MINUTES

Financial Accounting Standards Board

To: Board Members

From: Revenue Recognition Team
(Kazazean, ext. 327)

Subject: Minutes of the May 7, 2003 Board Meeting

Date: May 13, 2003

cc: Leisenring, Bielstein, T. Johnson, Smith, Petrone, MacDonald, Mahoney, Swift, Polley, Thompson, Gabriele, Sutay, Patton (GASB), Slayton, Manders, Wilson, Kazazean, Cohen, Cropsey, Lapolla, Paul (IASB), Intranet

<u>Topic</u>: The Definition of Revenue

<u>Basis for Discussion</u>: Memorandum dated April 24, 2003

<u>Length of Discussion</u>: 9:00 a.m. to 10:20 a.m.

<u>Attendance</u>:

Board members present: FASB: Herz, Crooch, Foster, Trott, Schieneman, Schipper, Wulff

IASB: Leisenring

Board members absent: None

Staff in charge of topic: T. Johnson

Other staff at Board table: Bielstein, Slayton, Cropsey, Kazazean

Outside participants: Paul (by Phone)

Summary for ACTION ALERT:

The Board continued its discussion of issues related to the conceptual definition of revenues. The Board considered the implications of different combinations of the liability extinguishment and broad performance views for the purposes of definition, recognition, and display, with the definition of revenue being based on one view and the recognition or display of revenue in the income statement being based on the other view. No decisions were made, and the Board asked the staff to further explore issues relating to definitions of revenues based on the broad performance view and the liability extinguishment view.

Matters Discussed and Decisions Reached:

The primary purpose of this discussion was for the Board to further narrow the field of alternative views on which to base the definition of revenues by deciding whether the liability extinguishment view or broad performance view should be used as the basis for the conceptual definition of revenues. The staff compared two definitions (one based on the broad performance view and one based on the liability extinguishment view) in the context of two cases. The key conceptual differences that arise from applying the alternative views, the staff noted, are permanent and temporary differences. Permanent differences generally derive from how the two views treat subcontracting, and temporary differences principally pertain only to differences in the timing (not the amount) of revenue recognized. The staff noted that revenues generally reflect two key properties, receipts from customers and contributions to profits, which may receive different emphasis in the two views. The staff noted that combining these views in the income statement would help to eliminate these differences. The staff asked the Board to choose a view or, if not, to state any questions they have in order to be better able to decide, so that the staff could focus on those questions in its further research.

Several Board members expressed approval for a proposed definition that is based on the broad performance view, as follows:

> Revenues are increases in the reporting entity's assets (including inflows of assets or enhancements of assets) or decreases in its liabilities resulting from activities that are integral to the provision of products (goods and services) by the entity itself that are ultimately destined for customers.

Mr. Trott supported that definition but expressed reservations about the inclusion of the word "itself" in the definition. Ms. Schipper suggested the use of terminology such as "direct performance" and "indirect performance" to capture performance by the entity itself, as opposed to performance arranged by the entity. Mr. Trott expressed the view that a reporting entity should recognize revenue for contracts in which it utilizes subcontractors but remains primarily liable, and he asked the staff to explore that issue more thoroughly. Mr. Crooch noted that the two views being considered appear to provide different answers relating to outsourcing, or subcontracting, of product sales versus outsourcing of services. Mr. Leisenring suggested that the staff choose a new term for what it now calls "subcontracting," for he believes that the tendency is to apply this term to arrangements that are not legally considered subcontracting arrangements.

Mr. Trott further expressed some concern about the recognition guidance offered in the staff's Combination Sequence 1, in which the broad performance view is used to define revenues and the liability extinguishment view is the basis for the recognition criteria. He noted that this guidance should be reordered to first focus on revenue from transactions with customers, and subsequently focus on revenue arising from production, which does not require a customer to be involved in the transaction.

Mr. Foster agreed with Mr. Trott that the broad performance view is an appropriate basis for the definition of revenues and expressed concern that the liability extinguishment view is not operational as a basis for the definition of revenues. The proposed definition based on that view is as follows:

> Revenues are decreases in the reporting entity's liabilities to customers resulting from the extinguishment of its performance obligations for which it is primarily liable. Those obligations are extinguished by providing goods and services to customers, either directly by the reporting entity itself or indirectly by having third parties provide them on its behalf.

Typically, a company is not paid until after a contract is signed and performance on the part of the reporting entity begins or is complete, in which case no liability exists to extinguish. He asked the staff to further consider revenues in the context of executory contracts. Mr. Herz and Mr. Wulff agreed, noting that the definition should focus on a company's satisfaction of its obligations, rather than the decrease in its liabilities. These Board members feel that the liability extinguishment definition, as currently worded, is too narrow and would exclude certain contracts with customers.

Ms. Schipper supported the broad performance view noting that, in some cases, having a customer does not add value. However, she cautioned the staff against the tendency to focus on too many stages of performance in contracts. [Mr. Herz and Mr. Wulff agreed.]

Mr. Wulff supported the liability extinguishment view and noted that the broad performance view seems to have more definitional issues and presents operational challenges that may be difficult to overcome. Mr. Wulff noted that recognizing revenue without a contract with a customer concerned him. [Mr. Schieneman agreed.] He also stated his belief that revenues and expenses from subcontracting are valuable pieces of information that users benefit from having in the income statement. Therefore, revenues from subcontracting should be displayed either in the income statement or through disclosure in the footnotes.

Mr. Schieneman noted his tentative preference for the liability extinguishment view, stating several factors that he would consider in making this decision: the importance of revenue to users, the need for revenue information to be objective, and the importance of revenue information's predictive value. Ms. Schipper noted that it would be difficult to operationalize the consideration of predictive value, for it would require the Board to understand what users are attempting to predict.

Mr. Herz also supported the liability extinguishment view as the basis for defining revenues. He stated that he has concerns with the operationality of a definition of revenue based on the broad performance view, as it seems to be similar to the current earnings process concept. He expressed concern with the "overdissecting" of arrangements and accelerating the recognition of revenue. He further stated that the industries that currently recognize revenue (or gains) prior to contracting with a customer might be considered exceptions to a definition based on the liability extinguishment view.

Mr. Trott stated that constituents have recently expressed confusion about the liability extinguishment view. To some, the term indicates that revenues can arise from satisfaction of a company's accounts payable or accrued loans, while the FASB's intent is to describe satisfaction of performance obligations owed by a reporting entity to its customers.

Follow-up Items:
None

General Announcements:
None