Financial Accounting Standards Board

International Accounting Standards Board

MINUTES

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

Subject: Minutes of the February 18, 2004 FASB Board Meeting
Date: February 25, 2004

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

Topic: Revenue Recognition—Use of the Term Conditional Rights and Obligations, Consistency of Measurement Decisions between the Revenue Recognition and Fair Value Measurement Projects, Approaches to Developing the General Standard and Related Application Guidance, and Draft Recognition and Measurement Principles

Basis for Discussion: Memorandums dated February 6, 2004

Length of Discussion: Starting Time: 9:00 a.m. Concluding Time: 10:40 a.m.

Attendance:

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

Board members absent: None

Staff in charge of topic: Figgie, Slayton, Sletten, T. Johnson

Other staff at Board table: Quiring

Outside participants: None

Summary of Decisions Reached:

The Board discussed four topics. First, the Board discussed the use of the term *conditional* rights and obligations in the Revenue Recognition Project. Next, the Board discussed whether the decision in the Fair Value Measurement Project that the estimate of fair value for financial instruments traded in active markets in which prices are quoted in terms of bid and asked prices should be determined using bid prices for long positions (assets) and asked prices for short positions (liabilities) *conflicts* with decisions on measuring performance obligations in this project. The Board then considered alternative approaches to completing the general revenue recognition standard and subsequent application guidance. Finally, the Board discussed draft recognition and measurement principles that might be included in the general standard. b

The Board reached the following tentative conclusions:

- The Revenue Recognition Project should continue to use the terms *conditional* and *unconditional* rights and obligations within the context of contractual arrangements.
- The decisions reached in the Fair Value Measurement Project do not conflict with decisions on measuring performance obligations in this project.
- The general standard for revenue recognition is expected to supercede certain existing guidance that is general in nature. For example, APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," and SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements,* would be superceded. Other industry specific or transaction specific guidance is expected to be superceded by subsequent application standards.
- The application standards will be developed for broad categories of arrangements (for example, rights of use, services, and products) and would include both guidance specific to the broad category and any additional guidance necessary for the individual types of arrangements that are classified within each category.
- Principles may be viewed as a "bridge" between the FASB's Concepts Statements and the more specific application guidance that reporting entities need to prepare their financial statements. As such, principles are a form of accounting guidance that is derived from the concepts and that

translates those concepts into higher-level implementation guidance. That implementation guidance is subject to the constraints imposed by the current state of the art and cost-benefit considerations.

- The draft principles generally are consistent with the Board's decisions reached to date and adequately capture the substance of those decisions.
- Liabilities that stem from implied contractual promises should be identified, recognized, and measured at fair value. Implied promises are inferred from a reporting entity's conduct, including its course of dealing with the counterparties, its usage of trade, its course of performance, or evidence of consistent additional terms.
- The effects of the time value of money and credit risk should be reflected in the fair value of contractual assets unless those effects are immaterial.

Matters Discussed and Decisions Reached:

Mr. Johnson opened the meeting and noted that the staff prepared four memorandums for discussion. Mr. Johnson noted that the first two memorandums were in response to concerns that Board members raised at previous Board meetings.

Memo 1: Use of the Term *Conditional* Rights and Obligations

Ms. Figgie noted the terms *conditional* and *contingent* (and *unconditional* and *noncontingent*) appear to be synonyms and generally are used interchangeably. However, in existing accounting literature, the probability associated with the future outcome of a right or obligation either acts as a recognition criterion or as a factor in measuring the related assets and liabilities. Ms. Figgie noted that legal literature uses the terms *conditional* and *unconditional* in the context of contracts. Therefore, the staff believes that it would not be as representationally faithful to use terminology different from that which is used in legal literature because the items to be accounted for in this project are legal creations.

Board members agreed that the Revenue Recognition Project should continue to use the terms *conditional* and *unconditional* within the context of contractual arrangements. Ms. Schipper encouraged the staff and the Board to remain mindful that terms are used consistently across projects when making future terminology choices. Ms. Seidman suggested that the staff include in the general standard's basis for conclusions an explanation of the use of the terms *conditional* and *unconditional* rights and obligations in this project versus the use of those terms in other standards. Mr. Crooch suggested developing a “dictionary” of the terms used in FASB standards so that the terms are used consistently going forward.

Memo 2: Consistency of Measurement Decisions between the Revenue Recognition and Fair Value Measurement Projects

Mr. Slayton noted that the second memorandum was in response to the Board’s question as to whether the decision in the Fair Value Measurement Project that the estimate of fair value for financial instruments traded in active markets in which prices are quoted in terms of bid and asked prices should be determined using bid prices for long positions (assets) and asked prices for short positions (liabilities) *conflicts* with the decision that the fair value of a performance obligation is the price that the reporting entity would pay a third party to assume responsibility for performing all of its remaining obligations (including performance guarantees).

Mr. Slayton noted that the staff believes that the two decisions do not conflict because the decision in the fair value project relates to which quoted price to use in an active market when there is a range of prices that might approximate fair value. The decision in the revenue recognition project relates to which market to use in determining fair value, and did not specifically contemplate what to do when there is a range of prices. Furthermore, performance obligations will not likely be quoted in active markets so estimates of fair value often will be made at Level 3 of the fair value hierarchy.

Board members generally agreed that the decisions do not conflict. However, Ms. Seidman noted that the two decisions may be perceived to be inconsistent because the Revenue Recognition Project uses the most advantageous market (that is, lowest price) to measure the fair value of performance obligation, while the decision in the Fair Value Project results in the use of the highest price for a liability.

Memo 3: Approaches to Developing the General Standard and Related Application Guidance

Mr. Slayton noted that the Board plans to issue Exposure Drafts for both a general standard on revenue recognition and the related amendments to the Concepts Statements in December 2004. The general standard would be followed by application standards that operationalize it for certain types of arrangements that require additional guidance. The staff asked the Board for direction on approaches to developing the general revenue recognition standard and subsequent application guidance.

Mr. Slayton described two alternatives to approaching the general standard:

1. Alternative A—The general standard would be effective for all current arrangements that are accounted for under existing *general* revenue recognition guidance such as APB Opinion No. 29, *Accounting for Nonmonetary Transactions,* FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables," and SEC Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements.*
2. Alternative B—The scope of the general standard would include the arrangements covered under Alternative A plus certain other specific types of arrangements or industries. Under this approach, the effective date of the general standard might be delayed until that arrangement-specific or industry-specific guidance is completed.

Mr. Slayton also referred to four approaches for sequencing the follow-on application standards:

1. Approach #1—Sequence the issuance of the follow-on standards by progressing from the greatest improvements in practice to smaller improvements in practice.
2. Approach #2—Provide application guidance first for the arrangements that will be affected the least and will take the least time to resolve. This will bring about the change more gradually and help build constituent acceptance.
3. Approach #3—Focus on the arrangement types that result in the most significant practice issues first. This approach is different than the others in that the sequencing does not originate from existing GAAP, but rather from the lack of existing GAAP ("gaps in GAAP").
4. Approach #4—Develop application guidance based on broad categories of arrangements (for example, rights of use, services, and products) rather than on specific types of arrangements. That guidance might include both guidance specific to the broad category and any additional guidance

necessary for the individual types of arrangements that are classified within that category.

Mr. Trott, Ms. Schipper, Mr. Batavick, and Mr. Crooch expressed support for Alternative A for the general standard and Approach 4 for the application standards. Mr. Trott stated that the general standard should specify clearly the guidance it is superceding and should identify which guidance will be subsequently superceded by the application standards. He also suggested that the staff develop the application standards simultaneously. The staff responded that the approach to the development of the application standards may be dependent on available resources. Certain Board members noted that application guidance for services transactions should be a priority.

Ms. Schipper noted that the only difference between Alternative A and Alternative B is the definition of "general" guidance. She noted that Board members may have different views about what level of guidance will be included in the general standard. She noted that Approach 4 for the application standards will provide the most consistent guidance across the categories of arrangements.

Mr. Schieneman stated that decisions about the issuance of the standards should be deferred until further application guidance has been developed to ensure that the revenue recognition model is operational. He noted that sector-specific guidance should be provided at the principles level.

Ms. Seidman expressed support for Approach 4, but stated that a decision between Alternative A and Alternative B should be delayed until after the staff has further developed the broad categories of arrangements under Approach 4.

Mr. Herz supported Approach 4, but he and other Board members expressed concerns that certain reporting entities may have difficulty in determining which guidance to look to. However, he does not support delaying the issuance of the general standard until all application guidance is completed.

Memo 4: Draft Recognition and Measurement Principles

Ms. Sletten asked for the Board's input on:

(1) The meaning of the term *principle* as it is used in the context of principles-based standards, in general, and in the context of the general accounting standard on revenue recognition, in particular.

(2) The form and content of several proposed draft recognition and measurement principles

Following is a summary of the staff's questions for the Board and Board members' answers to those questions. Draft recognition and measurement principles that were the subject of this discussion are listed in the appendix to these minutes.

Question 1: Do Board members agree with the proposed definition of the term *principle* as it is used in the context of the broad, general accounting standard on revenue recognition?

The Board agreed that a principle may be viewed as a "bridge" between the FASB's Concepts Statements and the more specific application guidance that reporting entities need to prepare their financial statements. Mr. Herz noted his agreement with the proposed layers of the revenue recognition guidance consisting of the conceptual model for revenue recognition that would be interpreted by general principles in the concepts-based general standard with more specific application guidance provided in the principles-based application standards.

Question 2: Do Board members agree that the proposed draft principles are consistent with and adequately capture the substance of the tentative decisions that have been made by the Board?

The Board generally agreed that the proposed draft principles are consistent with and adequately capture the substance of the tentative decisions that have been made by the Board. The Board agreed that it is necessary to further clarify the level (depth) of implementation guidance that should be included in the general standard.

Several Board members expressed concern with Recognition Principle #5. Their concern primarily related to the reliability of fair value measures of the performance obligations at contract inception. Ms. Seidman expressed her view that Recognition Principle #5 may be a sub-principle of Recognition Principle #6.

Mr. Trott stated that the fact that revenue is derived from the determination of the fair values of the related assets and liabilities should be made clear in the principles. Ms. Seidman and Mr. Herz expressed concern about the use of the word “final” in Recognition Principle #7. Mr. Schieneman questioned whether the model would improve analysts’ ability to predict an entity’s future revenues. Mr. Batavick expressed concerns about the readability of the principles.

Ms. Schipper noted that Recognition Principle #6 needs to be clarified after the Board decides whether to use the liability extinguishment or broad performance view for the definition of revenues.

Mr. Herz questioned how the principles would be operationalized for the measurement of performance obligations. He stated that he would not want to go below Level 1 of the fair value hierarchy. Mr. Trott noted that he would not restrict measurements to Level 1. Ms. Sletten commented that it would be difficult to measure dilution items (for example, returns, refunds, discounts, rebates, credits, and so forth) at Level 1 of the hierarchy. The Board suggested that further general implementation guidance be developed for the measurement of contractual liabilities (that is, how fair values of obligations should be determined).

Question 3: Are there additional significant principles that should be considered by the staff?

Board members suggested that additional principles be developed for (1) enforceable contracts and enforcement worthiness issues and (2) net versus gross presentation of contractual assets and liabilities in partially executed contracts.

Question 4: Do Board members agree with the proposed model for recognizing implied contractual liabilities that stem from customer contracts?

Board members agreed that implied contractual liabilities that stem from customer contracts should be identified, recognized, and measured at fair value.

Question 5: When, if ever, can the effects of the time value of money and credit risk be disregarded due to cost-benefit considerations?

Board members generally agreed that this question is a measurement issue. Ms. Seidman suggested an exception for high-volume, routine, short-term receivables. Mr. Herz responded that the decision would depend on the inflationary environment. The Board agreed that the effects of the time value of money and credit risk should be reflected in the fair value of contractual assets unless those effects are immaterial. Some Board members noted that it may be necessary to clarify the issue of the unit of account for purposes of assessing materiality.

Question 6: Should measurement guidance for the rights of refund relating to services differ from those relating to goods?

The Board asked the staff to compare and contrast a reporting entity's obligations to honor rights of refund in service transactions and demand deposit liabilities of financial institutions. That issue will be further discussed at a future meeting of the Board.

Follow-up Items:

None.

General Announcements:

None.

APPENDIX

Fundamental Revenue Recognition Principle

A reporting entity should recognize revenues in the accounting period in which they arise and measure them at their fair value on the date that they arise if it can determine both their occurrence and measurement with sufficient reliability.

Recognition Principle #1

Contractual revenues cannot arise before a contract with a customer exists.

Recognition Principle #2

A reporting entity should recognize contractual revenues when an increase in its claims against its customers can be determined to have occurred and the fair value of that increase can be measured with sufficient reliability.

Recognition Principle #3

A reporting entity should recognize contractual revenues when a decrease in claims against it by its customers can be determined to have occurred and the fair value of that decrease can be measured with sufficient reliability.

Recognition Principle #4

Increases in assets or decreases in liabilities that give rise to contractual revenues may stem from contractual promises that can be either express or implied.

Recognition Principle #5

Contractual revenues should be recognized at contract inception if the fair values of the contractual assets obtained on that date exceed the fair values of the contractual liabilities simultaneously incurred, and if those revenues can be measured with sufficient reliability.

Recognition Principle #6

Subsequent to contract inception, contractual revenues should be recognized upon the reporting entity's performance of its obligations under the contract, as evidenced by a decrease in its contractual liabilities or an increase in its contractual assets, the fair value of which can be determined with sufficient reliability.

Recognition Principle #7

Contractual revenues should be recognized upon contract completion to reflect any final increases in the fair values of contractual assets or final decreases in the fair values of contractual liabilities.

Fundamental Measurement Principle

A reporting entity should measure revenues arising from an increase in its assets or a decrease in its liabilities (or a combination thereof) at the fair value of that increase or decrease.

Measurement Principle #1

The estimates of the fair value that the reporting entity uses to measure revenues arising from increases in its assets or decreases in its liabilities should be those that have the highest relative reliability.

Measurement Principle #2

The estimates of the fair value of revenues that are consistent with Level 3 of the fair value hierarchy should be developed by means of multiple valuation techniques that maximize market inputs, such as a market approach or an income approach, whenever information necessary to apply those techniques is available.

Measurement Principle #3

The fair value of revenues arising from increases in the reporting entity's contractual assets reflects the effects of credit risk, the time value of money, and dilution risk.

Measurement Principle #4

The measures that reflect the effects of credit risk on the fair value of a reporting entity's revenues also should reflect expectations of recoveries, if any, in case of breach of the contract by the customer.

Measurement Principle #5

Any express or implied rights of return and refund, allowances, rebates, discounts, credits, and other similar rights granted to customers that reduce revenues by reducing the reporting entity's contractual assets or increasing its contractual liabilities should be measured at fair value.

Measurement Principle #6

Revenues arising from increases in contractual assets that stem from the reporting entity's rights to the customer's stand ready performance in case of occurrence or nonoccurrence of a specified event should be measured at fair value that reflects the assessment of the probability that the specified event will occur.