REVISED MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Revenue Recognition Team (Goetsch, ext. 447)
Subject:	Minutes of the September 21, 2005 FASB Board Meeting
Date:	September 30, 2005

cc: FASB: Bielstein, Petrone, Smith, T. Johnson, Tovey, Figgie, Kawanishi, Thuener, Lapolla, Goetsch (2), Strange, Carney, Cropsey, Gabriele, Gerard, Golden, MacDonald, Mahoney, Polley, 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 or Interpretation.

Topic: Revenue Recognition: Identification and Initial Measurement of Performance Obligations in Revenue Contracts.

Basis for Discussion: Memorandum Nos. 70, 71, and 72, dated September 7, 2005.

Periods of Discussion: 1:00 p.m. to 3:25 p.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schipper, Seidman, Trott, Young
Board members absent:	None
Staff in charge of topic:	Tovey, Figgie
Other staff at Board table:	Bielstein, T. Johnson, Goetsch
Outside participants:	None

Summary of Decisions Reached:

At its September 21, 2005 meeting, the Board considered certain issues relating to the initial identification and measurement of performance obligations in the context of an approach that would measure performance obligations based on an allocation of the customer consideration amount.

The Board made the following decisions:

1. Revenues arise when each contract deliverable (or performance obligation) is delivered (or extinguished). All legal rights conveyed to a customer in a revenue contract give rise to an element of revenue.

2. 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 the product (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 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.

3. The measurement of performance obligations should be based on the amount at which the product is sold or could be sold unless other GAAP requires that they be measured at fair value.

4. The amount at which the product is sold or could be sold should be measured by the most reliable available evidence (from most reliable to least reliable): (a) current prices charged by the reporting entity in an active market; (b) current prices charged by another entity (that is, a competitor) in an active market; (c) current prices charged by an entity in an inactive market; (d) entity inputs that reflect the reporting entity's own internal assumptions and data.

5. The difference between the customer consideration amount and the sum of the amounts at which the products are sold or could be sold should be allocated to those performance obligations on a pro rata basis. However, no part of that difference should be allocated to performance obligations that other GAAP requires to be measured at fair value.

The Board also decided not to explore an alternative approach in which performance obligations would be either permitted or required to be measured at fair value if active layoff markets for those obligations exist.

Objective of the Meeting:

The objective of the meeting was to consider certain issues related to the initial identification and measurement of performance obligations under an assets and liabilities approach based on the customer consideration amount.

Matters Discussed and Decisions Reached

1. Mr. Tovey began by updating the Board on the discussions at the IASB Board meeting on September 20, 2005. He noted that the majority of IASB Board members had tentatively agreed with the staff recommendations Memos No. 70, *Initial Measurement and Allocation* and No. 71, *Identifying Separate Units of Account in Revenue Contracts*.

2. Mr. Tovey opened the Board's discussion by explaining that the memorandums for the meeting presented the staff's first steps in the development of an assets and liabilities approach to revenue recognition that is based on the customer consideration amount, which is the approach the Board agreed to explore at its May 11, 2005 meeting.

Revenue Recognition Based on an Assets and Liabilities Approach

3. Mr. Tovey explained that an assets and liabilities approach to revenue recognition leads to an inference that a revenue transaction is an exchange of legally enforceable rights and obligations between the buyer and seller. Based on that inference, he noted that revenue[1] should arise when each component of the contract (performance obligation) is delivered (extinguished). Further, Mr. Tovey asserted that all legal rights conveyed to a customer in a revenue contract should give rise to an element of revenue. He asked the Board whether they agreed with the staff's assertions.

4. All Board members generally agreed with the staff. However, certain Board members expressed concerns about which performance obligations should be recognized as separate units of account.

5. Mr. Batavick explained that he agrees with the staff but questioned how finely a revenue contract should be disaggregated. He stated that certain components (deliverables) in a contract may be incidental to the contract and noted that perhaps those components should be aggregated with other components in the contract. However, he stated that, as a general concept, he agrees that revenue should arise from the extinguishment of the identified performance obligations in a revenue contract.

6. Ms. Seidman and Mr. Young noted that some obligations should not be recognized as separate units of account because they are incidental to the contract as a whole. Mr. Young acknowledged that aggregating performance obligations might have the result of recognizing revenue before all of the performance obligations have been extinguished.

7. Ms. Schipper and Mr. Crooch agreed with the staff that each legal right that is conveyed to a customer in a revenue contract should give rise to an element of revenue. However, Ms. Schipper added that there may be obligations that are "extra-contractual" (or outside of the contract) that do not give rise to

[1] The term *revenue* is used in these minutes to include all positive components of comprehensive income because the Board has not distinguished between revenues and gains.

revenue. She stated that revenue should arise only from those obligations that are included in the revenue contract.

8. Mr. Tovey asked Ms. Schipper whether obligations that are not explicitly included in the language of the contract, but are implied by the conduct of the reporting entity, should be considered part of the contract. Mr. Tovey cited an example where the contract does not explicitly provide for the right of return but the reporting entity has made a business practice of accepting them. Ms. Schipper clarified that obligations that are implied from the conduct of the reporting entity would be considered part of the revenue contract and their extinguishment would give rise to revenue. However, she noted that obligations that are statutorily imposed, such as those imposed by the U.S. Uniform Commercial Code, are not part of the revenue contract and should not give rise to revenue.

9. Mr. Herz agreed with Ms. Schipper's views. He stated that statutorily imposed legal obligations should not give rise to revenue because they are not bargained-for components of the revenue contract.

10. Mr. Trott agreed with the staff that revenue should arise when each component of the contract (performance obligation) is delivered (or extinguished) and that all legal rights conveyed to a customer in a revenue contract should give rise to an element of revenue. However, he noted that while the extinguishment of performance obligations should give rise to *revenue*, it may not give rise to *profit* because the amount of revenue recognized may be equal to the corresponding amount of costs incurred.

Identifying Separate Units of Account in a Revenue Contract

11. Ms. Figgie explained that the issue of disaggregating customer contracts deals with identifying the performance obligations that should be accounted for as separate units of account and whose extinguishment give rise to revenue. She stated that the Board agreed to explore an approach under which performance obligations would be measured based on the customer consideration amount, which appears consistent with the *customer's perspective*

of the arrangement because it is based on the price that the customer would pay for the good or service. Because the measurement attribute is based on the customer's perspective, the staff recommended that the separate units of account be identified from the customer's perspective as well.

12. Ms. Figgie noted that in order to use the customer's perspective to identify separate units of account, a reporting entity must analyze what the customer perceives it is receiving in the arrangement. That is, the reporting entity must determine which components of a contract have *utility to a customer*. Utility to a customer means that a marketplace participant perceives that the product (that is, a good, service, or other right) underlying the performance obligation is, in and of itself, fit for some purpose or is serviceable for some end.

13. Four Board members (Herz, Batavick, Seidman, and Young) agreed that revenue contracts should be disaggregated from the customer's perspective. Three Board members (Crooch, Schipper, and Trott) stated that they believe that revenue contracts should be disaggregated from the reporting entity's perspective. However, those three Board members acknowledged that the Board decided to explore an approach to revenue recognition under which performance obligations are measured based on the customer consideration amount and, based on that compromise, they agreed that performance obligations should be identified from the customer's perspective.

14. All Board members agreed that the notion of *utility to a customer* is useful in determining whether a performance obligation should be considered a separate unit of account.

15. Ms. Figgie stated that there is a continuum of alternatives for how much guidance the Board can give for determining whether a component has utility to the customer. The staff presented three alternatives, which were included in the Board meeting audience handout (that handout is included as an appendix to these minutes), and recommended Alternative 3. Under Alternative 3, a performance obligation would be treated as a separate unit of account if (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 for some period of time to provide goods, services, or other consideration to the customer if certain events occur or conditions arise.

16. Five Board members (Herz, Batavick, Crooch, Schipper, and Trott) agreed with Alternative 3. Two Board members (Seidman and Young) stated that only those obligations that are sold separately by any vendor (or as an optional extra) or that could be resold separately by the customer in the customer's reference market should be recognized as separate units of account.

17. Ms. Schipper agreed to pursue Alternative 3; however, she expressed concern about the wording of the two criteria in that alternative. She explained that the first criterion is phrased from the customer's perspective but the second criterion appears to be phrased from the reporting entity's perspective. Mr. Crooch agreed with Ms. Schipper. Mr. Crooch noted that the second criterion needs to be rephrased to focus on the right that the customer obtained rather than on the obligation that the reporting entity incurred.

18. Mr. Trott stated that it is critically important to identify stand-ready obligations as separate units of account. He noted that if the stand-ready obligation is aggregated with another performance obligation and accounted for as a single unit of account, revenue could be either: (a) frontloaded (if all of the revenue was recognized upon delivery of the first item) or (b) backloaded (if all of the revenue was recognized upon delivery of the last item).

19. Mr. Herz also agreed with Ms. Schipper. However, he noted that a performance obligation could be measured based on the reporting entity's internal costs to extinguish it if the reporting entity does not consider it to be a profit-generating activity.

20. Ms. Seidman stated that that only those obligations that are sold separately by any vendor (or as an optional extra) or that could be resold separately by the customer in the customer's reference market should be recognized as separate units of account. She explained that there is no need for

a separate criterion for unconditional stand-ready obligations because all performance obligations should be held to the same "threshold" to be recognized as a separate unit of account (and that threshold should be whether the component is or could be sold separately). She noted that some unconditional stand-ready obligations are sold separately and, thus, would meet that criterion and would be recognized as separate units of account.

21. Mr. Tovey responded by analogizing to the implementation guidance in the FASB Exposure Draft, *Business Combinations*. The guidance in that proposed Statement asserts that an intangible asset is identifiable separate from goodwill if either (a) it arises from contractual or other legal rights (the contractual-legal criterion) or (b) is separable (separability criterion). Intangible assets that meet the contractual-legal criterion are identifiable even if the asset is not transferable or separable from the acquiree or from the other rights and obligations. Ms. Schipper agreed with Mr. Tovey's analogy.

22. Mr. Young agreed with Ms. Seidman and stated that the second criterion did not reflect the customer's perspective. He expressed the view that unconditional stand-ready obligations that are not sold on a stand-alone basis do not have utility to a customer and should not be recognized as separate units of account.

23. Mr. Batavick expressed concern about the use of the word "could" in the first criterion. Mr. Batavick questioned whether that wording would result in contracts being disaggregated too finely because almost any obligation (or part thereof) *could* be resold—even if a market does not exist currently.

Definition of Customer-Based Value

24. In May 2005, the Board agreed to consider an approach to revenue recognition that would measure performance obligations based on an allocation of the customer consideration amount. That allocation would require that a reporting entity identify a customer-based value (CBV) for each performance obligation. The staff refined the definition of CBV and asked Board members whether they agreed with the expanded definition.

25. The Board agreed that customer-based-value (CBV) is the amount at which a product having utility to a customer is sold (or could be sold). *Product* in the context of this definition refers to goods, services, or any other rights that a vendor provides to a customer. A customer, as a marketplace participant, is presumed to be:

a. Unrelated to the reporting entity (that is, an independent third party)

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 do so

d. Willing to transact in the market for the product, that is, it is motivated but not forced or otherwise compelled to transact.

The Rationale for Customer-Based Value

26. Mr. Tovey explained that while the Board agreed to explore an approach under which performance obligations would be measured based on the customer consideration amount, Board members had different rationales for doing so. He asked Board members to provide their rationales for that decision.

27. Ms. Schipper and Mssrs. Crooch and Trott stated that they believe that fair value is the most appropriate measurement attribute for performance obligations; however, they agreed to explore CBV as a compromise to make progress in the Revenue Recognition project. Mr. Herz added that he believes that fair value is the most appropriate measurement attribute if market inputs exist for the performance obligation being measured. However, if market inputs do not exist, CBV is a reliable surrogate.

28. Ms. Seidman stated that the customer consideration amount reflects fair value from the perspective of the customer and that amount is the most appropriate measure of the reporting entity's performance obligations. Mssrs. Batavick and Young agreed and noted that CBV is a direct measure of the assets received from the customer and also may serve as a proxy for an entity's cost of

nonperformance (that is, assuming that damages would be limited to a refund of the sales price).

Customer-Based Value Hierarchy of Relative Reliability

28. Mr. Tovey explained that a relative reliability hierarchy exists for obtaining estimates of CBV. Mr. Tovey noted that the measurement objective of CBV is to measure the amount at which a product having utility to a customer is sold (or could be sold) and that there are a number of different methods for achieving that objective. Necessarily, some methods are more reliable than others. He outlined the hierarchy as follows:

a. Level 1: CBV shall be estimated using an entity's sales information, specifically, current sales prices based on current sales transactions in an active market.

b. Level 2: If Level 1 information is not available, CBV shall be estimated using other entities' (that is, competitors') sales information, specifically, current sales prices based on current sales transactions in an active market.

c. Level 3: If Levels 1 and 2 information is not available, CBV shall be estimated using an entity's sales information, specifically, current sales prices based on current sales transactions in an inactive market.

d. Level 4: If Levels 1, 2, and 3 information is not available, CBV shall be estimated using entity inputs that reflect an entity's own internal assumptions and data as a practical expedient.

29. Six Board members (Herz, Batavick, Crooch, Schipper, Trott, and Young) generally supported the hierarchy.

30. Mr. Young expressed support for the hierarchy but questioned whether Levels 2 and 3 were applicable to non-financial liabilities. He stated that other entities' (that is, competitors') products would not be similar enough to the reporting entity's products to provide useful market inputs.

31. Ms. Schipper noted that Level 4 could be used to measure a performance obligation when it *could* be exchanged but is not. Mr. Herz expressed concern that Level 4 appears to imply that there is a profit margin included in the measurement of every performance obligation and that may not be the case if a performance obligation is not considered to be a profit-generating activity for the

reporting entity. Mr. Trott agreed that the Board needs to explore that issue. Ms. Schipper added that the Board needs to clarify the meaning of “normal profit margin.”

32. Ms. Seidman agreed that the notion of a relative reliability hierarchy is useful. However, she stated that she does not agree with Level 4 because that level is not consistent with the customer’s perspective of the transaction. Ms. Seidman asserted that if information is not available from Levels 1–3, the component should not be recognized as a separate unit of account because it is not sold separately (or as an optional extra); therefore, Level 4 is unnecessary.

Measurement of Unconditional Stand-Ready Obligations

33. Mr. Tovey noted that one of the perceived strengths of CBV is that information necessary to estimate it should be readily available. However, he asserted that such information would be lacking for many unconditional stand-ready obligations. Moreover, the primary characteristic of stand-ready obligations is that the timing and amount of economic benefits required to settle them is uncertain. Fair value provides a comprehensive mechanism for dealing with that type of uncertainty. Therefore, the staff asserted that fair value is the best measurement for unconditional stand-ready obligations.

34. The majority of the Board (Herz, Batavick, Crooch, Seidman, Trott, and Young) stated that all performance obligations, including unconditional stand-ready obligations, should be measured at CBV unless other GAAP requires that they be measured at fair value (refer to the discussion in the following section).

35. Ms. Seidman stated she believes that all performance obligations should have the same measurement objective; therefore, she supports measuring all performance obligations based on the customer consideration amount. Mssrs. Batavick and Young agreed and noted that there should not be multiple measurement attributes for measuring the performance obligations in a revenue contract.

36. Mr. Trott noted that he supports CBV as the measurement attribute for performance obligations, but stated that, as a practical matter, many stand-ready obligations (such as product warranties and return obligations) would be measured on a portfolio basis.

37. Ms. Schipper agreed with the staff recommendation and stated that unconditional stand-ready obligations should be measured using fair value. She noted that she agrees with the staff that fair value best reflects the uncertainty inherent in the settlement of unconditional stand-ready obligations.

Allocation of the Customer Consideration Amount

38. Mr. Tovey noted that there are two main issues associated with allocating the customer consideration amount: (a) the first issue deals with those performance obligations that are required by other GAAP to be measured at fair value and (b) the second issue deals with selecting a method to allocate the difference between the sum of the CBVs of the recognized liabilities and the customer consideration amount.

39. The Board agreed that no part of the difference should be allocated to performance obligations that are required by other GAAP to be measured at fair value.

40. The Board further agreed that difference should be allocated to the other obligations on a pro rata basis based on their relative CBVs.

41. Ms. Schipper noted that she supports pro rata allocation because to do otherwise often would require an analysis of an individual reporting entity's business model and she does not think that an allocation methodology should be dependent upon a reporting entity's business model. Ms. Schipper also noted that an allocation methodology is an accounting rule (rather than a principle) and she preferred to keep that rule simple unless a more complex rule results in more decision useful revenue information.

42. Mr. Trott suggested that the Board consider an allocation based on the performance obligations' relative profit margins; however, based on the views of

the other Board members, he agreed to pursue a pro rata allocation based on the relative CBVs of the performance obligations.

Measuring Performance Obligations at Fair Value if an Active Market Exists

43. At the May 11, 2005 meeting, certain Board members expressed support for an alternative under which performance obligations would be either permitted or required to be measured at fair value if an active lay-off market exists. Those Board members asserted that under active market conditions, fair value is a more relevant measurement attribute than CBV. Mr. Tovey asked Board members whether they wanted the staff to explore such an approach. The Board decided not to ask the staff to explore that alternative.

44. Ms. Seidman explained that she does not support the staff further exploring the use of fair value instead of CBV at this time. Ms. Seidman recalled that several Board members would only use fair value in a very active market (such as commodities), and in those cases, the CBV and fair value measurement of a performance obligation most likely would be similar. She does not believe the benefit of capturing those differences is worth the added complexity to the model.

45. Ms. Bielstein responded that CBV and fair value could be different if there was an active lay-off market for the performance obligation.

46. Ms. Schipper stated that the Board agreed to explore an approach under which performance obligations would be measured based on CBV. She believes that the Board should remain committed to that compromise; therefore, Ms. Schipper does not want the staff to explore measuring performance obligations at fair value if active markets exist.

Follow-up Items:

None.

General Announcements:

None.

APPENDIX

Financial Accounting Standards Board

Board Meeting Handout

September 21, 2005
Norwalk, CT
Joint Revenue Recognition Project

PURPOSE OF TODAY'S DISCUSSION

At today's meeting, the Board will consider certain issues relating to the initial identification and measurement of performance obligations arising from its recent tentative decision to explore a revenue recognition approach that measures performance obligations using an allocation of the customer consideration amount rather than fair value. Specifically, the two topics of discussion for today's meeting are (a) initial measurement of performance obligations and allocation of the customer consideration amount and (b) identifying separate units of account in revenue contracts. The first topic also will include a discussion about when, if ever, fair value may be used to measure performance obligations.

ILLUSTRATIVE EXAMPLE

The Board will discuss those issues in the context of the following illustrative example:

> 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). In addition, 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.

REVENUE RECOGNITION BASED ON THE ASSETS AND LIABILITIES APPROACH

Both the FASB and the IASB Boards have observed that revenues are defined in terms of changes in assets and liabilities. In prior tentative decisions, the Boards also decided that those assets and liabilities usually arise from legally enforceable rights and obligations that are conveyed in contracts with customers. Thus, a seller is providing a set of legally enforceable rights and incurring a set of obligations for which it expects to be fully compensated. Legally enforceable rights and obligations give rise to assets and liabilities that, in turn, give rise to revenues. Revenue should arise when each deliverable (or performance obligation) is delivered (or extinguished).

Discussion Question No. 1(a): Do Board members agree, as a general concept, that revenues should arise when each contract deliverable (or performance obligation) is delivered (or extinguished)?

Discussion Question No. 1(b): Do Board members agree that all legal rights conveyed to a customer in a revenue contract give rise to an element of revenue?

IDENTIFYING SEPARATE UNITS OF ACCOUNT IN REVENUE CONTRACTS

Determining how to disaggregate a revenue contract (that is, identifying the separate units of account for the performance obligations) is an issue that is fundamental to revenue recognition and to the Boards' proposed assets and liabilities approach. That issue deals with identifying the obligations that should be accounted for as separate units of account. Because revenue results from changes in assets and liabilities, it is critical that those changes be identified so that the timing and amount of revenue is faithfully represented. Contracts must be disaggregated so that a reporting entity is able to evaluate when those changes occur.

The CBV measurement attribute appears consistent with the customer's perspective of the arrangement. That is because the performance obligation is measured based on the price that the customer can or would pay for the good or service. Because the CBV measurement attribute is based on the customer's perspective, then it is logical to also disaggregate revenue contracts and identify the separate units of account based on that perspective.

Discussion Question No. 2: Do Board members agree that performance obligations in revenue contracts should be disaggregated from the *customer's perspective*?

In order to disaggregate the revenue contract using the customer's perspective, a reporting entity must analyze what the customer perceives it is receiving (buying) in the arrangement. That is, the entity should evaluate which components of a contract have value to an average customer (that is, a marketplace participant). In other words, the reporting entity must determine which components have *utility to a customer*. Utility to a customer means that a marketplace participant perceives that the product (that is, the good, service, or right to use) underlying the performance obligation is, in and of itself, fit for some purpose or is serviceable for some end.

Guidance for Determining Whether a Component Has Utility to a Customer

There is a continuum of alternatives for how much guidance the Boards can give in the general standard on revenue recognition for determining whether a component has utility to the customer. The staff has reflected that continuum in the following three alternatives.

Alternative 1: Provide No Additional Guidance for Determining Whether a Component Has Utility to a Customer and Should Be Identified as a Separate Unit of Account

Under Alternative 1, the standards-level guidance would explain that revenue contracts should be disaggregated (that is, separate units of account should be identified) from the customer's perspective. Moreover, the guidance would describe the notion of *utility to a customer*. However, there would not be additional criteria in the standard for determining whether a component provides utility to the customer and should be treated as a separate unit of account.

Alternative 2: Specify Criteria Similar to Those in EITF Issue 00-21 for Determining Whether a Component Has Utility to a Customer and Should Be Identified as a Separate Unit of Account

Alternative 2 would include the guidance that is described above for Alternative 1. That is, under Alternative 2, the standards-level guidance would explain that revenue contracts should be disaggregated (that is, separate units of account should be identified) from the customer's perspective and that guidance would describe the notion of utility to a customer. However, under Alternative 2, the Boards would use the criteria in EITF Issue 00-21, "Revenue Arrangements with Multiple Deliverables," to determine whether a component has utility to a customer and, therefore, should be treated as a separate unit of account. Issue 00-21 prescribes criteria for determining whether a delivered component has value to a customer on a standalone basis—either (a) the component is sold separately by any vendor or (b) the customer could resell the component on a standalone basis.

Alternative 3: Specify Broader Criteria for Determining Whether a Component Has Utility to a Customer and Should Be Identified as a Separate Unit of Account

Alternative 3 would include the guidance that is described above for Alternative 2. That is, under Alternative 3, the standards-level guidance would explain that revenue contracts should be disaggregated (that is, separate units of account should be identified) from the customer's perspective and that guidance would describe the notion of utility to a customer. However, under Alternative 3, the Board would provide broader criteria than under Alternative 2 for determining whether a component has utility to a customer and, therefore, should be treated as a separate unit of account. Under Alternative 3, either of the following criteria would indicate that a component has utility to a customer:

a. The component 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. The component obligates the reporting entity to stand ready to perform over a specified term (that has been termed an unconditional *stand-ready obligation* in the Revenue Recognition project). The reporting entity may have the obligation to stand ready to provide goods, services, or other consideration if specified events occur.

The staff recommends that the Boards agree to pursue Alternative 3.

<u>Discussion Question No.3</u>**:** Do Board members think that the notion of *utility to a customer* is useful for determining whether a component should be considered a separate unit of account?

<u>Discussion Question No. 4:</u> Do Board members agree with the staff that Alternative 3 and the two criteria provided therein provide evidence that the component has utility to the customer? (Those two criteria are: (1) the component 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 and (2) that the component requires the reporting entity to stand ready to perform in the event that specified triggering events occur.)

INITIAL MEASUREMENT OF PERFORMANCE OBLIGATIONS AND ALLOCATION OF THE CUSTOMER CONSIDERATION AMOUNT

Definition of Customer-Based Value

Earlier this year, both the FASB and IASB Boards agreed to consider an approach to revenue recognition that would measure performance obligations based on customer-based value (CBV), which comprehends an allocation of the customer consideration amount. CBV can be defined as the amount at which a product having *utility* to a customer is sold (or could be reasonably sold) on a standalone basis. Utility to a customer means that the product underlying the performance obligation is, in and of itself, fit for some purpose or serviceable for some end as determined by the customer.

Discussion Question No. 5: Do Board members agree with the definition of CBV as described by the staff in Memo No. 70?

The Rationale for Customer-Based Value

As noted earlier, both the FASB and the IASB Boards have agreed to explore an approach to revenue recognition under which performance obligations would be measured based on customer-based value. The staff asserts that Board members have different rationales for deciding to explore CBV as the measurement attribute. Some Board members believe that fair value is the most appropriate measurement attribute for performance obligations; however, those Board members agreed to explore CBV as a compromise in the Revenue Recognition project. Other Board members believe that CBV is the most appropriate measurement attribute because it is a direct measure of the value in the market for the reporting entity's product that will be transferred to the customer.

Discussion Question No. 6: Do Board members agree with the rationales described by the staff in Memo No. 70 for supporting customer-based value as a relevant measurement? If not, what other rationales did Board members consider?

Customer-Based Value Hierarchy of Relative Reliability

As noted above, the measurement objective of CBV is to measure the amount at which a product having utility to a customer is sold (or could be reasonably sold). An important advantage of a measurement objective is that it establishes a goal to which all efforts can be directed. There are a number of different methods for achieving that objective and some methods are more reliable than others. Specifically, market-specific inputs are more reliable than entity-specific inputs. The staff developed the following hierarchy of relative reliability to be used in determining CBV:

a. Level 1: CBV shall be estimated using an entity's sales information, specifically, current sales prices based on current sales transactions in an active market. An active market is one in which prices are readily available (transactions occur with sufficient frequency to provide pricing information on an ongoing basis) and representative of CBV (a customer would currently transact at those prices).

b. Level 2: If Level 1 information is not available, CBV shall be estimated using other entities' (that is, competitors') sales information, specifically, current sales prices based on current sales transactions in an active market.[2]

c. Level 3: If Levels 1 and 2 information is not available, CBV shall be estimated using an entity's sales information, specifically, current sales prices based on current sales transactions in an inactive market.

d. Level 4: If Levels 1, 2, and 3 information is not available, CBV shall be estimated using entity inputs that reflect an entity's own internal assumptions and data as a practical expedient. Such inputs include extrapolated or interpolated inputs that cannot be corroborated with observable market data. Said differently, Level 4 estimates represent an estimate of an entity's costs and a normal profit margin.

<u>Discussion Question No. 7(a):</u> Do Board members agree with the notion that a relative reliability hierarchy is applicable to CBV measures?

<u>Discussion Question No. 7(b):</u> If Board members agree to Question No. 7(a), do Board members agree that the hierarchy levels described by the staff are appropriate? If not, why not?

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[2] An entity's sales information (current sales prices based on current sales transactions in an active market) is given primacy over other entities' sales information because CBV is based on the reporting entity's own product, which may have characteristics different from competing products. When determining whether Level 2 information is available, an entity must make a careful analysis of the qualities of competing products. For instance, if the competing product's brand value and quality are significantly different from the reporting entity's product, that sales information would not represent Level 2 information.

Measurement of Unconditional Stand-Ready Obligations

One of the perceived strengths of CBV is that information necessary to estimate it should be readily available. However, such information would be lacking for many unconditional stand-ready obligations. An unconditional stand-ready obligation requires the reporting entity to stand ready to perform over a specified term. The reporting entity may have the unconditional obligation to stand ready to provide goods, services, or other consideration if specified events occur. Moreover, the primary characteristic of stand-ready obligations is that the timing and amount of economic benefits required to settle them is uncertain. Fair value provides a comprehensive mechanism for dealing with that type of uncertainty. Therefore, the staff asserts that fair value is the best measurement for unconditional stand-ready obligations.

<u>Discussion Question No. 8:</u> Do Board members agree that unconditional stand-ready obligations should be measured at fair value?

Allocation of the Customer Consideration Amount

There are two main issues associated with allocating the customer consideration amount. The first issue deals with those performance obligations that are required by other GAAP to be measured at fair value. The second issues deals with selecting a method to allocate the residual (that is, the difference between the sum of the recognized liabilities and the customer consideration amount).

With respect to Issue 1, the staff recommends that none of the residual be allocated to recognized liabilities that other GAAP requires to be measured at fair value. To do otherwise effectively supersedes other guidance by imposing a special measurement attribute for certain liabilities.

With respect to Issue 2, there are several methods for allocating the residual to performance obligations. The residual could be allocated based on (a) the relative reliability of the measure of each performance obligation, (b) the pro rata CBV of each performance obligation, and (c) the nature of the residual (that is, if the residual decreases the sum of the recognized liabilities, then it is allocated to the first liability extinguished, and if the residual increases the sum of the recognized liabilities, then it is allocated to the last liability extinguished). The staff does not support allocating the residual by relative reliability because that means the least reliably measured performance obligation becomes even less so. Furthermore, the staff does not support allocating the residual based on the nature of that residual because its basis is conservatism (that is, it is more conservative to reduce revenue on the front end of a revenue arrangement or to increase revenue on the back end), which biases the measure. Hence, pro rata allocation is the remaining alternative. The staff acknowledges that such a method causes discounts or premiums to be evenly distributed pro rata among the performance obligations measured at CBV. That would be less harmful than those required by the other residual allocation methods suggested because the relative profit margins would still be reflected. Therefore, the staff recommends that pro rata residual allocation be employed.

Discussion Question No. 9(a): Do Board members agree that the residual should not be allocated to performance obligations measured at fair value?

Discussion Question No. 9(b): Do Board members agree that the residual should be allocated on a pro rata basis?

Measuring Performance Obligations at Fair Value if an Active Market Exists

Certain Board members have expressed support for an alternative under which performance obligations would be measured at fair value if an active market exists for an entity's performance obligations.[3] Those Board members assert that under active market conditions, fair value is a more relevant measurement attribute than CBV. That is because, under active market conditions, a fair value measurement is more relevant than CBV and, in addition, there are fewer concerns about using fair value estimates because the information is readily available and the degree of measurement error is minimized. Fair value measurements will provide more decision-useful information than other measurement attributes in that situation. Because decision usefulness is the primary quality of financial reporting that justifies the use of one accounting alternative over another, the staff asserts that such a rationale serves to provide a basis to use two different measurement attributes.

[3] That alternative was discussed at the Board's May 11, 2005 Board meeting and was referred to as "Alternative 2(a)."

Discussion Question No. 10(a): Do Board members agree that there is sufficient rationale to support the use of fair value to measure performance obligations under active market conditions?

Discussion Question No. 10(b): Do Board members want the staff to explore issues associated with using fair value under active market conditions?