Financial Accounting Standards Board

International Accounting Standards Board

MINUTES

To: Board Members

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

Subject: Minutes of the October 22, 2003 Tripartite FASB/IASB/AcSB Board Meeting

Date: October 30, 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—Measuring performance obligations

Basis for Discussion: Memorandums #1 and #2 dated October 10, 2003, and Memorandum #3 dated October 14, 2003

Length of Discussion: Starting Time: 1:00 p.m. Concluding Time: 2:45 p.m.

Attendance:

Board members present:	FASB: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
	IASB: Tweedie, Barth, Bruns, Cope, Garnett, Gélard, Jones, Leisenring, McGregor, O'Malley, Schmid, J. Smith, Whittington, Yamada
	AcSb: Cherry, Bowman, Cetkovski, Craven, Geremia, Lefrancois, Pare, Pahapill, Scott
Board members absent:	None
Staff in charge of topic:	Johnson, Slayton, Sletten (FASB), Paul (IASB)
Other staff at Board table:	Bielstein
Outside participants:	None

Summary for ACTION ALERT:

At the tripartite meeting of the FASB, IASB, and Canadian Accounting Standards Board (AcSB),[1] Board members discussed the conceptual model for revenue recognition with emphasis on measurement of performance obligations. Specifically, the Boards discussed the application of the fair value hierarchy described in the FASB's Fair Value Measurement Project to measurement of those obligations. Board members generally agreed that fair value is the relevant measurement attribute and that decisions about which measure of fair value to use should be based on the relative reliability of those measures. However, certain IASB Board members questioned whether the fair values of performance obligations should be measured in the "retail" markets as opposed to the "wholesale" markets as previously agreed to, in concept, by the FASB Board and as a working principle for purposes of this project by the IASB Board. Wholesale fair values measure performance obligations at the amounts that an entity would pay a third party to assume those obligations. Retail prices measure performance obligations at the amounts at which the reporting entity sold (or could sell) identical or similar products or services to similarly situated customers.

The Boards also discussed the FASB's fair value hierarchy, and several Board members noted that there may be difficulty in discerning differences between Level 2 and Level 3 estimates of fair value. Also, several Board members suggested avoiding the use of "default measures" because the term "default" implies an inconsistency with the measurement objective of fair value.

Matters Discussed and Decisions Reached:

Mr. Herz opened the discussion by describing the FASB's reasons for undertaking the project on revenue recognition. He noted that the United States has a great deal of revenue recognition literature related to specific industries and transactions but little general guidance. In addition, he noted that revenue

[1] This meeting was not a decision making meeting for the AcSB.

recognition is a focus of many SEC enforcement actions. Finally, he observed that revenues are usually the most significant item on companies' financial statements, further emphasizing the need for consistent revenue recognition guidance.

Mr. Herz noted that the IASB agreed to conduct the project jointly with the FASB in September 2002 and that, compared to US GAAP, international GAAP has relatively sparse revenue recognition guidance.

The FASB staff provided a brief overview of the conceptual model for revenue recognition, focusing on how that model might be applied in the context of related decisions that have been made in the FASB's Fair Value Measurement Project. In that project, the FASB decided that when an entity has access to multiple markets, the fair value is the most advantageous price in a market to which the entity has reasonable access. The IASB Board has adopted a similar view in its projects on financial instruments and business combinations. The staff observed that because wholesale markets normally yield the most advantageous prices for settling performance obligations, those obligations normally should be measured at their wholesale fair values.

The staff further noted that previous examples of the application of the conceptual model assumed that reliable wholesale fair values were available to measure the performance obligations. For the current meeting, Board members were asked to consider a series of cases that do not assume reliable measures of wholesale fair values are readily available. Instead, various techniques for estimating those fair values were discussed in the context of multiple element software arrangements and nonrefundable upfront fees for loan originations and commitments.

Staff members noted that estimates of fair value were formed within the boundaries of the fair value hierarchy that was developed in the FASB's Fair Value Measurement Project. Decisions about which estimates of wholesale fair values to use could be based on the relative reliability of those measures. The Boards agreed that reliability should be assessed in the context of *representational faithfulness* and *verifiability* as those terms are defined in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

One IASB Board member expressed concern with the overall principle that fair value should be used to measure performance obligations, although most Board members generally agreed to the use of some measure of fair value for those obligations.

Certain IASB Board members questioned whether the fair values of performance obligations should be measured in the retail markets as opposed to the wholesale markets as previously agreed to, in concept, by the FASB Board and as a working principle for purposes of this project by the IASB Board. Wholesale fair values measure performance obligations at the amounts that an entity would pay a third party to assume those obligations. Retail prices measure performance obligations at the amounts at which the reporting entity sold (or could sell) identical or similar products or services to similarly situated customers.

IASB Board members indicated that they had agreed to the use of wholesale fair value measures as a working principle in the Revenue Recognition Project but noted that they had not yet agreed that wholesale fair value is the most appropriate measure for entities' performance obligations.

Some Board members expressed concern with the "upfront" recognition of revenue for an entity's selling efforts. Several Board members noted that they were uncomfortable because they could not describe what this revenue was for and because measurement errors (for example, failure to identify all remaining performance obligations) might be inappropriately subsumed in the amount of revenue recognized upfront. Furthermore, some Board members suggested that it may not be appropriate to "jump" from the retail market where an entity-specific transaction took place to the wholesale market where performance obligations could be settled.

In addition, one Board member noted that using wholesale fair values seems inappropriate for "hypothetical" transactions (that is, when an entity intends to service its performance obligations itself). Another Board member expressed concern about an entity recognizing revenue prior to extinguishing the liability to its customer.

Several Board members were concerned about reliability of measures. One Board member held the view that estimates affecting revenue recognition may be subject to a higher test of verifiability than other estimates included in financial statements. Another Board member expressed concerns over how the conceptual model might be applied to unique contracts.

On the other hand, several Board members indicated their conceptual preference for the use of wholesale fair values, noting that retail prices do not produce representationally faithful estimates of fair values for performance obligations. One Board member noted that recognizing performance obligations at “entity-specific” prices might cause a company to misstate its liability. He stated that entity-specific measures would recognize a company’s own inefficiency or efficiency prior to providing a service, whereas a measure based on a wholesale fair value causes an entity to recognize its inefficiency or efficiency at the time that the service is provided.

IASB Board members generally expressed a preference for using the measure that would produce the most reliable results and noted that they preferred to discuss that matter amongst themselves at a later date. However, some Board members cautioned that both retail prices and wholesale fair value will present measurement challenges; in that respect, neither method is immune to concerns about reliability.

One Board member cautioned that reliability is often confused with what is described as “vouchability,” the ability to tie the numbers to a supporting document, and noted that these two terms do not have the same meaning. Another Board member observed that the Boards’ interpretation of the term *reliability* may differ from that of the Boards’ constituents and noted the need to clearly communicate the meaning of that term. An FASB Board member suggested that this issue might be more appropriately addressed in the FASB’s Fair Value Measurement Project.

Board members generally agreed that relative reliability should be the primary focus in deciding which measures should be used within the fair value hierarchy. Several Board members noted that there may be difficulty in discerning differences between Level 2 and Level 3 estimates of fair value. Those members believe that Level 2 and Level 3 could be combined because judgment as to whether items are sufficiently similar may be difficult and because estimates made at both levels are derived through adjustments to market inputs. Additionally, those Board members were concerned that an approach that would require the use of the top tiers of the fair value hierarchy (assuming that information is available) before considering the lower tier would eliminate judgment about which measures were most reliable.

Board members also discussed whether and, if so, when recourse to default measures might be necessary. Several Board members observed that default measures are not currently well defined. They might be simply less reliable estimates of fair value, or they might be measures of convenience that are not consistent with the fair value measurement objectives. Labeling them as defaults may be inappropriate because the term “default” implies an inconsistency with the measurement objective of fair value. One Board member noted that if wholesale fair value estimates were not available, it might be necessary to use measures derived from retail markets (even if those measures are not referred to as default measures).

One Board member stated that no other recent fair-value-based FASB standards, such as FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, proposes default criteria. Some Board members agreed that allowing the use of default criteria would allow the use of a measurement attribute that is substantially different from that proposed by the fair value hierarchy and that this outcome would be undesirable.

One IASB Board member suggested that there is a unit of account issue with measuring the fair value of a performance obligation. For example, should the wholesale fair value of a performance obligation composed of several "deliverables" be based on the price for transferring it on a piecemeal basis or in a single transaction?

Mr. Herz summarized the discussion, noting that a number of questions still exist for the Boards to consider. First, he acknowledged that there is some concern about whether the amount of an obligation should be based on its fair value or an entity-specific value. Next, he noted that the Boards need to continue discussions about whether the retail market or wholesale market is the relevant reference market for measuring performance obligations. Next, he stated that if wholesale markets are appropriate, the Boards will need to reach agreement on how the fair value hierarchy is to be applied. For example, preference of estimates formed within the fair value hierarchy could be based on which measures are deemed to be most *reliable* (both representationally faithful and verifiable) or they could be based strictly on a top-tier to bottom-tier approach. In addition, he noted that the Boards need to decide if the inclusion of default measures in the conceptual model is appropriate. Finally, the Boards must consider issues related to subsequent measurements.

<u>Follow-up Items</u>: None.

<u>General Announcements</u>: None.