REVISED MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Revenue Recognition Team (Goetsch, ext. 447)		
Subject:	Revised Minutes of the October 24, 2005 FASB-IASB Joint Board Meeting	**Date:**	November 15, 2005
cc:	FASB: Bielstein, Smith, Petrone, T. Johnson, Tovey, Figgie, Thuener, Kawanishi, Goetsch (2), Strange, Cropsey, Gerard, Golden, MacDonald, Cohen, Swift, Polley, Gabriele, Carney, Mahoney, Sutay, FASB Intranet; IASB: J. Brown, Hickey, Upton; 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: Identification and Initial Measurement of Performance Obligations in Revenue Contracts and the Definition of Revenues

Basis for Discussion: Memorandum Nos. 73, 74, 75, 77

Length of Discussion: 1:00–3:40 p.m.

Attendance:

Board members present:	FASB: Herz, Batavick, Crooch, Schipper, Seidman, Trott, Young
	IASB: Tweedie, Barth, Cope, Engström, Garnett, Jones, Leisenring, McGregor, O'Malley, Smith, Whittington
Board members absent:	FASB: None
	IASB: Bruns, Gélard, Yamada

Staff in charge of topic:	FASB: Tovey, Figgie
	IASB: Brown
	AASB: Paul
Other staff at Board table:	FASB: Bielstein, T. Johnson, Goetsch
	IASB: Hickey, Upton
Outside participants:	None

Summary of Decisions Reached:

The Boards refined some decisions reached in prior Board meetings. They:

- Clarified that the definition of performance obligations should include obligations to provide not only goods and services but also other rights, such as rights of use;
- Noted that the costs incurred to extinguish a performance obligation would be recognized as a component of comprehensive income and not as a reduction of the recognized performance obligation;
- Clarified the criteria for disaggregating contracts involving several performance obligations into separate components (‘units of account’); and
- Refined the proposed description of the way in which the customer consideration would be allocated among those units of account.

One of the proposed criteria for disaggregating contracts into separate units of account is that the goods, services, or other rights underlying a performance obligation are sold separately or as an optional extra by any vendor or could be resold separately by the customer. The Boards decided to specify the market in which such sales by the customer would take place. They asked the staff to consider how to define that market.

At their separate meetings in September, the Boards made decisions regarding the initial measurement of performance obligations in revenue contracts involving more than one unit of account. The Boards decided that the total customer consideration should be allocated to each unit of account based on the price at which the underlying good, service, or other right would be sold on a stand-alone basis. That price would be estimated by reference to the most reliable available evidence. At the joint meeting in October, the Boards affirmed that decision and asked the staff to review the guidance on estimating stand-alone prices in the absence of market evidence for consistency with the overall measurement objective.

At their September meetings, the Boards considered whether to make exceptions to the general proposal that performance obligations should be initially measured at the allocated customer consideration amount. Both Boards decided to make an exception for obligations—such as financial liabilities—that are required to be measured at fair value by other accounting standards. However, they reached different conclusions on whether to make a similar exception for all unconditional stand-ready obligations. The FASB Board decided those obligations should be measured at the allocated customer consideration amount (unless required to be measured at fair value by another accounting standard) while the IASB Board decided they should be initially measured at fair value. At their October meeting, the Boards decided to present both views in the Preliminary Views. The IASB Board further clarified that an unconditional stand-ready obligation would be measured at fair value even if that obligation is the only obligation in the arrangement. That means that for some arrangements, a reporting entity might recognize some revenue at the inception of the contract.

At their September meetings, the Boards decided to explore an alternative measurement principle that would permit or require a fair value measurement for any performance obligations that trade in active markets. At the October meeting, the Boards agreed to defer consideration of this alternative until the allocated customer consideration approach is more fully developed.

Illustrative examples

The Boards considered examples that illustrated the customer consideration allocation approach. They noted that the examples highlighted a need to consider further how the approach would apply to revenue transactions in which:

- Customers are not expected to exercise all rights under the contract, or
- Nonrefundable, upfront fees (such as loan origination fees) are paid to access another service or right.

The Boards considered an example involving statutorily imposed obligations (such as warranties that goods sold are fit for a particular purpose). The Boards decided that such obligations should be accounted for in the same way as any other contractual obligations. However, they acknowledged that in practice those types of obligations may be immaterial or inseparable from other obligations within a revenue contract.

Definition of revenues

The Boards discussed the circumstances in which transactions for the sale of goods, services, or other rights should be treated as generating revenues, rather than other positive components of comprehensive income (such as gains).

The Boards previously decided that the present distinctions between revenues and gains—based on ongoing major or central operations (FASB literature) or ordinary activities (IASB literature)—were somewhat ambiguous and difficult to put into practice.

At this meeting, the Boards considered an alternative basis for distinguishing revenues from other positive components of comprehensive income—namely, whether the transactions involved items produced or purchased by the entity for the purpose of sale or resale. They decided this proposed basis was sufficiently promising to merit further investigation and asked the staff to explore it further.

The staff noted that the question of whether production activities preceding entry into contracts with customers could give rise to revenues would be considered at a future meeting.

<u>Objectives of Meeting</u>:

The objectives of the meeting were (a) to clarify recent tentative decisions about the identification and initial measurement of performance obligations using an allocation of the customer consideration amount, (b) to illustrate those decisions by applying them to a range of examples, and (c) to reopen the Boards' discussion of the definition of revenues.

Matters Discussed and Decisions Reached:

IDENTIFICATION AND INITIAL MEASUREMENT OF PERFORMANCE OBLIGATIONS

Clarification of Separate Unit of Account Criteria and the Meaning of the Customer's Reference Market

1. Mr. Tovey stated that at their respective September 2005 meetings, both Boards tentatively agreed that performance obligations in revenue contracts should be disaggregated from the customer's perspective, based on whether the deliverable has *utility to the customer*. Additionally, the Boards agreed that the deliverable has utility to a customer if either (a) it is sold separately by any vendor (or as an optional extra) or it could be resold separately by the customer in the customer's reference market or (b) it obligates the reporting entity to stand ready to provide goods, services, or other consideration to the customer if specified events occur. Mr. Tovey noted that certain Board members asserted that those two criteria are inconsistent because the first criterion is described from the customer's perspective and the second criterion is seemingly described from the reporting entity's perspective. To address that concern, the staff proposed clarifications to the criteria for determining whether a deliverable has utility to a customer (and, thus, should be recognized as a separate unit of account). There were no objections to the staff's proposed clarifications. (Those clarifications were included in the Board meeting audience handout, which is attached as an appendix to these minutes.)

2. Additionally, Mr. Tovey noted that one of the proposed criteria for determining whether a performance obligation should be recognized as a separate unit of account is that the deliverable is sold separately or as an optional extra or could be resold separately by any vendor. He explained that it is necessary to identify the market in which such sales occur. The Boards agreed and decided to specify the market in which such sales would take place and asked the staff to consider how to define that market.

3. Mr. Tovey stated that such sales would occur in the customer's reference market (that is, the market in which the customer principally transacts).

However, Mr. Tovey added that a practical expedient could be developed that would permit (or require) the reporting entity to select one market for reporting purposes if its customers transact in multiple markets. Mr. Leisenring stated that it may be difficult for a reporting entity to identify the customer's reference market because the reporting entity may not know where a customer principally transacts. Mr. Tovey responded that the reporting entity generally operates as the seller in the customer's reference market; therefore, the reporting entity should be able to identify the appropriate market. Mr. Leisenring asked whether the customer's reference market should be defined as the market in which the reporting entity and the customer transact. Mr. Tovey agreed that it should.

4. Mr. Cope noted that the market in which the customer and the reporting entity transact could be different from the market in which the customer *usually* transacts. Mr. Tovey stated that the staff would consider further the issue of defining the customer's reference market.

5. Mr. Whittington stated he was troubled that a deliverable would be considered a separate unit of account if it could be *resold separately by the customer in the customer's reference market*. He questioned the effect of that criterion in cases in which the customer could resell the deliverable in a different market from where the customer purchased it. Mr. Tovey responded that the staff's thinking was to allow separate unit of account treatment in cases in which the customer could not purchase an item separately from a vendor but could resell the item to another party in the same or similar market. He posited an example in which a customer can only purchase an automobile with a standard warranty. In that example, an automobile would be treated as a separate unit of account because the customer could resell it separately (that is, without the standard warranty) to another customer. Mr. Tovey noted the validity of Mr. Whittington's concern and stated that the staff would make appropriate changes to the criterion in question. Ms. Schipper added that the criterion was to address identifying the units of account in a revenue contract, not initial measurement.

Definition of Performance Obligation

6. Mr. Tovey explained that the staff proposed refinements to the definition of a *performance obligation* to clarify that the definition include an obligation to provide not only goods and services but also other rights, such as right of use. He noted that the refinement was to clarify that certain rights, such as unconditional stand-ready rights, might not fit into the definition of either a good or a service. Moreover, Mr. Tovey noted that the phrase *legally enforceable* as it is used in the definition of performance obligation may be redundant because the notion of enforceability, as discussed in this project, comprehends the notion of legal enforcement.

7. Board members did not object to the proposed refinements to the definition of performance obligation. Mr. Batavick noted that the notion of a performance obligation in the context of a retail sale, in which the product is purchased and delivered instantaneously, might not accurately describe the transaction. Mr. Tovey responded that the Boards would consider this further when it deliberates the accounting for fully executory contracts.

Elimination of the Term *Customer-Based Value*

8. Mr. Tovey explained that several Board members expressed concerns about the term *customer-based value*. He introduced the term *allocated consideration amount* as an alternative and stated that it is a more descriptive and accurate representation of how performance obligations would be measured.

9. Board members generally agreed that the term allocated consideration amount better describes the way in which the customer consideration amount would be allocated among the units of account (that is, the term better describes how performance obligations would be measured).

10. Mr. Batavick questioned whether the term should be *allocated customer consideration approach* to better reflect the allocation process. Ms. Barth noted that the allocated consideration amount is a calculation method, not a measurement attribute. Mr. Tovey responded that historical cost is a measurement attribute in FASB Concepts Statement No. 5, *Recognition and*

Measurement in Financial Statements of Business Enterprises, and the allocated consideration amount could be considered an allocation of the historical cost or proceeds. Ms. Barth remarked that the allocated consideration amount is not the historical cost of each performance obligation on a stand-alone basis; it is the historical cost of the transaction as a whole.

Use of the Terms *Average Costs* and *Average Profit Margin*

11. Mr. Tovey stated that at the Boards' meetings in September, the Boards made decisions regarding the initial measurement of performance obligations in revenue contracts involving more than one unit of account. The Boards agreed that the total customer consideration amount should be allocated to each unit of account based on the price at which the underlying good, service, or other right would be sold on a stand-alone basis. That estimated sales price would be measured using the most reliable evidence available and that evidence would be ranked in an order of relative reliability (a relative reliability hierarchy). He noted that certain Board members requested more guidance in describing how to estimate a sales price in the absence of market evidence (that is, in Level 4 of the relative reliability hierarchy). In those circumstances, an entity would use its own internal assumptions and data. Mr. Tovey explained that the reporting entity's objective in Level 4 would be to estimate the stand-alone sales price (which is consistent with the measurement objective for all other levels) and that any guidance developed should be consistent with that measurement objective.

12. The Boards affirmed the decision they made in September. The Boards asked the staff to review the guidance on estimating stand-alone prices in the absence of market evidence for consistency with the overall measurement objective.

13. Mr. Smith stated that the relative reliability hierarchy only applies to contracts with multiple units of account. If there is only one unit of account in a revenue transaction, the customer consideration amount would be used to measure it.

Mr. Whittington asserted that evidence in Level 3 of the relative reliability hierarchy (that is, current sales prices charged by any entity in an inactive market) is more reliable than evidence in Level 2 (that is, current sales prices charged by other entities (competitors) in an active market). He noted that the current sales prices of the reporting entity—regardless of whether those sales prices are in an active or inactive market—are more reliable than current sales prices of other entities because it is difficult to determine if the competitor's product is the same as the reporting entity's product. Mr. Trott responded that prices in active markets are more reliable than those in inactive markets. Mr. Paul clarified that Level 2 assumes that the competitor's product is the same as the one being measured.

Measurement of Unconditional Stand-Ready Obligations

14. Mr. Tovey explained that at the September meetings, the staff proposed that unconditional stand-ready obligations be measured at fair value rather than at the allocated consideration amount. The IASB Board accepted that recommendation. However, the FASB Board rejected it, instead preferring to measure all performance obligations at the allocated consideration amount. Mr. Tovey stated that the Boards had valid reasons for arriving at their decisions and asked if the Preliminary Views should describe both approaches.

15. The Boards tentatively agreed to present both approaches in the Preliminary Views. Moreover, those IASB Board members that supported measuring unconditional stand-ready obligations at fair value clarified that they would continue to support that measurement even if there were no other performance obligations in the contract. That means that for some arrangements, a reporting entity might recognize some revenue at the inception of the contract.

16. Mr. Smith disagreed and expressed favor for a model in which unconditional stand-ready obligations in a contract with a single unit of account would be measured at the transaction price and unconditional stand-ready obligations in a contract with multiple units of account would be measured at fair value. He stated that he does not support recognizing revenue at the inception of a

contract. Messrs. McGregor and Leisenring noted that it is important to measure unconditional stand-ready obligations consistently. Mr. Smith responded that he would prefer to measure them all at an allocated consideration amount rather than measure them all at fair value. Ms. Seidman noted that she is troubled by measuring certain types of performance obligations at fair value (using a lay-off notion) and other performance obligations at an allocated customer consideration amount. She noted that unconditional stand-ready obligations often are single-element contracts with consideration exchanged (such as guarantees) and they should be measured in the same manner as other performance obligations. Ms. O'Malley stated that IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, would require that all unconditional stand-ready obligations be subsequently remeasured at fair value; therefore, it makes sense to initially measure those obligations at fair value.

17. Mr. Leisenring noted three approaches that could be considered: (a) a pure fair value approach (that is, all performance obligations would be measured at fair value), (b) a pure allocated consideration approach (that is, all performance obligations would be measured by allocating the customer consideration amount), and (c) a hybrid of the two (that is, performance obligations would be measured at fair value if reliable measures exist; otherwise, the obligations would be measured by allocating the customer consideration amount).

18. Ms. Barth questioned whether the allocated customer consideration approach solved certain Board members' concerns about the fair value approach. Mr. Herz noted that the majority of FASB Board members did not support the fair value approach without a reliability threshold for fair value measures. Mr. Batavick noted that the fair value approach lacked constituents' support and questioned why the Boards would continue to explore a pure fair value approach. Mr. Trott responded that the fair value approach was more conceptually pure.

19. Mr. Smith noted that fair value was the appropriate measurement attribute for some performance obligations. Mr. Batavick stated that he would not object to using fair value measures if there was active market information; however, he

would object to a pure fair value model. He also noted that he would object to a model under which revenue is recognized at contract generation. Mr. Tweedie agreed and stated that it is inappropriate to recognize revenue at contract generation if no performance obligation has been extinguished. He also noted his concern with recognizing revenue upon contract generation if that revenue included measurement error or if the contract could be cancelled.

20. Ms. Schipper noted that Board members had two distinct concerns about measuring performance obligations at fair value and recognizing revenue at contract generation. First, some Board members think that revenue should not be recognized until a performance obligation has been extinguished; therefore, revenue should never be recognized as a result of contract generation activities (even if the fair value of all of the performance obligations can be measured reliably). Second, some Board members think that revenue should not be recognized at contract generation if the fair value measures of performance obligations do not meet a specific reliability threshold; otherwise, measurement error could account for a portion of the revenue recognized at contract generation. She cautioned the Boards not to confuse those two concerns. Mr. Leisenring added that the Boards should not use measurement error as the only justification for not recognizing revenue at contract generation because some Board members would not recognize revenue even if there was no measurement error.

21. Mr. Trott asserted that it may be premature to discuss whether or not to include both of those approaches in the Preliminary Views because the Boards may agree on one approach. Moreover, he stated that he is concerned about an approach that relies on the fair value hierarchy as an "on/off switch" for determining whether to use fair value to measure performance obligations.

Administrative Matter on Project Issue Sequencing

22. Mr. Tovey explained that at the Boards' September meetings, the staff asked each Board whether it would like to explore an alternative approach under which assets and liabilities would be permitted or required to be measured at fair value under active market conditions. The IASB Board agreed that such an

approach should be developed further. However, the FASB Board was opposed to it. Mr. Tovey asked Board members whether they supported postponing consideration of this alternative approach until the basic approach is more fully developed. Both Boards agreed that consideration of that alternative approach should be postponed until after the allocated customer consideration approach is more fully developed.

Unconditional Stand-Ready Obligations and the Effect of Their Extinguishment

23. Mr. Tovey noted that based on the Boards' tentative decisions in September, a credit to the income statement is recognized when a performance obligation, including a stand-ready obligation (such as a warranty), is extinguished. Directly offsetting related expenses incurred against the performance obligation is not appropriate; such expenses are recognized as debits in the income statement when they are incurred. Mr. Tovey noted that the application of that treatment will require an amendment to both FASB Statement No. 5, *Accounting for Contingencies,* and IAS 37. Board members did not object.

ILLUSTRATIVE EXAMPLES

24. Ms. Brown introduced a set of examples that illustrated the proposed allocated customer consideration approach to a range of revenue transactions. She noted that the examples illustrate two versions of that approach. The first measures all performance obligations at their allocated consideration amount (that is, the estimated stand-alone sales price plus or minus a pro rata allocation of any difference between the sum of all of the stand-alone sales prices and the consideration receivable from the customer). The second measures unconditional stand-ready obligations at their fair value (that is, the legal layoff amount) and measures the remaining obligations by allocating the remaining customer consideration among them on the basis set out in the first approach.

25. The Boards noted that the examples highlighted a need to consider further how the approach would apply to revenue transactions in which (a) customers are not expected to exercise all rights under the contract (that is, breakage) and (b) non-refundable upfront fees (such as loan origination fees) are paid to access another service or right.

Example 1—Painting Contract

26. Ms. Brown stated that the objective of Example 1 was to determine whether the Boards agreed with the units of account identified by the staff. Mr. Trott noted that the example addressed breakage (that is, the expectation that customers would not take advantage of all their contractual rights). The painting contract includes three power washes but the measurement of reporting entity's obligation to provide those washes assumes that the customer only will demand two. Mr. Trott noted that breakage is an important issue and recommended the Boards address that issue separately in the future. Ms. O'Malley added that the Boards will have to consider cases in which the reporting entity includes an estimate of breakage in its measurement of a performance obligation but the customer demands all of its rights.

27. Mr. Leisenring noted that the customer has a general right to return any unopened can of paint and asked from whose perspective that right is being measured. Mr. Tovey explained that the right of return is being measured from the customer's perspective. He noted that the right of return is valued at the amount that the customer would pay to receive the right to return the product. He added that this notion is clearer in other examples such as the airline tickets, in which a customer can buy a ticket with and without cancellation privileges.

Example 2—Extended Warranty

28. Ms. Brown stated that the objective of Example 2 was to illustrate the difference between the two versions of the allocated customer consideration approach. She noted that under the second version the single performance obligation would be measured at fair value and $50 (the difference between the fair value of the warranty obligation and the customer consideration amount)

would be recognized as revenue at contract generation. The majority of those Board members that supported measuring unconditional stand-ready obligations at fair value affirmed that accounting treatment.

29. Mr. Smith stated that he did not support measuring the warranty at fair value and recognizing $50 as revenue at contract generation. Mr. Smith stated that in a single-element contract, an unconditional stand-ready obligation should be measured at the customer consideration amount. He noted that “selling” does not meet the criteria to be treated as a separate unit of account; therefore, revenue should not be ascribed to it. Ms. O’Malley noted that selling revenue could be viewed as a market access charge; an amount paid by the customer to gain access to a market that it ordinarily could not access.

30. Mr. Leisenring asked Mr. Smith if he would measure a warranty obligation at fair value if that warranty was sold bundled with an appliance (such as a washing machine). Mr. Smith acknowledged that he would measure the same unconditional stand-ready obligation differently based on whether the revenue contract had one unit of account or multiple units of account.

Example 3—Mortgage Origination Fees

31. Ms. Brown stated that Example 3 illustrated the staff’s preliminary thinking about upfront fees. She acknowledged that the example was simplified but noted that the staff would appreciate the Boards’ comments. The Boards agreed that transactions that include nonrefundable, upfront fees require further consideration.

32. Messrs. Smith and Trott stated that they are not sure the mortgage origination fee is a separate unit of account because a customer would not pay an upfront origination fee if that customer didn’t expect to also receive the mortgage loan. Mr. Smith noted that the two parts were interdependent. Ms. O’Malley added that the fair value of the initial event (that is, the application process) is very small because the customer really is paying for the subsequent event (that is, the loan).

33. Ms. Schipper stated that she applied the two criteria for determining whether something has utility to a customer (and, thus, should be treated as a separate unit of account) and she is not sure that the upfront fee meets either of those criteria. She advised the Board members to rely on the criteria for determining what is a separate unit of account and not allow intuition to play a part in that determination. Ms. Schipper noted that a potential solution would be to treat all nonrefundable, upfront fees consistent with the treatment required by FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. That is, if the application is rejected, the non-refundable, upfront fee would be recognized as revenue immediately, but if the application is accepted, the nonrefundable, upfront fee would be recognized over the life of the associated service or right.

34. Mr. Herz noted that there might be a difference between a nonrefundable, upfront fee paid when the subsequent service or right is likely to be obtained (for example, a mortgage origination fee and ensuing loan) versus one when the subsequent service or right is unlikely to happen (for example, the admission application fee for an Ivy League university and acceptance/tuition). Mr. Tovey asked the Boards if they thought the likelihood of the subsequent service or right being obtained affects the recognition of the nonrefundable, upfront fee. Messrs. Cope and Jones stated that the likelihood may matter. That is, they would be more likely to recognize the fee as a separate unit of account if it is fairly certain that the reporting entity will incur no further obligation(s). Ms. O'Malley questioned whether it would matter if the applicant knew what the acceptance requirements were and could assess whether it met the criteria.

35. Ms. Seidman questioned whether the customer perceived that it was receiving an unconditional right when it paid the nonrefundable, upfront fee. Mr. Tovey explained that if the customer meets certain criteria, the customer has an unconditional stand-ready right and the entity has an unconditional stand-ready obligation (that is, the reporting entity has to stand ready to grant a loan to the customer). Mr. Whittington asserted that the upfront event does have utility to the customer because it gives the customer the chance to get to the subsequent

event; that is, a university applicant pays the fee for the chance at getting accepted into the university.

36. Ms. Barth noted that the identification of separate units of account should have a reporting entity bias because the Boards tentatively decided in the Conceptual Framework project that financial statements should be prepared from the reporting entity's perspective. She noted that if there is tension between that decision in the Conceptual Framework project and the Boards' decision in the Revenue Recognition project to use the customer's perspective, the Boards should reconsider using the customer's perspective in the Revenue Recognition project.

37. Mr. Tovey asked Board members whether they thought the staff misapplied the criteria for identifying separate units of account. He asked whether nonrefundable, upfront fees could ever be recognized separately under the current criteria. Several Board members said that nonrefundable, upfront fees generally would not meet the criteria and should not be recognized as separate units of account.

38. Ms. Brown noted that Example 4, Sale of a Television, did not introduce any new issues and, therefore, she did not introduce this example for discussion.

DEFINITION OF REVENUES

39. Mr. Paul explained that the Boards previously discussed the definition of revenues in April 2004 and, at that time, the proposed definition of revenues was "…inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from the entity's production, sale, and delivery of products (goods and services) to customers." He noted that the Boards did not reach a decision on that definition and requested clarification of the meanings of the terms *customers* and *products*. Mr. Paul stated that the staff further developed the definitions of customers and products and was asking the Boards for their opinions on those definitions. He further noted that the staff proposed using the definition of products as a "filter" to determine whether the credit that results from a transaction is revenue or another positive component of

comprehensive income (such as a gain). (The staff's proposed definitions of customer and products are included in the Board meeting audience handout, which is attached as an appendix to these minutes.) The Boards tentatively agreed that the staff's proposed basis for distinguishing revenues from other components of comprehensive income was sufficiently promising to merit further investigation and asked the staff to explore it further.

40. Mr. Trott expressed concern about how the creation of a financial instrument would be accounted for under the staff's proposed definition of revenue. He explained that he does not believe that a bank providing a loan to a customer is a revenue generating transaction. Mr. Paul acknowledged that the staff needs to address that issue because the staff's proposed definition of products includes *other rights* and a loan appears to meet that definition. Ms. Schipper agreed that the application of the definition of revenues to rights to use (such as the right to use fiber optic cable) needs to be further analyzed and developed. Ms. Seidman asked whether the Boards' Performance Reporting project would reduce the stress in the Revenue Recognition project to distinguish between revenues and gains.

41. Mr. Tovey asked whether Board members would prefer to explore distinguishing between revenues and gains based on a notion of *ongoing major or central operations*. He noted that under that notion, reporting entities would decide what constituted their ongoing major or central operations and that would introduce noncomparability. Mr. Cope and Ms. Schipper noted that they would not be concerned with that noncomparability. Ms. Schipper posited an example in which a franchisor regularly bought poor performing franchises, improved them, and resold them. She asked whether that process should be considered revenue. Mr. Tovey responded that he thought it should be considered revenue based on the criteria being developed by the staff.

42. Mr. Leisenring stated that a reporting entity must have a customer before it can recognize revenue. He noted that he doesn't think a timber company should recognize revenue as the trees grow. He added that a customer is especially critical because the Boards tentatively agreed to explore an approach that is

based on the customer's perspective. Mr. Paul stated that the staff plans to address at a subsequent meeting the issue of whether production activities preceding contract generation could give rise to revenue.

STATUTORILY IMPOSED WARRANTY OBLIGATIONS

43. Ms. Figgie noted that one of the staff's illustrative examples, Example 4, Sale of a Television, discussed several unconditional stand-ready obligations to provide implied warranties that are statutorily imposed. In that example, the staff asserted that those implied warranties would be recognized as separate units of account and revenue would arise from their extinguishment. Ms. Figgie stated that the staff concluded, in general, all warranties—both express and implied—arise from the generation of a revenue contract and create an obligation on the part of the seller that the goods it sells will conform to certain qualities, characteristics, or conditions. Ms. Figgie asked whether Board members agreed that statutorily imposed obligations arise from revenue contracts and, thus, are not "extra contractual." The Boards tentatively decided that statutorily imposed obligations should be accounted for in the same way as any other contractual obligations. However, they acknowledged that those types of obligations may be immaterial or inseparable from other obligations in a revenue contract.

44. Mr. Whittington agreed with the staff's recommendation and noted that implied warranties should be accounted for in the same manner as express warranties. He added that statutorily imposed obligations are not always trivial and may, in fact, be significant. However, Mr. Whittington warned the staff not to segment contracts too finely. Ms. O'Malley added that although statutorily imposed obligations are implied, they are legally enforceable obligations that would not arise without a revenue contract.

45. Mr. Herz disagreed with the staff's recommendation and asserted that statutorily imposed obligations are not separable units of account because they are provided to all customers and do not add value to the contract. He stated that if an entity sells goods that do not meet the criteria imposed by the legislation, that sale is an illegal act. He added that not all unconditional stand-

ready obligations have utility to the customer, and therefore, they do not meet the criteria to be recognized as separate units of account. Mr. Batavick stated that statutorily imposed implied warranties are a cost of doing business and should be accounted for as such (that is, the expense should be accrued).

46. Mr. Trott stated that the Boards should not assume that statutorily imposed warranties are de minimus or that they are captured in the contract's express warranties. But, he suggested that as a practical expedient, all warranties—both express and implied—could be accounted for as one unit of account.

46. Mr. Smith asserted that he did not view statutorily imposed warranty obligations as unconditional stand-ready obligations because the reporting entity controls the triggering event and, therefore, is able to extinguish the implied warranty immediately. Mr. Tovey explained that in cases when the reporting entity knows it has fulfilled the requirements of the implied warranty, the liability has been extinguished upon delivery of the product (or the remaining obligation is very small). Ms. Schipper noted that the critical question isn't whether the warranty is statutorily imposed; the critical question is when the obligation is extinguished. Ms. Schipper asked whether there were similarities between the issue of statutorily imposed implied warranty obligations and the European Union's (EU) directive on the disposal of electronic waste because both impose on an entity a statutory obligation. The staff responded that there is no difference and each is an unconditional stand-ready obligation. Ms. Schipper noted that the cost of fulfilling obligations under the EU directive on electronic waste could be significant, illustrating that statutorily imposed performance obligations are not always immaterial in amount.

47. In summary, Mr. Tovey stated that statutorily imposed obligations that are unconditional stand-ready obligations would be accounted for as such. He added that the Preliminary Views would note that such obligations might be immaterial or inseparable from other stand-ready obligations and, therefore, may not merit separate accounting treatment.

Follow-up Items:

None.

General Announcements:

None.

Board Meeting Handout
October 24, 2005
Norwalk, CT
Revenue Recognition Project

PURPOSE OF TODAY'S DISCUSSION

At today's meeting, the Boards will discuss several topics. First, the Boards will consider certain clarifications of recent tentative decisions about the initial identification and measurement of performance obligations using an allocation of the customer consideration amount. Second, the Boards will discuss illustrative examples that apply those tentative decisions to a range of revenue transactions. Third, the Boards will discuss certain issues related to the definition of *revenues*, including the definition of *customer*.

IDENTIFICATION AND INITIAL MEASUREMENT OF PERFORMANCE OBLIGATIONS

Both the FASB and IASB Boards have agreed to explore an assets-and-liabilities approach that uses an allocation of the customer consideration amount for measuring performance obligations. At their respective September 2005 meetings, the Boards considered several issues relating to the initial identification and measurement of performance obligations. For today's meeting, the staff has clarified certain of those issues.

Clarification of the Separate Unit of Account Criteria and the Meaning of the Customer's Reference Market

The Boards tentatively agreed that performance obligations in revenue contracts should be disaggregated from the customer's perspective, based on whether the deliverable has *utility to the customer*, that is, whether the customer perceives that the good, service, or other right underlying the performance obligation is, in and of itself, fit for some purpose or is serviceable for some end. The Boards tentatively agreed that a good, service, or other right has utility to a customer if either:

a. It is sold separately by any vendor (or as an optional extra) or it could be resold separately by the customer in the customer's reference market
b. It obligates the reporting entity to stand ready to provide goods, services, or other consideration to the customer if specified events occur.

Certain Board members asserted that the two criteria are inconsistent because the first criterion is described from the customer's perspective and the second criterion is seemingly described from the reporting entity's perspective. In order to address that concern, the staff proposes the following changes:

> ~~The~~ A good, service, or other right ~~deliverable~~ has utility to a customer if either:
>
> a. It is sold separately or as an optional extra by any vendor in the customer's reference market ~~(or as an optional extra)~~ or it could be resold separately by the customer in that ~~in the customer's~~ reference market[1], or
>
> b. It gives the customer an unconditional right that obligates the reporting entity to stand ready to provide goods, services, rights, or other consideration ~~to the customer~~ if specified events occur.[2]
>
> [1] This criterion assumes that the customer would be able to resell the item at an amount that would substantially recover the original selling price.
>
> [2] The phrase "if specified events occur" also applies to situations in which the specified event is the nonoccurrence of an event (for example, the specified event in a loan guarantee arrangement is the debtor's nonpayment of a scheduled loan payment).

Discussion Question No. 1(a) of Agenda Paper 3A: Do Board members agree with the proposed edits of the criteria for determining whether a good, service, or other right has utility to a customer and, therefore, should be accounted for as a separate unit of account?

The staff thinks it is necessary to clarify the term *customer's reference market* as certain questions have arisen concerning the meaning of the term. The customer's reference market is the market in which it principally transacts. That is, the customer's reference market is the market in which a substantial majority of its purchases of goods, services, or other rights take place. Consequently, under a strict interpretation of the customer's perspective, a reporting entity's revenue contracts may be accounted for differently based on the unique characteristics of a particular customer's reference market.

For example, consider Company A, which sells two different goods—Good Y and Good Z—in the United States and in China. In the United States, retail customers can purchase each good individually (that is, Company A sells Good Y and Good Z on a stand-alone basis) or purchase the goods as a bundle. Therefore, both Good Y and Good Z would be considered two separate units of account for customers whose reference market is the retail market in the United States. However, in China, customers can purchase the goods as a bundle only (that is, Company A does not sell Good Y and Good Z on a stand-alone basis). Customers cannot resell the goods separately in China. Therefore, Good Y and Good Z would be considered a single unit of account for customers whose reference market is the retail market in China. Therefore, Company A would have to account for a U.S. transaction and a Chinese transaction differently under the strict interpretation described above.

Alternatively, consider the same example, but assume that *some* customers in China can and do transact in the U.S. retail market (and, therefore, are able to buy Good Y and Good Z separately) while other customers in China only transact in the Chinese retail market. Under a strict interpretation of the customer's perspective, the staff thinks that the reference market for the two customers in China would be different, and, therefore, their revenue contracts would be disaggregated differently.

Due to the practical difficulties associated with identifying customers' reference markets, the staff acknowledges that Board members may decide to provide a practical expedient for this issue. For example, the Boards could permit a reporting entity to designate one market in which it transacts as the average reference market for all of its customers.

<u>Discussion Question No. 1(b) of Agenda Paper 3A</u>: Do Board members agree with the strict interpretation of how the customer's perspective would be applied?

<u>Discussion Question No. 1(c) of Agenda Paper 3A</u>: Should the staff consider some form of practical expedient related to this issue?

Definition of Performance Obligation

The term *performance obligation* was defined by an earlier Board decision as a legally enforceable obligation of a reporting entity to its customer, under which the entity is obligated to deliver goods or render services. This definition has been questioned because it does not make reference to other rights that can be sold (for instance, a right to use an asset or a refund right). The staff understands that it was the Boards' intent to have the term *services* include other rights that can be sold. To more clearly communicate the nature of saleable items to which a performance obligation applies, the staff recommends that the definition of performance obligation be modified as follows:

> A *performance obligation* is a legally enforceable obligation of a reporting entity to its customer, under which the entity is obligated to ~~deliver~~ provide goods, ~~or render~~ services, or other rights.

The staff also would like to clarify the usage of that term. A performance obligation refers to any legally enforceable obligation of the reporting entity identified in a revenue contract (that is, all legally enforceable obligations are performance obligations). However, not all individual performance obligations meet the separate-unit-of-account identification criteria. Some individual performance obligations might be combined and reported as a single unit of account; thus, a single unit of account might consist of multiple performance obligations. Also, some performance obligations might be converted to unconditional rights to receive payment without ever being recognized as a liability (for example, the reporting entity delivers a product first and receives payment afterwards).

<u>Discussion Question No. 2(a) of Agenda Paper 3A</u>: Do Board members agree with the proposed changes to the definition of *performance obligation*?

<u>Discussion Question No. 2(b) of Agenda Paper 3A</u>: Do Board members have any concerns about the clarification of usage for the term *performance obligation*?

Elimination of the Term *Customer-Based Value*

Several Board members expressed concerns about the term *customer-based value*. Consequently, the staff proposes to define the measurement attribute as the *allocated consideration amount* and to define that term as follows in a new working criterion:

> *Measurement subcriterion (1b)*—The allocated consideration amount of a performance obligation is the aggregate of (a) the price at which a good, service, or other right is or is capable of being sold on a stand-alone basis or as an optional extra to a customer[1] (referred to as its estimated sales price)[2] and (b) a pro rata portion, based on the performance obligation's relative estimated sales price, of the difference between the sum of the estimated sales prices of the performance

[1] As marketplace participants, customers are presumed to be (a) unrelated to the reporting entity (that is, independent third parties), (b) knowledgeable, having a reasonable level of understanding about all factors relevant to the product and the market(s) for the product based on available information, (c) able to transact in the market for the product, having the legal and financial ability to transact, and (d) willing to transact in the market for the product; that is, they are motivated but not forced or otherwise compelled to transact (neither party is at a negotiating disadvantage).

[2] An estimated sales price should be based on the average current sales price.

> obligations in a revenue contract and the customer consideration amount.[3]

Three changes have been made to this criterion. The first difference is that it uses the term *allocated consideration amount* to describe the measurement of a performance obligation. The second difference is the addition of the phrase *or as an optional extra* to include those items that are sold only in conjunction with other items but that would be capable of being sold as an optional extra (for instance, the price of a hotel room is quoted with and without a cancellation right). The third difference is the use of the term *estimated sales price* to describe the measurement objective in clause (a) of the subcriterion.

Discussion Question No. 3 of Agenda Paper 3A: Do Board members agree that the revised terminology better describes the measurement and measurement objective associated with using an allocation methodology?

Use of the Terms *Average Costs* and *Average Profit Margin*

The Boards tentatively agreed that the estimated sales price of a performance obligation should be measured using the most reliable available evidence and that evidence should be ranked in the following order of relative reliability (from most to least reliable):

a. Level 1: current sales prices charged by the reporting entity in an active market
b. Level 2: current sales prices charged by other entities (that is, competitors) in an active market
c. Level 3: current sales prices charged by any entity in an inactive market; and
d. Level 4: estimated current sales prices based on entity inputs that reflect the reporting entity's own internal assumptions and data.

FASB Board members suggested that more guidance was required to explain *how* the estimated sales price should be determined at Level 4. In order to give more guidance and strengthen Level 4 estimates, the staff proposes the following fundamental principle.

> *Sub-Principle M3*
>
> To determine the estimated sales price of a performance obligation, a reporting entity should use the most reliable evidence available (from most reliable to least reliable): (Level 1) current sales prices charged by the reporting entity in an active market; (Level 2) current sales prices charged

[3] Performance obligations required by other GAAP to be measured at fair value are excluded from the allocation.

> by another entity (that is, a competitor) in an active market; (Level 3) current sales prices charged by any entity in an inactive market; (Level 4) estimated current sales prices based on entity inputs that reflect the reporting entity's own internal assumptions and data. In developing a Level-4 estimate of the estimated sales price, a reporting entity should take into account the average costs[4] and average profit margin[5] of providing the good, service, or other right. If the performance obligation being measured based on Level 4 information is one of a group of identical performance obligations incurred by the reporting entity, the estimate should reflect the activity for that group (not just that related to the individual performance obligation being measured).

Discussion Question No. 4 of Agenda Paper 3A: Does the Board agree that the addition of the term *average* and the statement about portfolio-basis measurement sufficiently strengthen the Level-4 estimate by taking into account uncertainty related to the timing and amount of cash flows associated with settlement?

Measurement of Unconditional Stand-Ready Obligations

At the September 2005 meetings, the staff proposed that unconditional stand-ready obligations be measured at fair value rather than at the allocated consideration amount. The IASB Board accepted this recommendation. However, the FASB Board rejected it, instead preferring to measure all performance obligations at the allocated consideration amount. Given the differences, the staff recommends that the Preliminary Views address both approaches.

Discussion Question No. 5(a) of Agenda Paper 3A: Do Board members agree that both approaches should be presented in the Preliminary Views?

Discussion Question No. 5(b) of Agenda Paper 3A: Should one of the approaches be presented as the Boards' preferred approach?

Unconditional Stand-Ready Obligations and the Effect of Their Extinguishment

Based on the Boards' tentative decisions in September 2005, a credit to the income statement is recognized when performance obligations are extinguished. Said differently,

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[4] The term *average costs* refers to the sum of the probability-weighted distribution of costs for a group of identical performance obligations. For a new good to be sold, the reporting entity considers the costs for all of the units expected to be produced, rather than the costs of the individual unit being measured. Similarly, for an unconditional stand-ready obligation, the reporting entity considers the range of possible costs for a group of identical obligations. Costs include all costs that the reporting entity would incur, including an allocation of overhead, to provide the good, service, or other right to a customer. In calculating average costs, a reporting entity should consider the time value of money.

[5] The term *average profit margin* refers to the sum of the probability-weighted distribution of profit margins. That is, a reporting entity considers the profit margins for a group of identical performance obligations rather than the profit margin of the individual obligation being measured.

all performance obligations, including unconditional stand-ready obligations, should be ascribed an element of revenue[6] that will be recognized when performance occurs. The staff has provided the following example to emphasize this point:

> A manufacturer sells a good with a standard manufacturer's warranty. The good and warranty were sold for cash of €1,000. The allocated consideration amount and fair value of the warranty are both assumed to be €100, which is recognized as warranty performance obligation on Day One. The standard warranty expires in one year. The risk associated with this contract is assumed to diminish ratably over that one-year period.

The application of the Boards' decision to this example is that €100 of warranty service revenues will be recognized as a credit in the income statement over the one-year warranty period.

<u>Discussion Question No. 6 of Agenda Paper 3A</u>: Do Board members have any questions about this issue?

Administrative Matter on Project Issue Sequencing

At the September meetings, the staff asked each Board whether it would like to explore an alternative approach under which assets and liabilities would be measured at fair value under active market conditions. The IASB Board was keen for such an approach to be developed further. However, the FASB Board was opposed to it. The staff recommends postponing consideration of this alternative approach until the basic approach has been fully developed.

<u>Discussion Question No. 7 of Agenda Paper 3A</u>: Do Board members have any concerns with sequencing the development of the alternative approach after the allocated consideration amount approach is developed?

ILLUSTRATIVE EXAMPLES

The staff prepared four examples to illustrate the application of the proposed approach to a range of revenue transactions.

The examples illustrate two versions of the approach:

a. Approach A: All performance obligations[7] are measured at their allocated consideration amount (that is, the estimated stand-alone sales price +/- a pro rata

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[6] The term *revenue* is used to include all positive components of comprehensive income because the Board has not distinguished between revenues and gains.
[7] Other than those required to be measured at fair value by another accounting standard.

allocation of any difference between the sum of all of the stand-alone sales prices and the consideration receivable from the customer).

b. Approach B: Unconditional stand-ready obligations[8] are measured at their fair value (that is, the legal lay-off amount). The remaining obligations are measured by allocating the remaining customer consideration amount among them on the basis set out above in (a).

For simplicity, the examples ignore the time value of money and assume that prices remain unchanged for the duration of the contracts.

Example 1—Painting Contract

PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer to paint the customer's house for $3,000.

The price is inclusive of all paint. The customer is given the right to purchase paint separately if so desired (although the customer did not opt to do so in this example). The paint would have cost the customer $900 if purchased from a hardware store. PainterCo delivers the paint a day before beginning the work. The customer has a general right to return any unopened can of paint. There are no other return rights.

The price is also inclusive of power washing services once a year for the next three years. It is the customer’s responsibility to request and schedule such services each year during the three-year period. On average, customers request two of the three power washings to which they are entitled. PainterCo sells power washing services on a stand-alone basis and charges $50 to power wash a residential house of average size. PainterCo believes $50 is also representative of the amount it would have to pay to legally layoff an obligation to perform one power washing.

PainterCo would have charged $2,150 for the painting service without the paint and power washing service. PainterCo frequently provides the painting service without supplying paint, but never supplies paint without providing the painting service.

Identification of the Separate Units of Account

The following obligations satisfy the proposed criteria for identification as separate units of account:

a. *Paint:* other vendors (hardware stores) sell paint separately.

[8] And any other obligations required to be measured at fair value by another accounting standard.

b. *Painting service*: PainterCo sells painting services separately.

c. *General right of return*: The customer has an unconditional right that obligates PainterCo to accept returns of unopened cans of paint if they are surplus to requirements.

d. *Power-washing right*: The customer also has an unconditional right that obligates PainterCo to provide power washing services once a year for the next three years if so requested.

Measurement of the Separately Identified Performance Obligations

Performance obligations are measured by allocating the total consideration among them. The first step in this allocation is to estimate the stand-alone sales price of each separately identified performance obligation (other than those to be measured at fair value). The reporting entity determines this amount using the most reliable available evidence.

Approach A: All Obligations Measured using the Allocated Consideration Amount

The performance obligations are measured to be:

Unit of account	(a) Estimated sales price $	(b) Allocation of residual [9] $	(a) + (b) Measure of obligation $
Paint	870[10]	(41)	829
Painting service	2,150	(102)	2,048
Right of return	30	(2)	28
Power-washing right	100[11]	(5)	95
Total	3,150	(150)	3,000

[9] Pro rata allocation of difference between sum of stand-alone sales prices ($3,150) and total consideration ($3,000).

[10] Stand-alone sales price of $900 less estimated sales price of right of return of $30.

[11] Stand-alone sales price of two power washes.

Approach B: Stand-Ready Obligations Measured at Fair Value

Suppose PainterCo estimates the fair value of the right of return to be $28 and the fair value of the power-washing right to be $100, the performance obligations would be measured as follows:

Unit of account	(a) Estimated sales price $	(b) Allocation of residual $	(a) + (b) Measure of obligation $
Paint	870	(43)[12]	827
Painting service	2,150	(105)[13]	2,045
Total measured at allocated cons. amt.	3,020	(148)	2,872
Right of return	28	-	28
Power-washing right	100	-	100
Total	3,148	(148)	3,000

<u>Discussion Question 1(a) of Agenda Paper 3B:</u> Do Board members agree that all the separate units of account have been identified in accordance with the proposed criteria?

<u>Discussion Question 1(b) of Agenda Paper 3B</u>**:** Do Board members agree with the way that estimated sales price has been obtained for each performance obligation?

<u>Discussion Question 1(c) of Agenda Paper 3B</u>**:** Do Board members have any concerns or questions about this example?

Example 2—Extended Warranty

GasCo undertakes repair and maintenance of domestic gas appliances, such as central heating boilers, gas stoves, and room heaters. A significant proportion of GasCo's revenue arises from extended warranty agreements. GasCo sells extended warranties under arrangements with major domestic appliance retailers. The retailers provide GasCo

[12] Residual allocated to paint = total residual of $148 multiplied by $870 / $3,020.
[13] Residual allocated to painting service = residual of $148 multiplied by $2,150 / $3,020.

with customer information (names, addresses, and appliance purchased). GasCo then contacts the customers directly to offer them extended warranty cover. GasCo has a fixed set of prices that depend on the nature and make of the appliance and the duration of the agreement.

There is a market for portfolios of extended warranty obligations of the type offered by GasCo. A few retailers sell the extended warranty agreements to customers themselves and then pay companies like GasCo to assume the obligations. GasCo and its competitors also occasionally trade portfolios of obligations.

GasCo sells to a customer a three-year extended warranty on a particular appliance for $500. By reference to the price it paid recently to transfer a portfolio of similar agreements, GasCo estimates the fair value of this warranty obligation to be $450.

Proposed Accounting Treatment

GasCo has only one identifiable performance obligation to the customer who purchased the above warranty: an unconditional obligation to stand ready to repair the appliance if it fails during the warranty period. Therefore, there is only one unit of account.

Approach A: Measurement at Allocated Consideration Amount

As there is only one separately identified performance obligation, the whole of the customer consideration of $500 (Level-1 evidence of the stand-alone sales price) is allocated to that obligation.

Approach B: Measurement of Unconditional Stand-ready Obligations at Fair Value

Approach B requires the unconditional stand-ready obligation to be measured at fair value (that is, $450). The $50 difference between the fair value of the performance obligation ($450) and the customer consideration ($500) is recognized as revenue immediately.

<u>Discussion Question 2(a) of Agenda Paper 3B:</u> Do Board members agree that the unit of account has been identified in accordance with the proposed criteria?

<u>Discussion Question 2(b) of Agenda Paper 3B</u>**:** Do Board members agree that the sole unit of account identified has been measured in accordance with the proposed criteria?

<u>Discussion Question 2(c) of Agenda Paper 3B:</u> Do Board members have any concerns or questions about this example?

Example 3—Mortgage Origination Fees

A mortgage lender provides residential mortgage loans. It has advertised a program of conventional 15-year mortgage loans, offered at competitive rates (based on the market interest rate prevailing when the loan is funded). Applicants are required to pay a 2 percent origination fee when they submit their applications. These fees are completely non-refundable, even if a loan application is not approved. Loan applications are not approved if the applicant does not satisfy stipulated lending criteria. A would-be borrower submits an application for a $100,000 loan and pays the required $2,000 fee.

Identification of the Performance Obligations

The mortgage lender incurs the following performance obligations when it accepts the application:

a. An unconditional obligation to act upon the loan application (for example, to assess the borrower's financial position and the adequacy of guarantees and other security arrangements)
b. An unconditional obligation to stand ready to grant the applicant an option to take out a loan if the application is approved. [14]

The lender's obligation to assess the application is not a stand-ready obligation. Hence, it would be regarded as having separate utility to the prospective borrower only if the underlying service is sold separately as an optional extra by any vendor or could be sold separately by the borrower. That criterion could be met in circumstances in which lenders are willing to rely on suitability assessments performed by other parties (for example, mortgage brokers) and potential borrowers are able to contract separately with these other parties for the provision of application approval services.

The lender's obligation to stand ready to grant the customer an option to take out a loan would meet the second criterion for determining whether a good, service, or right has utility to a customer. Therefore, it would be regarded as a separate unit of account.

Measurement of the Separately Identified Performance Obligations

Applying Approach A, the total consideration of $2,000 would be allocated between the two performance obligations on the basis of their relative stand-alone selling prices. The

[14] It is assumed that having accepted the application fee, the mortgage lender does not have the right to turn down the application if the applicant satisfies the relevant criteria (for example regarding financial position and adequacy of security).

selling price of the application approval service would be measured by reference to the prices charged by mortgage brokers (Level-2 evidence). The expected selling price of the option is likely to be small (because the loan will be priced at prevailing market interest rates).

Applying Approach B, the unconditional obligation to stand ready to provide the loan if the application is approved would be measured at fair value. (Again this is likely to be very small.) The remainder of the $2,000 consideration would be allocated to the obligation to act upon the application.

<u>Discussion Question 3(a) of Agenda Paper 3B</u>**:** Do Board members agree that all the separate units of account have been identified in accordance with the proposed criteria?

<u>Discussion Question 3(b) of Agenda Paper 3B:</u> Do Board members agree with the way that estimated sales price has been obtained for each performance obligation?

<u>Discussion Question 3(c) of Agenda Paper 3B:</u> Do Board members have any concerns or questions about this example?

Example 4—Sale of Television

On January 2, 20X6, Customer A purchases via a third-party sponsored credit card a high-end LCD television for 6,000 currency units (CU). DMD offers free delivery and installation on all televisions with a price of at least CU 4,000. As part of a New Year's Day sale, Customer A receives a three-year extended warranty at no additional charge. (Such warranties are normally priced and sold separately.) DMD has a 60-day, no questions asked sales return policy. Further, DMD has a customer-loyalty program in which customers receive one point for each CU spent; customers can redeem points for free or discounted products in stock (that is, the points cannot be used for special-order products). Points cannot be purchased for cash or redeemed for cash. In addition, Customer A is provided with a 25 percent discount on his next purchase over CU 200 within the following 120 days.

DMD's Rights and Obligations

The following table presents the performance obligations that are identified as separate units of account and their measurements (under both Approach A and Approach B):

	Approach B	**Approach A**
Recognizable Liability 1: Television	6,010	6,010
Recognizable Liability 2: Delivery	100	100
Recognizable Liability 3: Installation	100	100
Recognizable Liability 4: Extended Warranty	240	600
Recognizable Liability 5: Refund	667	90
Recognizable Liability 6: Customer Loyalty	480	480
Recognizable Liability 7: Discount	33	10
Recognizable Liability 8: Implied Warranties	0.19	0.19
	7,630	7,390
Transaction Price	6,000	6,000
Residual to be allocated	1,630	1,390

Liabilities subject to residual allocation:		
Recognizable Liability 1: Television	6,010	6,010
Recognizable Liability 2: Delivery	100	100
Recognizable Liability 3: Installation	100	100
Recognizable Liability 4: Extended Warranty	N/A	600
Recognizable Liability 5: Refund	N/A	90
Recognizable Liability 6: Customer	N/A	480

Loyalty		
Recognizable Liability 7: Discount	N/A	10
Recognizable Liability 8: Implied Warranties	N/A	0.19
	6,210	7,390

Liabilities recognized post allocation:	**Approach B**	**Approach A**
Liability 1: Television	4,432[15]	4,880
Liability 2: Delivery	74	81
Liability 3: Installation	74	81
Liability 4: Extended Warranty	240	487
Liability 5: Refund	667	73
Liability 6: Customer Loyalty	480	390
Liability 7: Discount	33	8
Liability 8: Implied Warranties	0.19	0.15
	6,000	6,000

<u>Discussion Question 4(a) of Agenda Paper 3B:</u> Do Board members agree that all the separate units of account have been identified in accordance with the proposed criteria?

<u>Discussion Question 4(b) of Agenda Paper 3B:</u> Do Board members agree with the way that estimated sales price has been obtained for each performance obligation?

<u>Discussion Question 4(c) of Agenda Paper 3B:</u> Do Board members have any concerns or questions about this example?

STATUTORILY IMPOSED WARRANTY OBLIGATIONS

In the section above, Example 4, Sale of a Television, describes the facts of a contract between DMD Company and a customer for the sale of a high-end LCD television. That example discusses several unconditional stand-ready obligations to provide implied warranties that are statutorily imposed (such as those imposed by the U.S. Uniform Commercial Code or the U.K. Sale of Goods Act). In that example, the staff argues that, in concept, those implied warranties would be recognized as separate units of account and, thus, revenue[16] would arise from their extinguishment.

In the United States, contracts for the sale of goods are governed by U.S. Uniform Commercial Code (the Code), which is a uniform state law governing commercial transactions. In general, all warranties create an obligation on the part of the seller that the goods it sells will conform to certain qualities, characteristics, or conditions. Warranties arise from a transaction between a buyer and a seller; that is, they exist because a sales transaction occurs. Moreover, all warranties provide the customer (the buyer) with a legally enforceable right and impose on the reporting entity (the seller) a legally enforceable obligation. Such warranties are not extra-contractual; they exist because a revenue contract exists.

The staff thinks that the economic phenomenon (a warranty obligation) to be accounted for by the reporting entity is the same, regardless of whether that warranty is expressed or implied. Both express and implied warranties arise from the generation of a revenue contract—that is, they exist because a sale was made. Moreover, both express and implied warranties give the customer an unconditional right that obligates the reporting entity to stand ready to provide goods, services, or other consideration if specified events occur.

<u>Discussion Question No. 1 of Agenda Paper 3E:</u> Do Board members agree that statutorily imposed implied warranties arise from revenue contracts and, thus, are not "extra-contractual"?

DEFINITION OF REVENUES

At their joint meeting in April 2004, the FASB and IASB Boards discussed the following proposed definition of revenues:

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from the entity's production, sale, and delivery of products (goods and services) to customers.

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[15] \$4,432 = \$6,010 – (\$1,630 x \$6,010/\$6,210). Other amounts are calculated in the same way.

[16] The term *revenue* is used to include all positive components of comprehensive income because the Boards have not distinguished between revenues and gains.

The Boards did not reach a decision on this definition and requested clarification on the meaning of *customers* and *products* before deciding on the definition. The meaning of customers and products is critical to how the proposed definition of revenues is interpreted. The basic question is whether all of an entity's sales transactions of goods, services, and other rights to other parties—regardless of the nature or function of those items[17]—should be treated as giving rise to revenues at some point in time.

Existing FASB and IASB Literature

The degree of recurrence of components of comprehensive income is a key reason for distinguishing revenues from other positive components of comprehensive income. Concepts Statement No. 6, *Elements of Financial Statements*, defines revenues and gains as follows:

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. [Paragraph 78]
>
> Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. [Paragraph 82]

IAS 18 *Revenue* defines *revenue* as follows:[18]

> *Revenue* is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. [Paragraph 7]

IAS 18 does not define *ordinary activities*.

The Boards previously decided that the current distinctions that Concepts Statement 6 and IASB literature make between revenues and gains (based on whether sale transactions occur as part of *ongoing major or central operations* or *ordinary activities*) are somewhat ambiguous and difficult to operationalize, and explores other criteria.

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[17] For example, regardless of whether the items are inventories, investment securities, or items of property, plant, and equipment.

[18] The IASB *Framework* defines *income*, but not revenues, as an element of financial statements. However, it states that "revenue arises in the course of the ordinary activities of an entity" (paragraph 74) and that "gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity" (paragraph 75).

Defining an Entity's *Customers*

The staff explored whether a workable definition of customers could be developed to act as the only filter that precludes some sales transactions from qualifying as revenue-generating. Customers are defined in the existing U.S. authoritative literature. The term customer appears in IASB literature, but is not defined. While the staff acknowledges that it is desirable to use the same definition consistently in the accounting literature; existing definitions appear relevant primarily for their respective pronouncements. Therefore, the staff thinks that a better working definition is needed for the Revenue Recognition project.

Based on its research, the staff recommends the following definition:

> A *customer* is an entity[19] that purchases the reporting entity's products.

The staff acknowledges that adopting an all-inclusive definition of *customers* would make the definition of *products* the only filter precluding particular sales transactions from qualifying as revenue-generating.

<u>Discussion Question No. 1 of Agenda Paper 3C:</u> Do the Boards agree with the proposal to define a *customer* as an entity that purchases the reporting entity's products?

Defining an Entity's *Products*

Products are not defined in the existing authoritative literature. However, at the September 2005 Board meetings, the staff presented a description of *products* as any rights, including rights to goods, services, or rights to use and stand-ready rights that a vendor provides to a customer. In this regard, the reference to *other rights* encompasses stand-ready rights (that is, the customer's rights corresponding to the reporting entity's stand-ready performance obligations). The staff proposes to replace the term *products* with *goods, services, or other rights* in the definition of revenues.

For the purpose of the definition of revenues, the reference to goods, services, or other rights could be limited to such items when they are sold to customers on a recurring basis. However, defining goods, services, or other rights (and thus revenues) in terms of recurrence is problematic because of the subjectivity of assessments of whether particular

[19] An entity can be an individual or an organization (for example, business, not-for-profit entity, or government).

transactions will recur. Without the benefit of hindsight, such assessments cannot be verified at the time of preparing financial statements.

Alternatively, the reference to goods, services, or other rights could be limited to such items that are provided in particular activities (for example, ongoing major or central operations or ordinary activities). However, what constitutes a particular reporting entity's ongoing major or central operations or ordinary activities is somewhat subjective, and different entities may interpret their activities differently.

IAS 18 provides criteria that are less ambiguous for defining goods, services, or other rights. Those criteria refer to activities that tend to be recurring, without requiring an entity to determine which items are recurring in nature. IAS 18 describes goods as items produced for the purpose of sale and items purchased for resale (paragraph 3). The staff observes that services and other rights could be defined consistently with the definition of goods.

Accordingly, the staff proposes the following definition of *goods, services, or other rights* for the purpose of determining whether transactions for the sale of particular items give rise to revenues:

> *Goods, services, or other rights* are items, tangible or intangible, that are produced or purchased by the reporting entity for the purpose of sale or resale.

The staff also proposes to provide the following guidance on this definition:

In the definition:

a. *Produced* means created or enhanced. An example of enhancement is increasing the utility of an asset without creating a new asset.
b. Items purchased by the reporting entity for sale include goods, services, or other rights provided by other entities on behalf of the reporting entity.[20]

Applying a *purpose of sale or resale* test involves subjectivity and reliance on management intent. Assets may be purchased for multiple purposes. For example, a car rental company may purchase cars to generate cash inflows from rental and subsequently

[20] The reference to other entities acting *on behalf of the reporting entity* is made to reflect the Boards' decision in April 2004 that a reporting entity should recognize revenues for the performance by third parties of its obligations to deliver goods or render services to customers unless those obligations are legally assumed by those third parties.

to generate cash inflows from sale (as used cars) in retail markets. Conversely, equipment purchased for use in the production or supply of goods is not reclassified as a good if it is subsequently held for sale, because sale is incidental to the purpose for which the equipment was acquired. The implications of purchasing assets for multiple purposes would be explored by the staff if the Boards decide the general approach described here looks promising and merits further investigation. Another issue the staff would explore is whether the nature of the market(s) in which the reporting entity transacts should affect whether particular sales transactions are revenue-generating.

Discussion Question No. 2 of Agenda Paper 3C: Do the Boards agree with the proposal to define *goods, services, or other rights* as follows?

> *Goods, services, or other rights* are items, tangible or intangible, that are produced or purchased by the reporting entity for the purpose of sale or resale.

Discussion Question No. 3 of Agenda Paper 3C: Do the Boards agree with the following guidance on the proposed definition of *goods, services, or other rights*?

In the definition:

a. *Produced* means created or enhanced. An example of enhancement is increasing the utility of an asset without creating a new asset.
b. Items purchased by the reporting entity for sale include goods, services or other rights provided by other entities on behalf of the reporting entity.

Discussion Question No. 4 of Agenda Paper 3C: Do the proposed definitions of *customers* and *goods, services, or other rights* (and related guidance) look sufficiently promising to merit further investigation? That is, do they represent good prospects for significantly improving the current guidance in Concepts Statement 6 and IASB literature on the distinction between revenues and gains?