

MINUTES



To: Board Members
From: Mathys (ext. 446)
Subject: September 24, 2008 Board Meeting Minutes: Revenue Recognition **Date:** October 10, 2008
cc: FASB: Bielstein, Golden, Stoklosa, Proestakes, Posta, Lott, T. Johnson, Bement, Reager, Bonn, Zeyher, Zhu, Nickell, Yust, C. Smith, Glotzer, Mechanick, Gabriele, Chookaszian, Klimek, Allen, Sutay, Mathys, FASB Intranet; IASB: Leisenring, Rees, Pitman, Wright, Wilks, Upton, Clark, Peerless, Knubley; GASB: Patton, Driscoll, Reese

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Topic: Revenue Recognition
Basis for Discussion: Board Memorandum No. 114
Length of Discussion: 9:00 to 10:15 a.m.
Attendance:
Board members present: FASB: Herz, Batavick, Linsmeier, Seidman, and Smith
Board members present: IASB: Leisenring
Staff in charge of topic: Bement, Rees
Other staff at Board table: Golden, Proestakes, Bonn, Reager, and Mathys
Participating by phone: Wilks, Pitman, and Wright
Outside participants: None

Summary of Decisions Reached:

The Board discussed subsequent measurement of performance obligations in contracts with customers. Specifically, the Board discussed the nature of an onerous test in the customer consideration approach of measuring performance obligations. The Board also considered the IASB's recent discussion on whether remeasurement of performance obligations is needed in circumstances other than when those obligations are deemed onerous.

The Board considered two approaches for an onerous test: one based on the entity's expected cost of performance and another based on expected cost plus a margin. It tentatively decided that a performance obligation is deemed onerous when the entity's expected cost of performance exceeds the carrying amount of the performance obligation. The performance obligation is then remeasured to the entity's expected cost of performance. The Board noted that the IASB tentatively decided that some performance obligations would need to be remeasured at each financial statement date rather than by exception when deemed onerous. Performance obligations that may require remeasurement might include those that are long term and have significant variability of outcome. Such remeasurement would not affect the total revenue reported for the contract.

The Preliminary Views to be issued in the fourth quarter of 2008 will seek constituents' input on which performance obligations may require remeasurement at each financial statement date and will consider possible remeasurement approaches.

Objective of Meeting:

The objectives of this meeting were to:

- a. Consider the main issues associated with an onerous test and obtain the Board's preliminary view on the nature of an onerous test.
- b. Discuss the IASB's recent meeting regarding an onerous test

The objectives were met.

Matters Discussed and Decisions Reached:

- Issue 1: Nature of onerous test (paragraphs 1-25)
- Issue 2: Report on the IASB's discussion on the subsequent measurement of performance obligation (paragraphs 26-42)

ISSUE 1: NATURE OF ONEROUS TEST

1. Mr. Bement began by reviewing the Board's preliminary views on measurement of performance obligations in contracts with customers. In May, the Board voted in favor of the customer consideration approach that only remeasures a performance obligation when it is deemed onerous. In July, the Boards considered whether performance obligations should be remeasured in circumstances other than when deemed onerous. The FASB concluded that an approach that only remeasures a performance obligation when deemed onerous would provide decision-useful information in a general revenue recognition standard. The IASB, however, did not reach a conclusion because (a) it was not sure what was meant by an onerous test, and (b) it was concerned with an approach that only remeasures performance obligations when deemed onerous (that is, only remeasures by exception).
2. Mr. Bement reminded the Board that this would be the final meeting to capture the Board's views on measurement for the Discussion Paper if it is to be issued in the fourth quarter of 2008.
3. Mr. Bement noted that the purpose of the discussion was to address only the core issues relating to an onerous test and whether the customer consideration approach with that test would be suitable as the measurement approach in the general revenue recognition standard. Two core issues needed to be considered: (a) the onerous trigger (that is, when is a performance obligation deemed onerous?) and (b) the remeasurement basis (that is, how should the performance obligation be measured once deemed onerous?).
4. Mr. Bement summarized the options for an onerous test. Under Option A, a performance obligation is deemed onerous when an entity's cost of performance exceeds the carrying amount of the performance obligation. The performance

obligation would then be remeasured to the entity's expected cost of satisfying the performance obligation. A consequence of Option A is that the initial margin in the performance obligation serves as a buffer to absorb some adverse changes in the performance obligation. Two advantages of this option are its consistency with some current standards and its simplicity. A disadvantage is that some adverse changes in the performance obligation are reported in a less timely manner than they would under Option B. Under Option B, a performance obligation is deemed onerous when its measurement (in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, or other similar current price) exceeds the carrying amount of the performance obligation. The performance obligation would then be remeasured in accordance with IAS 37. A consequence of this approach is more frequent remeasurement and a reduction of the buffer to absorb adverse changes in the performance obligation. An advantage is that adverse changes are reported in a more timely manner, but a disadvantage is the added complexity and subjectivity of introducing a margin into the measurement.

5. Mr. Bement asked for Board comments and for the Board to express a preference in favor of either Option A or B.

Issue 1 Board Comments

6. Mr. Linsmeier questioned the necessity of an onerous test in this model. Mr. Herz responded that it might be useful to signal changes in the contract. However, Mr. Linsmeier questioned the importance of signaling only when the margin will not be realized and not when the margin is changing. He noted that the onerous test is not consistent with the perspective of neutrality in financial reporting because it recognizes only some downside movements.
7. Ms. Seidman stated that she believes the onerous test would be more appropriately addressed in a project other than the revenue recognition project, but noted that some Board members believe that the revenue model would be incomplete without a reference to the current practice of recognizing losses in cases in which costs will not be covered.

8. Mr. Linsmeier suggested the staff establish whether an onerous test is a natural part of the proposed model and include a third option in the Discussion Paper, which would be that no onerous test is necessary.
9. Mr. Linsmeier also expressed concern with the first sentence of paragraph 12 and stated that, absent a circumstance in which the entity has an onerous contract, the performance obligation in the customer consideration measurement approach does not measure the *outflow* of resources required to satisfy the obligation. It measures the inflow received for using resources to create the performance obligation, which includes a margin not consistent with the outflow.
10. Mr. Rees stated that that margin is important in trying to depict the riskiness of the outflow in a contract. Therefore, the measure of the performance obligation that includes a margin gives an indication of the relative outflows so that if there is a higher margin in one performance obligation over another, it does indicate the different risks relative in those two performance obligations.
11. Mr. Leisenring noted that the onerous test should not affect revenue. He also noted that tradition has always been to sometimes remeasure for both the IASB and the FASB, but remeasurement based only on cost would be inconsistent with inventory accounting under Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, which includes a margin in the lower of cost or market test. Also, the onerous test under IAS 37 is not clear regarding what costs to include, for example, whether CEO stock option expense is included in the cost.
12. Ms. Seidman stated that points such as those raised by Mr. Leisenring should be brought up as follow-up points in an Exposure Draft, but not as part of the Discussion Paper.
13. Mr. Smith asked Ms. Seidman to clarify her statement that the onerous test is not a revenue issue. He stated that he would specifically like to know how the test would be treated if it does not go through revenue. Ms. Seidman said that a liability would be accrued and the revenue line would not be debited; therefore, when the costs are actually incurred in the future, they would offset the previously established liability.

14. Ms. Seidman stated that she understands that the onerous test is naturally a part of the discussion for the IAS 37 project and other projects dealing with the measurement of liabilities. Although it is not a central issue to the revenue project, she would be willing to carry over the longstanding practice of discussing remeasurement in the Boards' proposed model because it is a Discussion Paper. Mr. Linsmeier stated that an alternative to discussing specific onerous test options could be to state that there are onerous contract issues involved with the revenue model, but that they are the subject of another project. He then asked about the IASB's views on the matter.
15. Mr. Bement responded that the IASB voted by a narrow majority (7–6) in favor of Option A for the onerous test. One reason for the vote was to avoid the complexity issues related to IAS 37 and another reason relates to the discussion Mr. Rees would lead later in this meeting.
16. Mr. Leisenring added that the IASB vote was so close, that it was not clear that the IASB could get enough votes to issue the Discussion Paper.
17. Mr. Herz stated that he would prefer a more entity-specific remeasurement approach such as one based on direct expected cash outflows rather than a margin approach; however, then a discount rate must be chosen, which would counter the basic customer consideration model. Mr. Herz also stated that he would prefer to capture both positive and negative changes because that would be more decision-useful. Mr. Herz also would support a remeasurement trigger when direct costs will be higher than the carrying amount of the performance obligation, which is more traditional accounting. He clarified, however, that these questions are not the main issue at this stage of the project.
18. Mr. Leisenring said that the IASB believes it would be inappropriate to measure the performance obligation at the customer consideration amount because the actual cost to satisfy the obligation may be higher or lower; although it might be appropriate to have the customer consideration amount in the revenue line.
19. Mr. Herz stated that he thinks customer consideration is a measure of deferred revenue. Ms. Seidman believes it measures the performance obligation on Day One,

and the question is whether one would remeasure it, and if so, when. Mr. Leisenring said that customer consideration may not be the measure of the performance obligation at Day One because AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production Type Contracts*, identifies numerous contracts that are loss contracts on Day One. Therefore, the onerous test could apply on Day One.

20. Mr. Rees said that he believes that part of the confusion is the fact that people decided to measure the performance obligation initially at the customer consideration amount for different reasons. For some, it is more of a proxy of a measure of the performance obligation at a fulfillment price, and at some point it may no longer be a good proxy for the fulfillment price. At that time, remeasurement would be necessary. He noted that currently under IAS 37 when a provision (liability) is recognized for an onerous contract, the entity does not incur a new obligation at that time. Rather, the obligation arose at contract inception. Hence, the onerous contract provision is really more of a remeasurement of an existing obligation rather than the recognition of a new obligation. Practically, however, a new liability would be recognized and called an “onerous provision.” Therefore, Mr. Rees explained that the reason the staff believes the onerous test is part of the revenue recognition model is because it relates to the remeasurement of the performance obligation arising under the contract.
21. Mr. Leisenring questioned the value of issuing a Discussion Paper that simply states that the customer consideration is the revenue line without addressing or answering all of the other questions that arise from that conclusion. Mr. Smith responded that by issuing a Discussion Paper and receiving constituent input, the staff will be able to begin answering the additional questions in the project. Mr. Smith said if he was voting now he would vote for Option A.
22. Ms. Seidman stated that she agrees with Mr. Smith and would not proceed with the alternative suggested by Mr. Linsmeier (no onerous test) primarily because the benefit of issuing the Discussion Paper for comment is to try to get broader input regarding whether the revenue line should be subject to remeasurement and to determine the extent to which the cost line should be subject to anticipated changes.

Ms. Seidman also expressed concern that if the Discussion Paper is too vague, constituents may think they will have to default to IAS 37, which means remeasuring both up and down, and Ms. Seidman does not agree with that approach.

23. Mr. Bement clarified that Mr. Smith and Ms. Seidman are in favor of Option A and requested the views of other Board members. Messrs. Batavick, Linsmeier, and Herz expressed preference for Option A, although Messrs. Herz and Linsmeier stated that their preference was marginal. Mr. Herz said that remeasurement based on expected costs provides better information.
24. Mr. Rees said that the staff would present a better argument for the reasons behind having an onerous contract, which was Mr. Linsmeier's suggestion early in the meeting.

Issue 1 Board Vote

25. The Board unanimously expressed a preliminary view in favor of Option A for subsequent measurement of performance obligations in contracts with customers. The Discussion Paper will present both Option A and Option B and express the Board's preference for Option A.

ISSUE 2: REPORT ON THE IASB'S DISCUSSION ON THE SUBSEQUENT MEASUREMENT OF PERFORMANCE OBLIGATIONS

26. Mr. Rees updated the Board on the IASB's September 15 discussion on subsequent measurement. The IASB had narrowly favored Option A over Option B, but still had concerns about relying solely on the onerous test to determine when remeasurement should occur in a revenue standard. The three concerns raised were that the test (a) is a one-way test and only picks up some adverse changes, (b) delays the reporting of some changes, and (c) is remeasurement by exception rather than on a continuous basis, which is inconsistent with IAS 37 and the general approach in the IASB's insurance project.
27. The staff had asked the IASB to consider whether their concerns could be addressed by additional disclosure or by scoping decisions. However, the majority of the IASB had concluded that their concerns would be best addressed by having a second measurement approach in the revenue recognition standard that would apply to a

limited set of performance obligations (those that are highly uncertain). This second measurement approach would require performance obligations to be measured at each financial statement date rather than by exception when deemed onerous.

28. Some IASB Board members had noted that if there were two measurement approaches in the general revenue standard, then the measurement principle of the general revenue recognition standard would be to remeasure performance obligations at the financial statement date. However, due to cost-benefit considerations, the approach of allocating customer consideration to the performance obligation, accompanied by an onerous test, would be specified as the presumptive measurement approach and would deal with the vast majority of the performance obligations.
29. The IASB had also discussed the ramifications of this approach in the Discussion Paper. There were three ideas that came out of that discussion:
 - a. The question of remeasurement needs to be fully discussed in the Discussion Paper.
 - b. The Discussion Paper must note that some Board member's tentative view is that a second measurement approach will be required for certain types of contracts in which the customer consideration approach with onerous test does not work well.
 - c. The IASB was not trying to reach a preliminary view about the principles specifying when the second measurement approach would be required or what would be the second measurement. Instead, they would like to seek input from constituents about when a second measurement approach would be appropriate, and the Discussion Paper should consider the possible approaches that could be used for subsequent measurement.

Issue 2 Board Comments

30. Mr. Batavick asked for clarification on what attributes would be included in the second class of performance obligations that Mr. Rees termed "highly uncertain." Mr. Leisenring said that the customer consideration model may work for 90 percent of the transactions in the market, but not by dollar volume and not by financial reporting problems. Mr. Rees said that the staff would hone the analysis in the Discussion Paper to list some types of contracts in which uncertainty is a concern and is a more significant feature of the contract than in a simple retail sale.

31. Mr. Linsmeier stated that he is very sympathetic to trying to build a whole revenue recognition principle, and uncertainty is important, but he also would like to include *long-duration* contracts. Mr. Herz agreed with the term *long-duration*, but prefers the term *variability* over *uncertainty*. All Board members agreed. Ms. Seidman asked for clarification of whether *variability* refers to inflow or outflow. Mr. Herz answered that it refers to the variability of the cost to perform. Mr. Golden noted that he believes it would be both inflow and outflow because that would measure variability of margin.
32. Ms. Seidman asked how much of the 10 percent that would not fit into the presumption (using a customer consideration model with an onerous test) would fit into the scope of an existing agenda project such as insurance, financial instruments, or leasing. She continued that she would strongly prefer to deal with this concern through the scope. She noted that it is urgent to issue a standard on revenue recognition to deal with the 90 percent of sale of goods and services that are not in the scope of any other active agenda project.
33. Mr. Linsmeier was concerned that if the scope is not broader, the current problem of having multiple, industry-specific revenue recognition approaches for different types of contracts would be recreated. Mr. Leisenring agreed and expressed concern that issuing a Discussion Paper that solves no existing problems (because those problems are related to the 10 percent of transactions being scoped out) would not be worthwhile.
34. Mr. Linsmeier suggested that if performance obligations in contracts with highly variable outcomes are measured both upwards and downwards, there may be no need for an onerous test for other performance obligations. Mr. Smith expressed concern that by remeasuring for *variability*, the 10 percent discussed as potentially scoped out could morph into the 90 percent category because the determination of *sufficient variability* may be vague.
35. Mr. Herz stated that another option other than remeasurement would be to include footnote disclosures related to the costs to fulfill a performance obligation and the variability of the costs and margins. Ms. Seidman noted her support for Mr. Herz's idea, even though it might eliminate the onerous test.

36. Mr. Linsmeier asked whether the IASB would require discussion of the onerous test in the Discussion Paper in order to vote for it. Mr. Rees responded that the IASB would like the Discussion Paper to note that a majority of the IASB believes that a second measurement approach should be considered, but also note that there are other Board members who think that scope and disclosure are another way to deal with the problem of highly variable or uncertain contracts.
37. Mr. Smith said the key to the discussion of another measurement approach is defining *uncertainty* to determine whether the transaction is in the 10 percent of transactions that would require the second remeasurement approach.
38. Mr. Smith noted that remeasurement is possible without going to a full fair value model and Mr. Herz agreed. Mr. Smith continued, however, that included costs and the discount rate would have to be specified, and there would have to be mechanical guidance. Mr. Herz said that he prefers the customer consideration model with no onerous test but with good disclosure in the footnotes about variability of outcome.
39. Mr. Leisenring said that he thinks neither other literature nor the IASB would support Mr. Herz's suggested conclusion because that loss should be recorded if a contract is at a loss on Day One. Mr. Smith agreed. Mr. Linsmeier also agreed and retracted his prior support of having no onerous test.
40. Mr. Golden clarified that there was a majority support for the customer consideration model. He suggested that the Discussion Paper explain that the Boards considered both a customer consideration model with an onerous test and a fair value model with continuous remeasurement. The Boards rejected complete remeasurement and focused on customer consideration, but some Board members still believe there should be remeasurement in certain circumstances, for example, circumstances in which a contract is either onerous or highly variable. Perhaps the Boards should not come to a preliminary view of when to remeasure, but make it clear that there is some future debate about the need to remeasure uncertain items. Then the Boards can ask constituents how the remeasurement should be displayed—in revenue, in margin (cost), or excluded altogether.

41. Mr. Herz said he would support Mr. Golden's suggestion, but that he also would support no remeasurement with disclosure about variability. Ms. Seidman agreed that that idea could be included in the Discussion Paper. Mr. Rees stated that Mr. Golden's description was how the staff plans to articulate the discussion about measurement in the Discussion Paper. Mr. Smith agreed as well. Mr. Smith asked whether there was enough support of Mr. Herz's view (disclosures) to put it in the Discussion Paper. Mr. Linsmeier supported including Mr. Herz's view in the paper.

Issue 2 Board Vote

42. The Board voted to include Mr. Herz's disclosure view (no remeasurement even on Day One) in the Discussion Paper as a potential option for dealing with highly uncertain or variable contracts. All Board members agreed.

Follow-up Items:

None

General Announcements:

The Board received requests to consider deferral or modification to FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, for non-public companies. After receiving Board members' input, it has been added to the agenda to be discussed at a future Board meeting.