



MINUTES

To: Board Members

From: Revenue Recognition Team
(Kazazean, ext. 327)

Subject: Minutes of the December 10, 2003 FASB Board Meeting **Date:** December 17, 2003

cc: Leisenring, Bielstein, T. Johnson, Smith, Petrone, MacDonald, Mahoney, Swift, Polley, Thompson, Gabriele, Sutay, Patton (GASB), Slayton, Sletten, Figgie, Cohen, Cropsey, Lapolla, McKenna, Pinson, Paul (IASB), Intranet

Topic: Revenue Recognition—A Recapitulation of Conceptual Decisions and a Summary of Open Issues

Basis for Discussion: Memorandum #1 dated November 26, 2003

Length of Discussion: Starting Time: 1:15 p.m. Concluding Time: 3:00 p.m.

Attendance:

Board members present: FASB: Herz, Batavick (by phone), Crooch,
Schieneman (by phone), Schipper, Seidman,
Trott

IASB: Leisenring

Board members absent: None

Staff in charge of topic: Slayton, Johnson

Other staff at Board table: Bielstein, Sletten, Cropsey, Figgie, Kazazean

Outside participants: None

Summary of Decisions Reached:

The Board discussed decisions made to date at the concepts level and considered the nature of additional conceptual guidance that may be needed.

The Board affirmed the following decisions at the concepts level:

1. The elements criterion adequately describes when a change in assets and liabilities results in revenues.
2. An enforceable contract gives rise to rights and obligations that might meet the definitions of assets and liabilities. Specifically, unconditional and mature rights and obligations might meet the definitions of assets and liabilities, but conditional rights and obligations do not meet the definitions.
3. A rebuttable presumption is that the unit of account for a wholly executory contract is the contract as a whole, unless the remedy of specific performance in the event of breach is a stated requirement in the contract or ordered by a court.
4. For initial recognition, the most relevant measurement attribute of the assets and liabilities associated with revenue is fair value. (Board members agreed to postpone discussion of *subsequent* measurement of the assets and liabilities associated with revenue).
5. Assuming an active “wholesale” market exists, the fair value of performance obligations should reflect the price that the reporting entity would have to pay a third party to assume responsibility for performing all of its remaining obligations.
6. The definition of revenues should be based on the “broad performance view,” the “liability extinguishment view,” or a combination thereof, rather than the “gross inflows view” or “value-added view.”
7. Revenues for a reporting entity do not arise from the performance by third parties of its obligations to deliver goods or render services if those obligations have been legally assumed by those parties.

The Board deferred extended discussion of whether additional conceptual guidance is needed and directed the staff to begin exploring the operationality of the conceptual model at the standards level.

Matters Discussed and Decisions Reached:

Mr. Slayton opened the discussion and noted that the Board would be asked to affirm the conceptual decisions made to date and to consider the nature of any additional conceptual guidance that may be needed.

Question 1: Do Board members agree that the elements criterion adequately describes when a change in assets and liabilities results in revenues (keeping in mind that this criterion must be viewed in conjunction with the definition of revenues)?

Most Board members agreed that the elements criterion adequately describes when a change in assets and liabilities results in revenues. However, some Board members observed that market-based changes in fair value that are not related to performance should not be treated as revenues. One Board member indicated a preference for excluding financial instruments from the scope of the project.

The IASB Board member noted that some subcriteria of the elements criterion repeat parts of the definitions of assets and liabilities and suggested that those subcriteria be removed in order to avoid redundancy.

One Board member expressed concern that the language in the elements criterion and certain other definitions (for example, “preperformance” assets and liabilities) used in this project may be difficult to understand. He urged the staff to simplify the definitions using “plain English.”

Question 2: Do Board members agree that an enforceable contract gives rise to rights and obligations that might meet the definitions of assets and liabilities? Specifically, do Board members agree that *unconditional* and *mature* rights and obligations might meet the definitions of assets and liabilities, but that *conditional* rights and obligations do not meet the definitions of assets and liabilities? An affirmative answer indicates agreement with the notion that a reporting entity might recognize certain “preperformance” assets and liabilities upon entering into an enforceable contract.

Board members generally agreed that (a) an enforceable contract gives rise to rights and obligations that might meet the definitions of assets and liabilities, and (2) unconditional and mature rights and obligations might meet the definitions of assets and liabilities. In addition, most Board members agreed that conditional rights and obligations do not meet the definitions of assets and liabilities; however, some Board members expressed concern about the use of the term “conditional” rights and obligations and its interaction with the term “contingent” assets and liabilities in the Board’s Business Combinations Project. The Board directed the staff to resolve the terminology issue.

Two Board members who initially expressed concern about treating unconditional rights and obligations as assets and liabilities indicated that they could affirm the Board’s decision, given that the word “might” is included.

Question 3: Do Board members agree to a rebuttable presumption that the unit of account for “preperformance” assets and liabilities is the contract as a whole (that is, recognize them net) unless the remedy of specific performance in the event of breach is available?

Board members agreed that the unit of account for “preperformance” assets and liabilities should be the contract as a whole. One Board member noted that the contract should be considered to be in the “preperformance” stage until one party performs, either partially or in whole. Another Board member noted that the contract should not be recorded at all until performance has occurred and expressed uncertainty about how contracts should be recorded when specific performance is the remedy.

Question 4: Do Board members agree that the most relevant measurement attribute of the assets and liabilities associated with revenue is fair value?

Initially, some Board members expressed concern about measuring the assets and liabilities at fair value. One Board member questioned whether fair value measurements were appropriate outside of financial instruments. Another Board member noted that, with the adoption of derivative accounting, accountants had crossed the threshold into measuring contracts at fair value. Other Board members doubted that any measures other than fair value could be employed.

Some Board members were concerned about subsequent measurement at fair value and whether market-based changes in the fair value represented revenues (or gains). One Board member suggested bifurcating the staff's question. First, she asked the Board to consider whether they agreed that the initial valuation of the assets and liabilities associated with a contract should be measured at fair value. The second part of the question could then address the subsequent measurement of the assets and liabilities.

One Board member stated that the contract's assets and liabilities should be measured based on the contract's transaction price. Other Board members noted that, at a contract's inception, the transaction price normally would reflect fair value. However, those Board members also observed that if entities offer deeply discounted or free goods and services to customers (for example, in order to develop a customer relationship) or employees (for example, as compensation for services), the transaction price may be below the fair value. Board members generally agreed that in such situations fair value would be the most relevant measurement attribute and that an expense would be recorded for any difference between the fair value and the transaction price.

Board members generally agreed that the assets and liabilities associated with a contract should be initially measured at fair value.

Board members were not asked to make a decision regarding subsequent measurement of contractual assets and liabilities. That issue will be discussed by the Board at a future meeting.

Question 5: Assuming an active “wholesale” market exists, do Board members agree that fair value of *performance obligations* should reflect the price that the reporting entity would pay a third party to assume responsibility for performing all of its remaining obligations?

One Board member observed that the “retail” fair value approach that another standard setter has proposed is a misnomer and that the approach was one of allocating the transaction price.

Most Board members agreed, in concept, that fair value of the seller's obligations should reflect the price that the reporting entity would pay a third party to assume

responsibility for performing all of its remaining obligations (the “wholesale” fair value). Some Board members expressed concern that, in practice, active markets may not exist or reporting entities may not have access to active markets. The staff acknowledged that the term “active market” had not been defined. One Board member stated his belief that the value of the performance obligations should reflect the transaction price.

In addition, some Board members expressed concern that the term “wholesale” fair value may be misunderstood to imply that the third party assuming the obligations would not require a reasonable profit margin and that the wholesale gross margin could be recognized upfront. The staff agreed that the terminology may be confusing and noted that it had begun to replace the term “wholesale” fair value with the term “business-to-business fair value.”

One Board member asked the staff to consider the impact on the revenue recognition project of decisions made in the fair value measurement project regarding the bid-ask spread. That project has proposed using, in active markets, the bid price as the fair value for assets and the ask price as the fair value for liabilities.

Question 6: Do Board members agree that the staff should continue to explore a definition of revenues based on the “broad performance view” or “liability extinguishment view,” or another alternative that might display revenues based on a combination of those views?

Board members generally agreed that the liability extinguishment approach should be pursued and indicated that that approach might rely less on the notion of performance, which is the focus of the broad performance view. Some Board members expressed a preference for the use of the liability extinguishment definition combined with enhanced income statement display. This enhanced display would identify more clearly the amount of revenue generated by the entity’s own performance and the revenue associated with the performance of third parties.

The staff noted that one particular issue that needed to be discussed was the appropriate revenue recognition for assets that are so readily marketable and

measurable that selling them requires negligible effort on the part of the seller (for example, certain commodities).

In response to a question from a Board member about whether the Board was being asked to decide on a particular view of revenues, the staff stated that was not the case but rather that the Board was being asked to affirm its prior decision to eliminate the gross inflow view and value-added view from further consideration.

Question 7: Do Board members agree that revenues for a reporting entity do not arise from the performance by third parties of its obligations to deliver goods or render services to its customers if those obligations are legally assumed¹ by those parties?

Board members agreed that revenues do not arise from the performance by third parties of its obligations if the obligations have been legally assumed by a third party.

Question 8: Are there any additional conceptual issues that were not identified in Memorandum 1 that the staff should address in this project?

When asked about additional conceptual issues that should be addressed, Board members had varied responses. Some Board members asked the staff to consider how the conceptual model meets the objective of decision usefulness, including predictability. One Board member observed that the objective of the conceptual model is to recognize and measure assets and liabilities and not to produce predictable income statement results by smoothing revenues and profits. She noted that existing financial statement analysis practices may need to change, but that the model would produce information that is useful for predicting future results.

Other conceptual issues that will be addressed by the Board in future meetings are (1) distinguishing between revenues and gains, (2) subsequent measurement of contractual assets and liabilities, (3) discerning contractual rights and obligations (that is, unit of account), (4) suitability of “default” measures in the context of the fair value hierarchy when fair value is not reliably measurable, (5)

¹ The staff may need to provide further guidance on what it means to be legally assumed for accounting purposes.

distinction between conditional and unconditional rights and obligations, and (6) implications of bid-ask spreads in fair value measurement.

However, prior to the staff addressing additional conceptual issues, the Board asked that they begin developing standards-level guidance for the application of the conceptual model.

Follow-up Items: None.

General Announcements: The Board will discuss the enforceability of contracts under the conceptual model (Memorandum #2), which had been originally scheduled for discussion at the December 10, 2003 meeting, at its meeting on December 17, 2003.