

## MINUTES



Financial Accounting  
Standards Board

**To:** Board Members

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

**Subject:** Minutes of the August 4, 2004 FASB Board Meeting      **Date:** August 10, 2004

**cc:** FASB: Bielstein, Smith, Petrone, T. Johnson, Sletten, Thuener, Figgie, Kawanishi, Quiring (2), Hoermann, MacDonald, Proestakes, Mahoney, Cohen, Golden, Cropsey, Lapolla, McKenna, Munro, Pinson, Swift, Polley, Getz, Thompson, Gabriele, Sutay, Intranet; GASB: Patton; IASB: Leisenring, Paul, Crook

*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—Accounting for Contractual Obligations from a Customer Perspective versus a Reporting Entity Perspective and Accounting Treatment of “Residual” Created upon Contract Generation

Basis for Discussion: Two memorandums dated July 29, 2004

Periods of Discussion: 9:00 a.m. to 11:05 a.m.

### Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott  
IASB: Leisenring

Board members absent: None

Staff in charge of topic: T. Johnson, Thuener, Sletten

Other staff at Board table: Bielstein, Figgie, Quiring

Outside participants: None

### Summary of Decisions Reached:

The Board discussed the following two issues:

1. Whether a reporting entity's contractual rights and obligations should be viewed from a customer perspective versus a reporting entity perspective
2. How "selling revenue" that is measured as a residual should be recognized at contract generation when there are uncertainties surrounding its measurement.

The Board affirmed its previous decision that a reporting entity's contractual rights and obligations vis-à-vis its customers should be accounted for on a basis that reflects the reporting entity perspective. Under the reporting entity perspective, the fair value of an entity's performance obligations should reflect the price that the reporting entity would have to pay an unrelated party of equal credit standing to assume legal responsibility for performing all of its remaining obligations (that is, the layoff price).

Board members did not reach a decision on the accounting treatment of selling revenue that is measured as a "residual" when there are uncertainties surrounding its measurement. However, the Board agreed that the residual should not be recognized as a component of other comprehensive income (OCI). The Board will continue discussing the accounting treatment of the residual at a future meeting.

### Objective of Meeting:

The objective of the meeting was to respond to issues raised by Board members about fair value measurement.

### Matters Discussed and Decisions Reached:

Mr. Johnson opened the discussion and noted that the staff prepared four memorandums for the meeting addressing concerns about fair value measurement expressed by FASB and IASB Board members.

#### **Memorandum 1: Accounting for Contractual Obligations from a Customer Perspective versus a Reporting Entity Perspective**

Mr. Johnson began by describing the customer perspective and the reporting entity perspective. Under a customer perspective, performance is viewed *only* in

the context of *liability extinguishment* (that is, in terms of extinguishing the reporting entity's contractual obligations vis-à-vis its customers). Prior to such extinguishment through performance, the entity generally would be regarded as owing its customers the consideration that they paid. Under a reporting entity perspective, performance under the contract is viewed more broadly, that is, in the context of the *sacrifices required* of the reporting entity in conjunction with the contract. Those sacrifices relate not only to the contractual obligations incurred (which relate to contract fulfillment) but also to the services provided to customers in entering into the contracts (which relate to contract acquisition).

Please refer to the appendix to these minutes for the example used by the Board to discuss the customer and reporting entity perspectives. Board members were asked whether they agreed with the staff's recommendation that:

1. In Scenario 1, Retailer A's liabilities for extended warranties should be measured at \$300 rather than \$1,000.
2. In Scenario 2, RepairCo's liabilities for extended warranties should be measured at \$300 rather than \$1,000.
3. In Scenario 3, Retailer A's liabilities for extended warranties should be measured at \$600 ( $\$300 + \$300$ ) rather than \$2,000 ( $\$1,000 + \$1,000$ ) or \$1,300 ( $\$1,000 + \$300$ ).

The Board affirmed its previous decision that a reporting entity's contractual rights and obligations vis-à-vis its customers should be accounted for on a basis that reflects the reporting entity perspective. Under the reporting entity perspective, the fair value of an entity's performance obligations should reflect the price that the reporting entity would have to pay an unrelated party of equal credit standing to assume legal responsibility for performing all of its remaining obligations (that is, the layoff price).

Ms. Schipper and Messrs. Trott, Crooch, and Herz agreed with the staff's recommendation in Memorandum 1 (that is, a reporting entity's obligations should be measured at their fair values of \$300, \$300, and \$600 in Scenarios 1, 2, and 3, respectively).

Ms. Schipper noted that if the customer accounted for the selling services and convenience received in the transaction, the customer's accounting might look more like that of the reporting entity. Ms. Schipper also noted that the customer

perspective is not a representationally faithful reporting of an entity's rights and obligations. She stated that the fair value of an entity's performance obligation should be defined as the amount of assets required to be sacrificed by the entity to settle the obligation. That fair value is not the customer consideration amount because a refund of customer consideration would be required for settlement only in the case of a failure of the reporting entity to perform, not in its normal business model.

Mr. Trott noted that in certain instances, the fair value of performance obligations from a reporting entity perspective may be higher than the customer consideration amount. That may happen, for example, when a reporting entity incurs customer acquisition costs.

Mr. Leisenring noted that a reporting entity should not measure identical obligations at different amounts because it would result in the recognition of assets and liabilities based on the sequence of transactions that led to their existence. He also stated that the rationale for why an entity's performance obligations are not recognized at the customer consideration amount must be explained in the basis for conclusions to the standard.

Mr. Crooch agrees that performance obligations should be recognized and measured at fair value; however, he believes that in practice, it may be difficult for entities to develop fair value estimates of their performance obligations.

Mr. Herz stated that he would arrive at the same answers as those in the staff's recommendation, but that he would get to those answers in two steps: (1) initially recognize the obligations at the transaction amount and (2) then remeasure the remaining obligations at fair value (the layoff price) a "nanosecond later."

Mr. Leisenring noted that he did not understand how the fair value of identical obligations can change a "nanosecond later."

Ms. Seidman and Messrs. Batavick and Schieneman stated that the obligations in all three scenarios should be measured at their transaction amounts (\$1000, \$300, and \$1300, in Scenarios 1, 2, and 3, respectively).

Ms. Seidman noted that she uses a different definition of fair value than those in favor of the staff's recommendation. She stated that the contract price is an

appropriate measure of the fair value of an entity's obligations because each transaction is between a willing buyer and seller. She noted that selling effort is not a separate contract element from the customer's perspective. She also commented that both parties' perspectives are considered when determining if a liability has been extinguished. Therefore, no revenue should be recognized at contract inception because both parties to the contract do not perceive the extinguishment of a liability.

Ms. Schipper noted that if the customer pays for access to goods or services, the seller extinguishes an obligation to provide that access.

Ms. Seidman stated that a reporting entity may have access to both retail and wholesale markets, but the price of a contract will be different in those markets. She stated that it is inappropriate for a reporting entity to take a contract generated in the retail market and recognize selling revenue based on wholesale prices because that is akin to "jumping markets".

Ms. Schipper responded that the reporting entity is not "jumping markets" because it is transferring something of value (selling services) to its customers and then measuring its remaining performance obligations.

Ms. Seidman also stated that, as previously noted by Mr. Leisenring, paragraph 75 of Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides two objectives of measuring liabilities at fair value: to estimate the value of the assets required currently to (1) settle the liability with the holder or (2) transfer the liability to an entity of comparable credit standing. It is not clear why, in the context of revenue recognition, performance obligations should be measured at the value of the assets required to transfer those obligations to an entity of comparable credit standing, rather than at the value of the assets required to settle those obligations with the customer. She provided an example of a debt instrument that, under current accounting guidance, is not measured at the amount at which the issuer could transfer the debt instrument to an entity of comparable credit standing, but rather is measured at the amount the investor is entitled to receive from the issuer.

Ms. Schipper responded that a reporting entity has two alternatives for settling the liability with the customer. It can (1) arrange to perform by delivering goods or services or (2) refund the contract price. Because the reporting entity perspective presumes rational economic behavior, the entity would measure its obligation to perform, rather than its obligation to refund the contract price in case of a failure to perform.

Mr. Batavick stated that the reporting entity should recognize its performance obligations at the transaction amount because that is the amount the reporting entity must stand ready to refund to the customer.

Mr. Schieneman stated that a reporting entity should measure its obligations based on contractual amounts because those amounts reflect the substance of the transaction. He noted that the measurement of a reporting entity's obligations should be based on how the obligations were acquired by the entity.

Ms. Schipper cautioned Board members that measuring obligations at different amounts depending on the manner in which the obligations are acquired may permit manipulation by companies using swap arrangements.

## **Memorandum 2: Accounting Treatment of "Residual" Created upon Contract Generation**

Ms. Sletten asked Board members to consider the accounting treatment of selling revenue that is measured as a "residual" when there are uncertainties surrounding its measurement.<sup>1</sup>

Board members did not reach a decision on the accounting treatment of selling revenue that is measured as a residual. Board members continued to discuss whether and in which instances selling revenue should be recognized upon contract generation. All Board members agreed that the residual should not be

---

<sup>1</sup> Under the assets and liabilities approach to revenue recognition, a reporting entity may recognize some revenue upon entering into a contract with a customer (that is, when "contract generation" has occurred) even though delivery of contracted goods or services ("contract fulfillment") has not occurred. That revenue has been referred to as "selling revenue," which results from providing customers with retail access and selling services. In certain instances, selling revenue may be measured as a "residual" (that is, at the fair value of the net increase in an entity's assets, such as the excess of cash received over the sum of the fair values of the entity's remaining performance obligations, including any performance guarantees).

recognized as a component of OCI. The Board will continue discussing the accounting treatment of the residual at a future meeting.

Ms. Schipper noted that if the residual relates to selling services, then it should be recognized as revenue upon contract generation. On the other hand, if the residual is a result of measurement error, the residual should be recognized as part of the performance obligations. She stated that a method will need to be developed to attribute the residual related to measurement error to the remaining obligations. Ms. Schipper also noted that the residual should not be recognized as a separate liability because it will be impossible to determine when it has been discharged.

Ms. Schipper asked Board members what they would do if the residual was negative (that is, a debit instead of a credit). She also stated that the Board must articulate in the revenue recognition standard when a measure is reliable and must consider how to balance verifiability and representational faithfulness. For example, an estimate of fair value that is developed based on significant entity-specific inputs (such as “cost plus profit markup”) may be verifiable, but in the absence of market inputs it may be difficult to evaluate its representational faithfulness. One approach could be to accept an estimate as a reliable estimate of fair value if it can be verified. Alternatively, the Board could consider a verifiable estimate to be reliable only if additional support for its representational faithfulness exists. The standard must articulate how to apply professional judgment to determine when an entity may not have evidentiary support for reliability of fair value estimates based on entity-specific inputs.

Mr. Herz stated that he does not support recognizing selling revenue unless a reporting entity (1) has reliable measures of its remaining performance obligations and (2) is certain that all of its performance obligations have been identified. He stated that he continues to support a higher reliability threshold for fair value estimates affecting revenues than for other estimates that may be included in financial statements. Mr. Herz believes that for purposes of revenue recognition, reliable estimates of fair value of performance obligations could be obtained in active markets (Level 1 of the fair value hierarchy) or based on prices in actual transactions with capable, willing, and reliable service providers. In the

absence of reliable measures, he would measure the remaining performance obligations based on entity-specific inputs and allocate the residual to the performance obligations.

Mr. Trott disagreed with requiring a higher reliability threshold for fair value estimates affecting revenues. He stated that he would recognize the residual as revenue in all cases in which performance obligations can be measured at fair value (at any level of the fair value hierarchy). He also noted that the residual is accompanied by costs incurred to obtain the contract, such as advertising, and deferring the residual leads to complexities in dealing with those costs.

Mr. Leisenring expressed support for recognizing selling revenue upon contract generation if that revenue can be measured directly or if all of the entity's performance obligations can be measured reliably. He stated that if one of the remaining performance obligations could not be measured reliably, he would combine the residual with that performance obligation. He also noted that he does not support a higher reliability threshold for fair value estimates affecting revenues. However, he does not like the alternative of recognizing revenue immediately when it might include measurement errors.

Mr. Crooch expressed concern about measurement uncertainty and the ability of entities to obtain fair value measures of performance obligations. He stated that an entity should recognize the residual as a liability until the entity meets the reliability threshold for recognizing the residual as revenue.

Ms. Seidman stated that she would measure an entity's performance obligations at fair value (that is, legal layoff prices). However, the residual should not be recognized as revenue at contract inception, even if it can be measured directly. She stated that since the entity has not taken any steps to satisfy the obligation to the customer, no revenue should be recognized.

Mr. Schieneman stated that most investment decisions are based on forecasts and that for purposes of forecasting revenues, analysts are interested only in the overall contract profitability.

Ms. Schipper responded that the proposed model may help analysts better understand an entity's business model and profitability as well as improve

corporate governance because entities will report profit margins on economic components of their contracts. If an entity performs some of its obligations at a loss, its business model may necessitate an adjustment.

Mr. Johnson stated that the staff would analyze the Board's comments and prepare memorandums for discussion of fair value measurement issues at future meetings. He also noted that due to time constraints, Memorandums 3 and 4 would be discussed at a future meeting.

Follow-up Items:

The staff will analyze Board members' comments from the meeting and prepare additional memorandums to assist the Board in making decisions on the accounting treatment of selling revenue that is measured as a residual when there are uncertainties surrounding its measurement. Memorandums 3 and 4 will be discussed at a future meeting.

General Announcements:

None.

## APPENDIX

The Board considered the following example which illustrates accounting for contractual rights and obligations from the perspective of the customer:

Retailer A is a consumer electronics company that sells television sets for \$300 that it buys from the manufacturer for \$250. Like other consumer electronics retailers, Retailer A also sells for \$100 warranty contracts that extend 2 years beyond the manufacturer's 1-year product warranty. Those extended warranties are offered only on products that are sold in the same transaction and the high profit margins on the warranties allow the products to be offered at highly competitive prices. The fees charged for those extended warranties are not refundable except for cause. That is, the fees are not refundable unless Retailer A fails to perform, in which event holders of the warranty contracts are entitled to a pro rata refund of the \$100 contract price for any unperformed portion of the warranty period.

Like other consumer product sellers, Retailer A can either service the warranties itself or pay reliable third-party administrators (such as RepairCo, an entity with an equivalent credit standing) to legally assume the warranty servicing obligations. Past history indicates that 1 in 10 sets will experience a failure during the extended warranty period, and that the average incremental cost to repair or replace a defective unit is approximately \$140. Reliable third-party administrators are willing to legally assume the warranty obligations (including the refund obligations) for a price of \$30 per contract. Because past history indicates that refunds from failure to perform the warranty services as promised will approximate 1.5 percent of the original price of the warranties, those administrators are willing to undertake the warranty obligations without legal assumption (that is, without the refund obligations) for \$28 per contract.

At the end of Year 1, Retailer A sells 10 television sets with extended warranties and collects the selling price in full. The manufacturer's warranty covers all of Year 2, and the extended warranties cover Years 3 and 4.

How should the warranty obligations to the customers (warranty holders) be measured?

The Board considered the accounting implications of adopting the customer perspective in the context of the following scenarios:

Scenario 1—Retailer A itself services all of the extended warranties that it sells.

Scenario 2—Same as Scenario 1 except that Retailer A legally lays off to RepairCo all of the warranties that it sells on the date of sale (Retailer A has a standing arrangement with RepairCo under which it can lay off its warranty obligations) and pays RepairCo in full on that date.

Scenario 3—Same as Scenario 1 except that Retailer B (a competitor to Retailer A) also sells an equal number of identical warranties at the same prices and on the same date as Retailer A. Retailer B legally lays off all of those warranties to Retailer A on that date (Retailer B has a standing arrangement with Retailer A under which it can lay off its warranty obligations) and pays Retailer A in full on that date.

For purposes of this example, it is assumed that the warranty services are rendered (and any warranty costs are incurred) by the reporting entity evenly over the two-year warranty period. It is further assumed that the prices of warranties and the costs associated with them remain constant throughout Years 1–4.

### Accounting by Customers

In all three scenarios, Retailer A’s customers (collectively) might account for their extended warranties as follows:

Year 1	Warranty Assets	\$1,000
	Cash	\$1,000
	<i>To record purchase of extended warranty contracts from Retailer A (10 contracts at \$100 per contract)</i>	
Year 2	[No entry]	
Year 3	Warranty Expense	\$500
	Warranty Assets	\$500
	<i>To record consumption of first year of warranty services and related assets</i>	
Year 4	Warranty Expense	\$500
	Warranty Assets	\$500
	<i>To record consumption of final year of warranty services and related assets</i>	

## Accounting by Reporting Entities under the Customer Perspective

### Scenario 1

#### Accounting by Retailer A

Year 1	Cash	\$1,000	
	Warranty Liabilities		\$1,000
	<i>To record sale of 10 extended warranty contracts to customers</i>		
Year 2	[No entry]		
Year 3	Warranty Liabilities	\$500	
	Revenues		\$500
	<i>To record rendering of warranty services and related extinguishment of warranty liabilities for first year of warranties</i>		
Year 4	Warranty Liabilities	\$500	
	Revenues		\$500
	<i>To record rendering of warranty services and related extinguishment of warranty liabilities for final year of warranties</i>		

### Scenario 2

#### Accounting by Retailer A

Year 1	Cash	\$1,000	
	Warranty Liabilities		\$1,000
	<i>To record sale of extended warranty contracts to customers</i>		
Year 1	Warranty Liabilities	\$1,000	
	Cash		\$300
	Revenues		700
	<i>To record legal layoff of warranty liabilities to RepairCo for \$300 (10 warranty contracts at \$30 per contract)</i>		

#### Accounting by RepairCo

From the perspective of the warranty holders, the fair value of their warranty assets is \$1,000 both before and after the assumption. Accordingly, RepairCo would have to recognize a liability for those warranties in the amount of \$1,000 when it becomes the obligor on the contracts in order for its accounting to mirror that of the warranty holders. That would require RepairCo to recognize a \$700 loss upon assuming the warranties, as follows:

Year 1	Cash	\$300
	Loss on Assuming Warranties	700
	Warranty Liabilities	\$1,000

*To record legally assuming 10 extended warranties from Retailer A*

When RepairCo subsequently renders the warranty services, its accounting would be as follows:

Year 3	Warranty Liabilities	\$500
	Revenues	\$500

*To record rendering of warranty services and related extinguishment of warranty liabilities for first year of warranties*

Year 4	Warranty Liabilities	\$500
	Revenues	\$500

*To record rendering of warranty services and related extinguishment of warranty liabilities for final year of warranties*

### **Scenario 3**

#### ***Accounting by Retailer B***

Retailer B's accounting in this scenario would be identical to that of Retailer A in Scenario 2 and, for that reason, is not repeated here.

#### ***Accounting by Retailer A***

From the warranty holders' perspective (collectively), the 20 warranties (10 originated by Retailer A and 10 assumed from Retailer B) constitute assets totaling \$2,000. Thus, for Retailer A's accounting to mirror that of the warranty holders, it would have to recognize liabilities of \$2,000. It also would have to recognize a \$700 loss upon assuming the warranties from Retailer B. Retailer A's accounting for the warranties it originated and those it assumed would be as follows:

Year 1	Cash	\$1,000
	Warranty Liabilities	\$1,000

*To record sale of 10 extended warranty contracts to customers*

Year 1	Cash	\$300
	Loss on Assuming Warranties	700
	Warranty Liabilities	\$1,000

*To record legal assumption of 10 extended warranty contracts from Retailer B*

Retailer A would record extinguishment of the liabilities as follows:

Year 3	Warranty Liabilities	\$1,000
	Revenues	\$1,000

*To record rendering of warranty services on 20 extended warranty contracts and related extinguishment of warranty liabilities for first year of warranties*

Year 4	Warranty Liabilities	\$1,000
	Revenues	\$1,000

*To record rendering of warranty services on 20 extended warranty contracts and related extinguishment of warranty liabilities for final year of warranties*