of profit because entities also incur costs to obtain a contract.

14. Mr. Garnett questioned whether an entity must record a contract loss at inception when it sells an item for \$150 while market participants sell it for \$200. Mr. Leisenring clarified that the selling price of the competitor is not relevant because the current exit price would be the price a third party is willing to pay to take on the **remaining** obligations. Ms. Barth noted that in this example, it is likely a contract loss would result when the current exit price of the remaining obligations is measured and compared with the contract right. Mr. Linsmeier further clarified that this analysis would only apply to contracts that are not onerous.

15. Next, Mr. Rees presented the accounting for a contract after inception. Revenue arises as the entity satisfies obligations in the contract, and the amount of revenue recognized is derived from the change in the contract asset or liability. Mr. Rees noted that this helps explain the earlier discussion about total revenue not equaling customer consideration. While price changes are reported outside of revenue, they are reflected in the remeasured contract asset or liability. Therefore, when the obligation is subsequently satisfied, it is the remeasured amount that comes through to revenue rather than the amount that was initially recognized. In effect, revenue represents the value of the goods or services provided to the customer on a given date. This is what causes total revenue to not equal customer consideration. Mr. Rees informed the Boards that the staff would be presenting various display options in later meetings.

16. Mr. Yamada commented that it is misleading to say that price changes are reported outside of revenue when they eventually affect revenue. Furthermore, he did not understand why they affect revenue. Mr. Yamada views the initial measurement of the performance obligation as the true obligation regardless of changes in measurement due

to price changes. Mr. Rees responded that upon remeasurement, the performance obligation is no longer the initial measurement but rather the subsequent measurement. Mr. Herz noted that increases in the current value of the performance obligation increase revenue reported even though no payment is actually received for those increases. The reverse is also true. Mr. Leisenring stated that this is no different from a forward contract.

17. Mr. J. Smith questioned whether the timing in the contract (that is, immediate delivery of a good versus a one month delay) affects the revenue reported. He proposed an example in which a customer paid \$150 for a good delivered the same day, but the layoff price of that obligation was \$180. Mr. Smith asked whether revenue would equal \$150 or \$180. Mr. Wilks responded that to be consistent under the Measurement model, revenue should be \$180. In those situations, a transaction would be recorded with lower or higher revenue than consideration received along with an offsetting contract gain or loss. Mr. Rees commented that the Measurement model was not intended to change practice for cash transactions, but that the consistency of measurement was an important issue to address in the future.

18. Mr. Linsmeier noted the difficulty with accurately separating and displaying changes in measurement due to price changes and changes due to satisfaction of obligations. Nevertheless, even if the separation is not completely accurate, the disaggregated information may still help users better predict future revenues. Mr. Rees acknowledged this point and stated that the difficulty in distinguishing changes depends on how often an entity remeasures its obligations. He also noted that to avoid complicated accounting, some may argue that **all** changes should be reported in revenue in the aggregate.

Allocation Model

19. Ms. Pitman started her presentation by explaining that like the Measurement model, the Allocation model is an asset and liability model where the assets and liabilities arise directly from the contract with the customer. However, the measurement attribute is different. The Allocation model measures the underlying rights at the amount of

customer consideration. This measurement of the rights is then allocated to the performance obligations identified in the contract. These obligations are never remeasured. Therefore, revenue always equals the amount of customer consideration.

20. Ms. Pitman noted that since the rights and obligations are both equal at inception, the net contract asset or liability at inception will always be zero. Thus, there will never be revenue at inception under the Allocation model. Revenue is the decrease in contract liability, or increase in contract asset, that results from an entity satisfying its performance obligations. Any movement in the rights of the contract is not reflected in revenue.

21. Ms. Pitman further explained that the satisfaction of performance obligations that gives rise to revenue occurs when an entity transfers goods and services specified in the contract to the customer. In some cases, this obviously happens when legal title transfers. Conversely, there are many instances in which an assessment is needed to determine whether the seller or the customer actually has the rights and obligations of the underlying asset in the contract.

22. Next, Ms. Pitman discussed the identification of performance obligations in a contract. Each good or service in the contract has the potential to be a separate performance obligation if it is sold separately or if it could be bought and sold separately. However, the good or service must be capable of separate satisfaction within the terms of the contract.

23. Ms. Barth noted that the staff should clarify whether the term *sold separately* refers to the context of the market, the entity only, or both. Mr. Leisenring added that a right of return could significantly change the analysis, and both models needed to address the issue. Ms. Pitman responded that the staff was planning to include a right of return example in the future expanded memos.

24. Ms. Barth questioned why it was necessary to identify potentially separate performance obligations if the contract ultimately determines what is separate. Ms. Seidman mentioned that it is useful when the contract is silent on a particular issue. Mr.

J. Smith stated that the distinction is not explained as clearly in the summary memo for this meeting as it will be in future memos. Ms. Pitman confirmed that this discussion will be expanded in the next few months.

25. Mr. Leisenring noted that the staff should consider whether entities can change their pattern of revenue recognition by explicitly identifying obligations in the contract that otherwise would not be mentioned or considered to be part of the contract. Mr. Linsmeier agreed that the staff should consider if and when the structure of contracts having the same economics would change the revenue pattern. Mr. Gélard stated that the accounting should reflect the way the contract is written because both the customer and the seller negotiated for it and are bound by it. Mr. Leisenring agreed as long as both parties are truly affected by alterations to a contract. Mr. Batavick mentioned that, regardless, both the Measurement and Allocation models assume there will be an enhanced disclosure on revenue recognition so that users can understand and evaluate the reported revenue number.

26. Ms. Pitman continued her presentation by discussing which obligations are not performance obligations. She clarified that statutory warranties were described incorrectly in the memo and that they would be considered performance obligations and therefore attract revenue. Other obligations like discount vouchers are still considered ancillary and would not attract revenue because the customer has the option of using it.

27. Ms. Pitman then directed the Boards' attention to the reasoning behind allocating customer consideration to performance obligations. The staff has taken the view that contracts arise out of arm's-length transactions and, therefore, the performance obligations are worth the same amount as the customer consideration. The staff acknowledges that pre-contractual activities occur, but assumes an entity's pricing model is designed to recover all costs including those associated with pre-contractual activities.

28. Mr. Upton noted that sales of goods or services involving a large commission expense upfront make an entity look worse as more contracts are formed until the cycle turns. This is because the expense is considered pre-contractual and has no offsetting

revenue like it does under the Measurement model. Several Board members agreed that this is an issue in current practice, and the Allocation model provides for no change.

29. Ms. Pitman moved on to explaining the allocation of customer consideration to separate performance obligations. An entity would use the most reliable price according to the hierarchy described. Level 1 is the current sales price charged by the entity itself in an active market. Level 2 is the current sales price charged by the entity in an inactive market. Level 3 is the current sales price of competitors in an active market. Level 4 is an internal estimate of the sales price using inputs that reflect the entity's assumptions.

30. Mr. L. Smith asked why the measure described in Level 3 is lower than the one described in Level 2. Ms. Seidman responded that the current prices charged by an entity are most consistent with the prices implicit in a contract whether the entity is in an active or an inactive market. It is only when the entity does not typically sell a performance obligation separately that it would look to a competitor for the price. The goal is to have pricing that is consistent with what went into building up a particular contract.

31. Ms. Pitman noted that any excess customer consideration remaining after allocation to each performance obligation would be allocated to the performance obligations pro rata. However, if a performance obligation is measured at a Level 1 price, it would not receive any of the excess allocation.

32. Next, Ms. Pitman stated that contract losses under the Allocation model would be anticipated and accounted for according to existing GAAP. She noted that the staff has not discussed this issue extensively and will need to address it more fully in the future. Mr. McGregor asked how the difference between the initial measurement and the remeasurement is handled. Ms. Pitman responded that the staff's initial view is that the performance obligation would remain at the initial measurement and revenue would be recorded as it is satisfied like normal. The only difference is that a loss provision would need to be made.

33. Ms. Barth commented that she did not understand how an entity would know that a contract was onerous. Mr. Herz thought that a loss would be anticipated when an entity

realizes its outflows (costs) will exceed its inflows under the contract. Mr. J. Smith responded that the mechanism for measuring and determining a loss has not been decided, but the principle is that an expected loss would be recognized under the Allocation model.

34. Ms. Barth also noted that she did not understand why a model that takes the customer's perspective ever remeasures the obligation. Furthermore, she questioned why it would be remeasured for a loss but not for a gain. She requested clarification in future memos regarding those questions. Mr. Garnett also requested specification about whether this concept applied to portions of the contract, the aggregate contract, or both.

Examples

35. Mr. Bement introduced the example on the sale of a television with an extended warranty. He explained that the staff chose this example for several reasons. First, warranties are common in the current economy. Second, accounting for warranties is often cited as an example of inconsistency in current revenue recognition guidance. Finally, warranties are often long-term contracts that extend over several reporting periods. The Measurement and Allocation models handle changes in circumstances differently, and the staff wanted to highlight those differences.

36. Mr. Bement continued by noting that revenue and margin at inception are significantly higher under the Measurement model than they are under the Allocation model. This occurs not only because of the basis of measurement, but also because the Measurement model recognizes revenue from both obtaining the contract and delivering the televisions.

37. Mr. Bement also acknowledged that the accounting for Year 1 under the Allocation model was prepared with the understanding that the statutory warranty was not a performance obligation and did not attract revenue. However, as already discussed, this thinking has been updated and the amounts for Year 1 need to be updated as well. Mr. Wilks noted that in this example, there would be no observable separate selling price

because neither the entity nor its competitors sell the statutory warranty separately. Therefore, the sales price would have to be a Level 4 internal estimate.

38. Mr. Bement noted that the Allocation model allocates the discount to the identified performance obligations based on their relative fair values. Conversely, the Measurement model does not allocate the discount because of its explicit measurement approach. Finally, Mr. Bement pointed out that total revenue under the Allocation model equals customer consideration whereas total revenue under the Measurement model is not equal to customer consideration.

39. Mr. J. Smith stated that with the exception of the statutory warranty, he thought the examples accurately depicted the models. Ms. Bielstein questioned whether the statutorily-imposed warranty had to be explicitly stated within the contract in order to be considered a performance obligation and attract revenue. Mr. J. Smith responded that it does not have to be since the warranty arises by law when the contract is formed, thereby evidencing that it is part of the contract. After further questions and discussion about warrants related to defects (that is., general warrant of merchantability), Ms. Pitman stated that the staff will attempt to clarify this issue in future memos.

40. Mr. McGregor questioned why the staff stated that total revenue under the Allocation model **generally** equaled customer consideration. Mr. Bement clarified that in theory, they always will be equal. However, due to collection issues, it is possible that total consideration actually received from the customer could be less than revenue. Mr. Leisenring asked how customer credit issues were handled under the Measurement model. Mr. Rees responded that credit characteristics are factored into the current exit price measure. Changes in measurement due to changes in credit risk would not be reported in revenue but would be reported as a gain or loss on a separate line.

41. Mr. McGregor also requested an example that shows how each model deals with onerous contracts. Mr. Bement noted this comment for future memos.

Asset Derecognition

42. There were several discussions throughout the Board meeting that dealt with the underlying issue of asset derecognition. Ms. Barth, Mr. McGregor, and other Board members expressed concern that the models came to different conclusions for asset derecognition based on the same set of facts. Mr. Wilks noted that this was because the Board advisors came to different conclusions, and the staff articulated their views.

43. Mr. Herz stated that he thought there was probably a concept that would be applicable to both models. Mr. Wilks asked the Board if the two models could reasonably arrive at two different asset derecognition principles. The Boards responded that models drafted under the same conceptual framework should not have different asset derecognition. In other words, it is fundamental that asset derecognition be the same for both the Measurement and Allocations models.

Follow-up Items:

None.

General Announcements:

None.