

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Revenue Recognition Team
(Quiring, ext. 326)

Subject: Minutes of the March 16, 2004 FASB Board Meeting **Date:** March 23, 2004

cc: Leisenring, Bielstein, T. Johnson, Smith, Petrone, MacDonald, Proestakes, Mahoney, Swift, Polley, Thompson, Gabriele, Sutay, Patton (GASB), Slayton, Sletten, Figgie, Cohen, Golden, Cropsey, Lapolla, Kawanishi, McKenna, Munro, Pinson, Paul (IASB), Intranet

Topic: Revenue Recognition—Revisions of Principles and Implementation Guidance, Initial Fair Value Measurement of Performance Obligations, and Obligations to Be Included in the Scope of the Standard on Revenue Recognition

Basis for Discussion: Memorandums dated March 2, 2004

Length of Discussion: Starting Time: 9:00 a.m. Concluding Time: 10:45 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman (by phone), Schipper, Seidman, Trott

Board members absent: None

Staff in charge of topic: Slayton, Figgie, Sletten

Other staff at Board table: Bielstein, T. Johnson, Pinson, Quiring

Outside participants: None

Summary of Decisions Reached:

The Board discussed three topics. First, the Board discussed clarifications of certain revenue recognition principles considered at the last Board meeting and implementation guidance related to those principles. Next, the Board considered issues related to the initial fair value measurement of performance obligations.

Finally, the Board discussed the nature of obligations to be included in the scope of the standard on revenue recognition.

The Board reached the following tentative conclusions:

- Implementation guidance should be included in the general standard to clarify the term *customary business practice* as it is used in one of the standard's recognition principles.
- Explanatory guidance, including the definition of a contract, should be included in the standard to emphasize that enforceability is a necessary characteristic of a contract. However, the Board decided that it would not provide guidance on enforceability of contractual rights and obligations across legal jurisdictions.
- Implementation guidance should be included in the general standard to clarify that a contract does not have to be worthy of enforcement in order to give rise to assets and liabilities.
- Recognition Principle #7 should be withdrawn from the model and reconsidered once further progress has been made on the application of the recognition and measurement principles.
- Only legally enforceable obligations (contractual and noncontractual) should be included in the scope of the revenue recognition standard.

The Board also confirmed its previous decision that performance obligations should be measured based on the price that the reporting entity would have to pay a third party to assume responsibility for performing all of its remaining obligations (that is, the "layoff price").

Matters Discussed and Decisions Reached:

Memorandum 1: Revisions of Principles and Implementation Guidance

Mr. Slayton noted that the first memorandum is a follow-on to the discussions held at the February 18, 2004 Board meeting regarding certain revenue recognition and measurement principles for the general standard.

The Meaning of "Customary Business Practice"

Mr. Slayton noted that at the February 18, 2004 Board meeting, the staff suggested that additional implementation guidance might be necessary regarding the phrase *customary business practice* when used in the context of determining

whether a contract with a customer exists. He noted that the staff proposed four alternatives to the Board, ranging from deleting certain information previously suggested, to making no change, to adding descriptive guidance, and that the staff recommended adding guidance similar to that in SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements*, and AICPA Statement of Position No. 97-2, *Software Revenue Recognition*.

The Board generally agreed that the general standard on revenue recognition should include the following implementation guidance (language is subject to modification) for the term *customary business practice*:

Customary business practices and processes for documenting sales transactions vary among companies and industries. Business practices and processes may also vary within individual companies (for example, based on the class of customer, nature of product or service, or other distinguishable factors). If a company does not have a standard or customary business practice of relying on written contracts (that is, contracts physically signed by both parties) to document a sales arrangement, it would be expected to have other forms of written or electronic evidence to document the transaction. For example, a company may not use written contracts but instead may rely on binding purchase orders from third parties or online authorizations that include the terms of the sale and that are binding on the customer and the reporting entity.

Even if all other requirements set forth in this standard for the recognition of revenue are met, no [contractual] revenue should be recognized unless a contract with the customer exists.¹

Mr. Trott expressed concern that the second paragraph of the implementation guidance is too much of an “on-off” switch for revenue recognition, allowing management to control the period in which revenue is recognized. Ms. Schipper responded that she supports including the second paragraph because signing a contract is a “real” action, and managers can always take “real” actions to shift income between periods.

Several Board members noted discomfort with the guidance in Recognition Principle #1 requiring entities to obtain a legal opinion in order to overcome the

¹ Guidance was extracted from SAB 104 (Section A, Part 2, Question #1) and SOP 97-2 (paragraph 17).

presumption that a customer contract does not exist unless its existence is documented in accordance with the reporting entity's customary business practices for similar contracts. Mr. Trott stated that the requirement would put too much pressure on the definition of a contract and that requiring a legal opinion would not necessarily provide discipline for revenue recognition. Ms. Schipper noted that past Board attempts to rely on legal opinions have not always been successful. Mr. Herz suggested modifying Recognition Principle #1 to state that the presumption may be overcome based on conclusive evidence that a contract exists. The Board generally agreed with the proposed modification.

Mr. Herz also recommended modifying the standards section guidance related to Recognition Principle #1 to clarify that the existence of a signed contract is acceptable evidence that a contract exists, even if it is not an entity's customary business practice. The Board generally agreed with the proposed modification.

Mr. Trott noted that guidance should be included in the general standard describing the proper accounting if an entity does not meet the customary business practice criteria. Board members directed the staff to include guidance in the standard stating that if an entity does not meet the customary business practice criterion and if conclusive evidence that the contract exists is not available, no revenue may be recognized until the transaction is completed.

Enforceability

Mr. Slayton noted that the Board previously asked the staff to consider whether the notion of enforceability, as it relates to contracts, should be included in the standard, and whether the standard should specifically address enforceability when a contract binds parties in different legal jurisdictions. He noted that the staff believes that a contract is by definition enforceable and recommends highlighting that fact by defining the term *contract* in the glossary to the standard. He also noted that the staff recommends the standard not provide specific guidance for enforceability across legal jurisdictions because the determination of whether the rights and obligations in the contract are enforceable usually is made

based on the terms of the contract, and if the contract does not specify such terms, the determination would be a legal decision.

Mr. Trott recommended that the guidance on enforceability be included in the text of the general standard rather than in the glossary. He also suggested that the requirements of a contract be explained in both legal terms and “plain English” terms. Ms. Schipper noted that it would be better to avoid terms that have a specific legal meaning. Mr. Herz suggested that the definition of the term *contract* be modified to make it applicable in jurisdictions in which a court is not responsible for enforcing contracts. The staff agreed to revise the definition of a contract in order to incorporate Board members’ suggestions.

The Board agreed that the general standard for revenue recognition should not include guidance on enforceability of contractual rights and obligations across legal jurisdictions.

Enforcement Worthiness

Mr. Slayton noted that at the Board’s request the staff proposed language to be added to the standard that describes the notion of enforcement worthiness in order to clarify that the decision as to whether a contract is worthy of enforcement affects the measurement of the specific rights and obligations, but not the recognition of them.

The Board agreed that the notion of enforcement worthiness should be reflected in the standard as follows:

A contract conveys to the seller rights for which the seller can seek enforcement by the courts. However, the costs of enforcing some enforceable rights may exceed the benefits of doing so. In case of breach, a seller might not seek to enforce a contract if the combination of direct costs (such as legal fees) and perceived indirect costs (such as customer “ill will” costs) exceeds the benefits expected to be obtained as a result of the enforcement action. The assessment of the probability that contractual rights will contribute to future net cash inflows and contractual obligations will result in future net cash outflows should affect measurement, but not recognition of related assets and liabilities.

The notion of *enforcement worthiness* also will be illustrated in an example that will be included in an appendix to the standard.

Reconsideration of Recognition Principle #7

Mr. Slayton noted that the staff recommends that Revenue Recognition Principle #7 be removed until the Board makes additional decisions on recognition and measurement. The Board agreed with that proposal.

Memorandum 2: Initial Fair Value Measurement of Performance Obligations

Ms. Figgie stated that on February 18, 2004, the staff distributed a memorandum to Board members that presented an example in which a customer wants to purchase a blue sweater from a retail store but the store does not have the customer's size in stock. The retail store offers to obtain the sweater for the customer. The customer agrees and pays the full price (\$100) for the sweater in advance. That memorandum outlines the store's three alternatives for delivering the sweater and extinguishing its liability to the customer. That memorandum asked Board members to express their views as to which price best reflects the fair value of the store's performance obligation. The example is included as an appendix to these minutes.

Ms. Figgie noted that the staff received feedback from all of the Board members. She then asked Board members to confirm the majority view that Alternative B (\$85) is the best measure of Store X's remaining performance obligation or to explain the rationale for a different view.

The majority of the Board reconfirmed that Alternative B is the best measure of Store X's remaining performance obligation. The majority stated that by selecting Alternative B, the Board was reaffirming its previous decision that performance obligations should be measured based on the price that the reporting entity would have to pay a third party to assume responsibility for performing all of its remaining obligations (that is, the layoff price).

Ms. Seidman stated that she does not agree that Alternative B is the best measure of the entity's remaining performance obligation. Ms. Seidman believes

that the entity's remaining obligation is \$100 because it has not extinguished any portion of its obligation until it delivers the sweater to the customer. She expressed concern that the measurement of the entity's remaining obligation in Alternative B allows revenue to be recognized before the entity has extinguished any of its obligation. She expressed concern that a simple retail sale would be viewed as having more than one element. She also believes that in sales of goods and services, it is inappropriate to have the measurement approach drive the timing of revenue recognition in cases in which the derecognition event—extinguishment of the performance obligation—has not yet occurred. She also stated that the Board should revisit the issue of the definition of revenues soon.

Mr. Batavick stated that Alternative B is the best measure based on the decisions that the Board has made to date. However, he expressed concern about how the fair value measurement of performance obligations may impact comparability among reporting entities.

Mr. Herz noted that he is comfortable with Alternative B because there is a third party readily available to service Store X's obligation. Therefore, the example assumes that the layoff price is known and reliable. However, he expressed concern about situations in which the layoff price is not known and the measurement of performance obligations may not be as reliable.

Memorandum 3: Obligations to Be Included in the Scope of the Standard on Revenue Recognition

Ms. Sletten noted that the Board previously agreed that contractual obligations (legally enforceable by definition) and legally enforceable noncontractual obligations should be included in the scope of the standard. She asked for the Board's input on whether noncontractual obligations that are not legally enforceable should be within the scope of the standard.

Ms. Sletten noted that the staff recommends that only legally enforceable obligations be included in the scope of the revenue recognition standard. She noted that the staff also proposes that absent evidence to the contrary, reporting entities should presume that all express and implied promises made to their

customers, on which customers are justified in relying, are legally enforceable. The Board agreed that only legally enforceable obligations (contractual and noncontractual) should be included in the scope of the revenue recognition standard.

Follow-up Items:

None.

General Announcements:

None.

APPENDIX

EXAMPLE

Case Statement

On Monday, Suzie Customer chooses a blue sweater in Store X that she likes and wants to buy. Store X does not have Suzie's size in stock, but offers to obtain one for her. Suzie pays Store X for the full price of the sweater (\$100).

Consider the following three alternatives.

Alternative A

Store X can order the sweater from its supplier, Sweater Maker, for a price of \$60. Sweater Maker's standard delivery method is ground service, which guarantees that the sweater will arrive at Store X a week from Friday with Store X's usual shipment of sweaters. However, Sweater Maker requires that Store X purchase at least 12 sweaters per shipment.

The price of the sweater (\$60) does not include freight or shipping insurance charges. Moreover, if Suzie returns the sweater to Store X, it will not be able to return the rejected sweater to Sweater Maker for a credit of \$60 unless the sweater has a manufacturing flaw (that is, unlike Store X, Sweater Maker will not accept returns for any reason other than a manufacturing flaw). Also, Store X will have 11 extra sweaters and is unsure whether it can sell those sweaters without cutting the sales price.

Alternative B

Sweater Maker will ship the sweater directly to Suzie using an express service (such as FedEx or United Parcel Service), which guarantees that the sweater will arrive at Suzie's house by Wednesday. The sweater will be packaged attractively in a Sweater Maker gift box. Suzie can return the sweater to Sweater Maker if she decides that she doesn't like it, and Sweater Maker will include a prepaid envelope that she can use for her return. Sweater Maker will charge Store X \$85, which is inclusive of freight and shipping insurance charges for delivery to Suzie's home.

Alternative C

Store Y is across the street from Store X and sells the same sweater. Store Y has a blue sweater in Suzie's size in stock and will sell the sweater to Store X for \$80. Store X can pick up the sweater immediately and deliver it to Suzie before she finishes her shopping. However, if Suzie returns the sweater, Store X will be responsible that return. Store X cannot return the sweater to Store Y but can return it to Sweater Maker for a \$60 credit if it has a manufacturing flaw.

QUESTION FOR THE BOARD

Which amount (\$60, \$85, or \$80) best reflects the fair value of Store X's performance obligation and why?