



MINUTES

To: Board Members

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

Subject: Minutes of the December 17, 2003 FASB Board Meeting **Date:** December 24, 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—Enforceable Rights and Obligations

Basis for Discussion: Memorandum #2 dated November 26, 2003

Length of Discussion: Starting Time: 8:30 a.m. Concluding Time: 9:15 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott

Board members absent: None

Staff in charge of topic: Sletten, T. Johnson

Other staff at Board table: Bielstein, Slayton, Cropsey, Figgie, Kazazeen

Outside participants: None

Summary of Decisions Reached:

The Board discussed various concepts-level issues related to "enforceable" rights and obligations as that term is utilized in the conceptual model for revenue recognition. The Board reached the following tentative conclusions:

1. The term "enforceable" refers to legal compulsion for the counterparties to perform their promises. Enforceable rights and obligations may be contractual or noncontractual (for example, rights and obligations that are legally enforceable under the doctrine of promissory estoppel). Unconditional rights and obligations that stem from contracts with customers and other legally enforceable promises might meet the definitions of assets and liabilities.
2. A contract does not have to be worthy of enforcement in order to give rise to assets and liabilities. (A contract is not worthy of enforcement if the costs of enforcing it would outweigh the benefits of doing so.) The assessment of the probability that contractual rights will contribute to future net cash inflows and contractual obligations will result in future net cash outflows should affect measurement, but not recognition of related assets and liabilities.
3. Contracts that include cancellation and "cancellation-like" provisions might give rise to assets and liabilities that should be recognized and measured at fair value. The concepts-level guidance should include an acknowledgement that measurement uncertainties might dictate whether assets and liabilities that arise from contracts with "cancellation-like" provisions should be recognized.
4. Concepts-level guidance should acknowledge that contractual promises may be express or implied. Standards-level guidance should be provided for implied contractual promises, including those that may arise as a result of the seller's history of providing concessions.
5. Concepts-level guidance should address contracts and contractual rights and obligations. Standards-level guidance should be provided for what constitutes evidence that a contract with the customer exists.

6. Standards-level guidance should acknowledge that “side agreements” alter the nature of contractual rights and obligations and should be viewed as an integral part of the contract for purposes of analyzing assets and liabilities that arise from contractual rights and obligations.

Matters Discussed and Decisions Reached:

Ms. Sletten opened the discussion and noted that the Board previously asked the staff to further clarify the meaning of the term “enforceable contracts” as it is used in the conceptual model. She noted that contracts entered into by business enterprises generally are enforceable at law by the courts, and it may be sufficient to use the term “contract with customer,” rather than “enforceable contract.” She also noted that some noncontractual promises might be enforceable, including promises that are enforceable under the doctrine of promissory estoppel (for example, charitable promises to give). Thus, unconditional rights and obligations that stem from contracts with customers and other legally enforceable promises might meet the definitions of assets and liabilities.

At the meeting, the staff asked the Board for decisions on five issues that are stated below, together with tentative decisions reached by the Board. Those decisions pertain primarily to concepts-level guidance.

Issue 1: Do Board members agree that the term “enforceable” as it is used in the conceptual model refers to legal compulsion?

All Board members agreed that the term “enforceable” refers to legal compulsion for the counterparties to perform their promises. Ms. Schipper expressed a preference not to use the notion of legal enforceability but also indicated that the Concepts Statements should make clear that promises made in contracts with customers cause the counterparties to have little or no discretion to avoid the future sacrifices specified in contractual obligations. She drew a parallel between the Board’s current discussion and the guidance in SEC’s Staff Accounting Bulletin No. 101, *Revenue Recognition*, and the AICPA’s Statement of Position

No. 97-2, *Software Revenue Recognition*, which require that evidence of an arrangement exist and clarify that generally the seller's customary business practices determine what constitutes persuasive evidence of an arrangement. Mr. Trott agreed, but thought that the guidance on evidence that a contract exists should be provided at the standards level rather than the concepts level.

Ms. Seidman asked if this tentative decision would change the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Mr. Johnson responded that it would elaborate on the definition of assets and liabilities in the context of contracts.

Issue 2: Do Board members agree that a contract does not have to be worthy of enforcement in order to give rise to assets and liabilities? If so, do Board members agree that the probability of future cash flows should be reflected in measurement?

All Board members tentatively agreed that a contract does not have to be worthy of enforcement in order to give rise to assets and liabilities. In addition, the Board agreed that, conceptually, the probability of a contract's enforcement should affect the measurement of the resulting assets and liabilities, but not their recognition.

Mr. Trott observed that this decision is consistent with the guidance provided in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. That Statement acknowledges that uncertainty about whether performance will be required does not affect recognition of the obligation to perform retirement activities. For example, a lessee must accrue a liability for its stand-ready obligation to reforest timberlands owned by the lessor even if there is uncertainty about whether the lessor will require reforestation. In that example, the lessee must factor the uncertainty about whether reforestation will be required into the measurement of the fair value through assignment of probabilities to cash flows.

Ms. Seidman cautioned that a contract that is not worthy of enforcement by either party could be analogous to a contract that is cancelable by both parties. Ms.

Schipper noted that enforcement worthiness is an intent-driven judgment made by management and determining that intent should not be used as a basis for this standard.

Mr. Batavick noted that applying probability in the *measurement* of assets and liabilities could have the same accounting result as applying probability in the *recognition* of assets and liabilities. For example, if a contractual right has a very low probability of embodying future economic benefit, that right may be measured at such an insignificant amount that it is not recognized at all. Ms. Shipper observed that, conceptually, a contingent right to receive a very large net cash inflow that has a low probability of favorable outcome might give rise to an asset whose fair value is not insignificant.

Mr. Schieneman and Ms. Seidman noted that considering probability of future cash flows in measurement rather than in recognition differs from the guidance prescribed in FASB Statement No. 5, *Accounting for Contingencies*. Ms. Schipper noted that the notion of measuring assets and liabilities at fair value is a direct disruption of the notion in Statement 5.

Issue 3: Do Board members agree that contracts that include cancellation and “cancellation-like” provisions might give rise to assets and liabilities that should be recognized and measured at fair value?

All Board members agreed that, in concept, contracts that include cancellation and “cancellation-like” provisions, such as rights of return (refund), customer acceptance provisions, and contingency clauses, might give rise to assets and liabilities that should be recognized and measured at fair value. In addition, most Board members agreed that the concepts-level guidance should acknowledge that measurement concerns might dictate whether assets and liabilities that arise from contracts with “cancellation-like” provisions should be separately recognized.

Mr. Crooch noted that even though a contract is cancelable, it does not necessarily mean that it should not give rise to assets and liabilities. Ms.

Seidman noted that a contract that is cancelable by both parties may not have sufficient substance to merit recognition. The staff agreed that wholly executory contracts that are cancelable by both parties without penalty may not give rise to preperformance unconditional rights and obligations that meet the definitions of assets and liabilities.

Issue 4: Should guidance be provided for *implied* contractual rights and obligations, including implied obligations that may arise due to the seller’s history of providing concessions? If so, should that guidance be at the concepts level or the standards level?

The Board agreed that concepts-level guidance should acknowledge that contractual promises may be express or implied. Standards-level guidance should be provided for implied contractual promises, including those that may arise as a result of the seller’s history of providing concessions.

Issue 5: Should guidance for “side agreements” be provided? If yes, should that guidance be at the concepts level or the standards level?

Board members discussed whether it was necessary to provide concepts- or standards-level guidance related to side agreements. Board members agreed that, at the standards-level, guidance should acknowledge that side agreements alter the nature of contractual rights and obligations and should be viewed as an integral part of the contract for purposes of analyzing assets and liabilities that arise from contractual rights and obligations.

Mr. Crooch stated that if side agreements are known, they should be defined as part of the original contract; treating them separately would imply that the agreements are not known. Ms. Schipper agreed and noted that management should be responsible for analyzing written, oral, and implied provisions of contracts. She noted that side agreements should not be addressed at the concepts level because, at that level, they should be considered to be part of a contract; however, more specific guidance may be needed at the standards level. Mr. Herz noted that the issue of side agreements may be more of an auditing issue rather than an accounting issue.

Follow-up Items: None.

General Announcements: None.