

MINUTES



To: Board Members

From: Revenue Recognition Team
(Ham, ext. 443)

Subject: Minutes of the January 30, 2008 Board Meeting: Revenue Recognition **Date:** February 12, 2008

cc: FASB: Bielstein, Golden, MacDonald, Posta, Cospers, Lott, T. Johnson, Revenue Recognition Team, Leasing Team, Bolash, Driscoll, Reese, Gabriele, Chookaszian, Klimek, Allen, Sutay, FASB Intranet; IASB: Leisenring, Rees, Pitman, Hickey, Upton, Clark, Peerless; AASB: Paul; GASB: Patton

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Topic: Revenue Recognition: Customer Consideration Model Measurement, Performance Obligations, and Examples

Basis for Discussion: Board Memorandum Nos. 102–105

Length of Discussion: 8:15 to 9:45 a.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, Smith, and Young

IASB: Leisenring

Board members absent: None

Staff in charge of topic: Wilks

Other staff at Board table: FASB: Bielstein, T. Johnson, Bement, Ham, and Reager

IASB: Pitman

Summary of Decisions Reached:

The Board discussed the customer consideration model, the second of the two revenue recognition models that were developed over the past year by the staff and a group of Board members (drawn from both the FASB and the IASB). In the customer consideration model, an entity accounts for the contract asset or liability that arises from the rights and performance obligations in an enforceable contract with a customer.

At contract inception, the rights in the contract are measured at the amount of customer consideration in the contract. That amount is then allocated to the individual performance obligations identified within the contract in proportion to the standalone selling price of each good or service underlying the performance obligation. Therefore, at contract inception, the sum of the amounts allocated to the individual performance obligations equals the customer consideration so that neither a contract asset nor a contract liability is recognized. Subsequently, the performance obligations are measured at the amount of the customer consideration allocated to them at contract inception. They are not remeasured except when the contract is judged to be onerous. As each performance obligation identified in the contract is satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

The Board also considered the nature of performance obligations. Both revenue recognition models are based on the principle that after contract inception, revenue is recognized when performance obligations are satisfied. The Board discussed the staff's suggestion that a performance obligation be defined as a promise in a contract between the entity and a customer to transfer an economic resource to that customer. Therefore, a performance obligation would be satisfied (and revenue recognized) when the economic resource is transferred to the customer. The Board discussed the following:

- In the case of a good, the economic resource is transferred when the entity relinquishes its enforceable right (or other access) to the good and the customer obtains that right (or other access) to that good.
- In the case of a service, the economic resource is transferred when the activities undertaken by the entity result in an immediate benefit to the customer (because the activities enhance an economic resource of the customer or the activities produce cash inflows or reduce cash outflows for the customer).

The Board was not asked to make any decisions. However, there was general agreement in three areas. First, the Board agreed that there are measurement issues in both the measurement and the customer consideration models, but most Board members seemed more comfortable with those issues in the customer consideration model. Second, the Board agreed that the preliminary definition of *performance obligations* is promising, but it asked the staff to continue testing the definition on other examples. Finally, Board members agreed that a simplifying assumption might help determine when an enforceable right to a good transfers to a customer. Specifically, Board members agreed that any time an entity is delivering both a good and services that will incorporate that good, it might be helpful to assume that the good transfers when it is used unless the language in the contract or the operation of law indicates that the customer has the enforceable right or access to the good once it is delivered.

Objectives of Meeting:

The objectives of the meeting were for the Board to (a) consider the measurement approach of the customer consideration model and (b) explore a preliminary definition of *performance obligations* and the criteria that would suggest when a performance obligation is satisfied. The objectives of the meeting were met.

Matters Discussed and Decisions Reached:

1. Mr. Wilks opened the meeting by stating that the staff requests comments on three aspects of the customer consideration model. Those include the sufficiency of the description in the memos, internal consistency, and strengths or weaknesses relative to current practice. Mr. Wilks also noted that the staff requests feedback on the preliminary definition of *performance obligations* as well as criteria for when a performance obligation is satisfied.

Customer Consideration Model

2. Ms. Pitman provided an overview of the three main characteristics of the customer consideration model. First, both the rights and obligations in a contract with a customer are measured at the amount of customer consideration. Therefore, neither an asset nor

liability arises at inception. Second, customer consideration is allocated to the performance obligations using standalone sales prices of the entity for each of those obligations. Third, the performance obligations are not subsequently remeasured.

3. Ms. Pitman then discussed the rationale for the measurement aspects of the customer consideration model. The rights in a contract are initially measured at the amount of customer consideration because that amount is typically observable, verifiable, and straightforward. On the other hand, the measurement of the performance obligations is not as straightforward. Two approaches—separate selling prices and lay-off price—were considered but rejected for various reasons detailed on pages two and three of memo 103 in the Board meeting handout.

4. Ms. Pitman explained that customer consideration was selected as the basis for measuring the obligations in a contract for several reasons. First, it supports the notion that each person gives and receives something of equal value in an exchange between willing and rational parties. In other words, the consideration promised by the customer equals the goods or services promised by the entity. Pre-contractual activities are ignored due to the inability to identify a principle that would determine which activities are part of the customer consideration and which are not.

5. Another reason customer consideration was chosen deals with costs versus benefits. Preparers benefit since the customer consideration amount is observable for the contract as a whole, and auditors benefit since it is verifiable. Together, those two individual benefits provide an overall anti-abuse benefit. In addition, customer consideration is understandable as it does not require any valuation techniques, which are difficult for non-specialists to understand. Customer consideration is familiar to users as a measure of revenue, and they have already learned to interpret the reported number or adjust it as needed for what-if or trend analyses. Finally, customer consideration is likely to be a more faithful representation of a particular entity's future costs than a market-based measure.

6. Ms. Seidman stated that she believes the description in memo 103 about why pre-contractual activities should be ignored is irrelevant to the customer consideration model.

In her opinion, a key reason why it is inappropriate to consider pre-contractual activities in a particular contract is that those activities are freely available to anyone, including potential and contracting customers. In other words, the resource is not scarce and, therefore, does not meet the current definition of an asset. Mr. Leisenring countered that this is a utility to the customer notion, which is rejected in memo 104 and, therefore, cannot be used. He suggested simply removing the discussion in the memo that Ms. Seidman disliked, and she agreed that would work as a solution.

7. Ms. Seidman also noted that she would like to add to the discussion in paragraph 24 on other advantages of the customer consideration approach regarding understandability. She observed that customer consideration resonates with both parties of the transaction in that it reflects what the parties think they have done. Moreover, since this is the most universal accounting standard that the FASB will ever write, it needs to be readily understandable and recognizable by everyone in an organization. She emphasized that the customer consideration model is understandable even to those that are not CPAs.

8. Mr. Linsmeier stated that, excluding remeasurements, the primary difference between the customer consideration model and the measurement model is that it does not recognize revenue at inception of the contract. A key issue is whether revenue is generated by obtaining a customer. The issue of whether that revenue only is associated with specific costs related to the contract is also open for discussion. Mr. Linsmeier noted that, in his opinion, memo 103 oversold the customer consideration approach and overly justified the decision to not recognize revenue at inception. Ms. Seidman requested that Mr. Linsmeier's views be presented as an opposing view in the discussion paper section on the customer consideration model. This is in contrast to adjusting the rationale presented by those who support the customer consideration model.

9. Mr. Linsmeier observed that the customer consideration model has the same measurement issues as the measurement model. In practice, the customer consideration model would often require estimates of standalone selling prices for performance obligations, and those estimates are used in the allocation process. Additionally, most standalone selling prices are equally as hypothetical as lay-off prices because the majority

of performance obligations are not sold separately. Mr. Linsmeier urged others to acknowledge that there are far fewer differences in the models than there are similarities. While measurement indeed differs between the models, the bigger issues of identifying performance obligations and determining when they are satisfied are common to both models.

10. Mr. Batavick acknowledged Mr. Linsmeier's position that there are measurement estimates for standalone selling prices in the customer consideration model. However, he thinks a revenue recognition model that constantly contemplates lay-off prices, especially when an entity has no intention or ability to actually lay off an obligation, is much more difficult to understand than the customer consideration model. Mr. Smith agreed that there is a dramatic difference between a selling amount and a lay-off amount. A sales price is easier to estimate and more realistic since the good or service is actually being sold while most obligations are not actually laid off. Mr. Linsmeier stated that it is fair to note that the measurement estimates in the two models deal with different markets.

11. Mr. Leisenring observed that an important strength of the customer consideration model is that it focuses only on the contract with the customer, and the basis of that contract is the customer consideration. Although the entity may have done something to get the contract, the entity has not yet performed under the contract. Therefore, the amount of customer consideration arguably represents the liability to the customer at inception of the contract. Mr. Smith agreed with and supported Mr. Leisenring's explanation of the recorded liability under the customer consideration model.

12. Ms. Bielstein requested clarification regarding Messrs. Leisenring's and Smith's suggestion that the liabilities (performance obligations) are different between the two models since they are supposed to be the same. Ms. Seidman explained that if pre-contractual activities generate revenue, then they must represent either an increase in assets or a decrease in liabilities. If there is no satisfaction of a performance obligation, then there must be creation of an asset. While some Board members preferred the argument that there cannot be an asset because the resources are not scarce, Mr. Leisenring suggested that an entity is better off (has an asset) since it now has a customer.

Whether that asset should be recognized and whether it should generate revenue are different issues. Ms. Bielstein confirmed that this was an asset issue, not a liability issue.

13. Mr. Herz stated that he supports the customer consideration model because it is understandable, operational, and verifiable. Nevertheless, he observed that a company is valued by looking at all contracts in the backlog and estimating future profit based on the timing and amounts of future cash flows. Therefore, a better and more useful measure of the obligations in a contract is future costs to the entity, which is closer to the measurement model. Mr. Herz noted that he does not believe everyone is ready to move to that type of accounting yet. Ms. Seidman observed that much of this information could be provided in disclosures. Mr. Herz agreed.

14. Next, Mr. Linsmeier addressed the structure of the discussion paper. He prefers the idea of describing a common asset and liability model that identifies performance obligations and determines when they are satisfied. After building that base, the paper could communicate the areas with differing views, including (a) whether obtaining a contract generates revenue and (b) measurement methods. He noted that remeasurement should not be addressed until later in the paper. Mr. Wilks confirmed that Mr. Linsmeier's description is very similar to the outline that the staff already drafted.

15. Mr. Leisenring observed that financial instruments can record gains on day one, but the customer consideration model does not allow revenue at inception of the contract. He noted that the distinction between the two is not clear, and the difference has not been reconciled. Mr. Young stated that he agrees with fair value for financial instruments but finds the customer consideration model more natural. He noted that, in his opinion, the revenue recognition project is fundamentally flawed because it assumes that there is one model when there are actually several models. It may be more valuable to create a framework to determine the most appropriate model in different situations. A list of factors could include the nature of the good or service, amount of risk, amount of value added, length of the contract (cycle time), and market structure.

16. Next, Mr. Leisenring mentioned the exception for readily observable lay-off prices in active markets described in paragraph 29 of memo 103. He questioned the need for an

exception to the principle and suggested that the principle could be wrong instead. Ms. Pitman responded that it is more of a clarification of the principle rather than an exception. Since the purpose of the measurement principle in the customer consideration model is to try to identify what the entity's selling price would be, there is an assumption that all entities dealing with a commodity are selling it at that price. If the contract value is different, then the entity is acting as a broker or providing some other extra service. Therefore, the commodity is being provided at the market price, and the remainder of the price is for access, brokerage, or another service. Mr. Linsmeier observed that this is not a measurement issue. It is an issue of identifying all of the performance obligations in a contract and deciding when they are satisfied.

17. Before moving on to the discussion on performance obligations, Mr. Wilks asked the Board if there were any other issues in memo 103 that it would like to address. Mr. Leisenring stated that a better explanation of onerous contracts should be included in the discussion paper. Mr. Wilks responded that this is one of the key issues that were raised at the IASB meeting last week, and the staff is planning to explain when a contract is loss-making as well as why an entity waits until that point to recognize it as onerous. The other three key issues that were raised at the IASB Board meeting include the following:

- a. Estimated standalone sales prices for deliverables that are never sold separately will be just as difficult to verify as lay-off prices
- b. Exception for measuring some deliverables at lay-off prices
- c. The measurement of the rights needs to be described more precisely, including whether and how the time value of money and the customer's credit risk are taken into account.

18. Ms. Seidman noted that she views the measurement of rights as a secondary issue because it is relevant to both models. In other words, it is an issue that can be dealt with after the Boards have chosen a model. Mr. Wilks agreed, but suggested the discussion paper should note that this is an issue the Boards will need to consider in the future.

Performance Obligations

19. Mr. Wilks introduced memo 104 by stating that the Boards instructed the staff to develop both a definition of performance obligations and criteria for when such

performance obligations are satisfied that are identical for both proposed models. In paragraph 8, the staff proposed that a performance obligation is an enforceable promise by an entity within a contract with a customer to transfer an economic resource to that customer. A promise is enforceable if the customer can require the entity to fulfill that promise, and a contract encompasses all promises to which the parties have agreed, including those invoked by commercial law. The phrase *transfer an economic resource* is discussed in paragraphs 14–23.

20. Mr. Wilks explained that in order to identify performance obligations, a contract must be searched for any promise to transfer an enforceable right to a good or to undertake activities that will immediately benefit the customer. He noted that the examples in this section are paint, rights of return, and promotional promises. Mr. Wilks then asked for comments that focused on whether the examples meet the definition of performance obligations as defined. In other words, the staff requests feedback on whether the definition is helpful.

21. Mr. Linsmeier commended the staff on a good start but raised two issues. First, he suggested using the broader word *arrangement* instead of *contract*. He noted that *contract* sounds like it must be written, formal, and legal. Second, Mr. Linsmeier requested testing the definition on other examples. He observed that it works reasonably well for the three examples in the memo, but he is not convinced it can work in all circumstances.

22. Mr. Young asked how the term *customer* compared with other terms already defined in FASB guidance like *counterparty* or *exchange*. Mr. Wilks responded that the staff did not perform that analysis and agreed that the definition of *customer* should be clarified. Mr. Young then asked if this might be connected to distinguishing between revenues and gains. Mr. Wilks observed that it could help deal with that issue ultimately, and it could also help distinguish between multiple revenue streams.

23. Next, Ms. Seidman addressed arrangements in which goods and service are combined such as in the paint example. She noted that a useful notion in determining performance obligations in those situations is as follows: if the goods are essentially

supplies that the service provider uses and those supplies would be transformed as a result of providing the service, then the goods should be considered part of the service unless the contract says the customer is actually buying the goods. She observed that the customer does not care if the paint is on his property because the contract was for the service of painting, not the paint.

24. Mr. Wilks observed that this notion relies on customer intent, which is rejected in memo 104. Furthermore, the paint in the painting service example meets the proposed definition of a performance obligation. However, the issue then becomes when the performance obligation is satisfied. Mr. Wilks noted that a simplifying assumption could be made so that any time an entity is delivering both an economic resource and services that will use that economic resource, the economic resource is assumed to transfer when it is used unless the language in the contract or the operation of law in that jurisdiction indicates that the customer has the enforceable right or access to the economic resource once it is delivered.

25. Mr. Leisenring expressed his concern that the term *enforceable* is not operational. He observed that as long as there is right of return, all contracts are not enforceable. Mr. Linsmeier responded that thinking of the return right as a separate promise outside the arrangement is a possibility instead of it obviating all other promises within the arrangement. Ms. Seidman agreed, noting that an entity would never sell a refund right without also selling something that can be returned. Therefore, the return right is clearly an obligation, but it may not be a performance obligation.

26. Mr. Smith addressed the discussion in memo 104 about return rights accounted for as a performance obligation or a failed sale. He asked how Board members would classify return rights and stated that he would classify them as a failed sale. Most Board members agreed that they would classify return rights as a failed sale as well. Mr. Herz noted that, in his opinion, a return right is conceptually a performance obligation. However, he noted that he prefers the failed sale approach for practical reasons. Mr. Wilks stated that the staff agrees with Mr. Herz. In addition, Mr. Smith stated that he simply does not view a return right as a revenue-generating activity.

27. Mr. Crooch asked the staff why there was a distinction between discount vouchers placed in a customer's bag or printed in a local newspaper. Mr. Wilks responded that the distinction is whether a customer negotiates in the current transaction for that future discount and whether that discount represents an economic resource. Mr. Linsmeier noted that there was too much analysis on promotional promises in his opinion, while Ms. Seidman also observed that there are cost-benefit issues relating to the value of accounting for something like a 10 percent discount voucher. Mr. Wilks agreed and expressed intent to make the example clearer and more concise.

28. Mr. Wilks then shifted the discussion to the satisfaction of performance obligations. He emphasized that the simplifying assumption discussed earlier was not an exception to the principle and did not dismiss the principle, but it instead helps in the interpretation and application of the principle.

29. Mr. Linsmeier observed that he, as a customer, would not be satisfied if a painter only painted half of his walls. However, Mr. Wilks noted that this was a customer intent perspective, which has been dismissed. If a customer gets a resource, that is satisfaction of an obligation. Even if the customer had to find another painter to paint the remaining half of the walls, it would cost half as much. Mr. Linsmeier clarified that he was trying to convey that he does not believe the transfer of an economic resource is the same as the satisfaction of a performance obligation. Satisfaction is completion of what the painter was hired to do. Mr. Wilks observed that this view leads to a completed-contract method of revenue recognition.

30. Ms. Seidman stated that she believes the transfer or satisfaction depends on the terms of the contract. For example, if the contract stated that the customer does not have to pay until the entire painting job is completed, then that would be different from the presumption that the benefit transfers along the way. Mr. Wilks responded that this particular issue—acceptance clauses—has not yet been discussed or articulated in the models. The staff may try to address it in the discussion paper.

31. Mr. Wilks concluded the discussion by reviewing the key issues raised during the IASB Board meeting last week. First, some Board members thought it was inconsistent

that the memo rejected the customer utility notion and then later relied on whether the customer had received an economic resource to decide when a performance obligation is satisfied. To clarify, the staff meant customer *intent* not customer *utility*. Second, there was agreement that the promise to transfer paint was its own performance obligation, but there was disagreement about when that performance obligation is satisfied. Third, there was disagreement about whether the promise to stand ready to accept returns and provide refunds was a performance obligation. Mr. Wilks noted that the majority of the staff thinks the promise to stand ready to accept returns and provide refunds is conceptually the same as an insurance entity's or warranty company's promise to stand ready. Therefore, the staff believes it is a performance obligation, but as mentioned before, it may not be recognized for practical purposes. Finally, the IASB asked the staff to circulate a short memo with the same examples in the performance obligation memo and ask Board members whether they think paint, rights of return, and promotional promises are performance obligations and when each would be satisfied.

32. Ms. Seidman questioned the consensus of the IASB that a return right stand-ready obligation is the same as the insurance or warranty stand-ready obligation. She observed that when she returns a sweater, it is an even exchange. With a warranty or insurance, if she decides to cancel, she cannot give back the coverage already provided. In other words, it is not an even exchange. Ms. Pitman clarified that the IASB is divided on this issue although the majority of the staff think the return right is a performance obligation not unlike the stand-ready obligations inherent in insurance and warranty arrangements.

33. Mr. Batavick asked Mr. Wilks if he had a sense of timing for the discussion paper. Mr. Wilks responded that the staff believes it can complete the first draft in the next two months, pending completion of the short memo the IASB requested.

Follow-up Items:

None.

General Announcements:

None.