MINUTES

Financial Accounting Standards Board

To: Board Members

From: Revenue Recognition Team

Subject: Minutes of the April 23, 2004 FASB-IASB Joint Board Meeting **Date:** May 3, 2004

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

Topic: Revenue Recognition—Defining Revenues and Other Components of Comprehensive Income, Readily Marketable Commodities, Performance by Third Parties, and Nonreciprocal Transfers and Refining the Definition of Revenues

Basis for Discussion: Four memorandums dated April 9, 2004

Periods of Discussion: 11:30 a.m.–12:30 p.m. and 1:30–2:45 p.m.

Attendance:

FASB Board members present:	Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott
IASB Board members present:	Tweedie, Barth, Bruns, Cope, Gelard, Jones, Leisenring, McGregor, O'Malley, Smith, Whittington, Yamada
Board members absent:	Garnett (IASB)
Staff in charge of topic:	T. Johnson and Kawanishi (FASB), Paul (IASB)
Other staff at Board table:	Bielstein (FASB), Stevenson and Upton (IASB)
Outside participants:	None

Summary of Decisions Reached:

The Boards discussed four topics. First, the Boards discussed the distinctions between components of comprehensive income, such as revenues and gains, and the merits of such distinctions. Second, the Boards considered whether the production of readily marketable commodities gives rise to a component of comprehensive income, and whether that component is a revenue, a gain, or some other type of comprehensive income. Third, the Boards considered whether engaging a third party to perform on behalf of a reporting entity by means of subcontracting or outsourcing ultimately gives rise to revenue, and also considered related matters of display in the financial statements. Finally, the Boards discussed whether nonreciprocal transfers from other entities should be included in the definition of revenues or in a different component of comprehensive income, and the related implications of the latter conclusion for the definition of revenues.

The Boards reached the following tentative conclusions:

1. Distinctions between different components of comprehensive income, such as revenues and gains, provide useful information to investors and creditors.
2. The present distinctions between revenues and gains should be sharpened; this may require defining other components of comprehensive income.
3. Production can give rise to a component of comprehensive income.
4. A reporting entity should not recognize revenues for the performance by third parties of its obligations to deliver goods or render services to customers if those obligations are legally assumed by those third parties.
5. In all other circumstances, a reporting entity should recognize revenues for the performance by third parties of its obligations to deliver goods or render services to customers.
6. Disclosures regarding outsourcing and subcontracting activities should not be required to be made on the face of the income statement, either by disaggregating revenues or by means of a line item for expenses.
7. Nonreciprocal transfers received should not be excluded from revenues, and should be disclosed as a separate line item in income statements.

Objective of Meeting:

The objective of the meeting was to continue discussion on the conceptual definition of revenues.

Matters Discussed and Decisions Reached:

Mr. Johnson opened the discussion and noted that the issues to be considered relate to the conceptual definition of revenues. He noted further that the Boards previously have discussed issues relating to that definition. Although the Boards narrowed down the alternatives in past meetings, they did not decide specifically what the definition should be.

Mr. Johnson commented that the joint meeting affords the Boards an opportunity to consider further the remaining issues relating to that definition. Some of those issues concern what should be included in or excluded from the definition of revenues. Another issue is whether there should be one or more positive components of comprehensive income in addition to revenues, such as gains or perhaps a third type of comprehensive income.

Memorandum 1: Defining Revenues and Other Components of Comprehensive Income

Ms. Schipper noted the difficulties that various committees have encountered with defining revenues, and suggested that revenues be defined as arising from transactions with counterparties that meet the definition of a customer.

Board members discussed the various factors on which distinctions have been made in practice between revenues and gains. They noted that classification as revenues or gains often does not depend on whether the inflows of economic benefits are presented on a gross or net basis. Board members also noted that ongoing major or central operations and ordinary activities are identified subjectively and depend on entity-specific circumstances. Mr. Leisenring expressed concern that if revenues and gains are distinguished according to the frequency of occurrence of particular transactions, economically similar transactions could be classified differently.

Ms. Seidman and Mr. Leisenring argued that it is more useful to focus on defining the circumstances in which inflows and outflows of economic benefits should be presented on a net basis in income statements. Ms. Seidman suggested that defining these circumstances should be addressed in the project on Reporting Comprehensive Income.

Mr. Smith argued that inflows of economic benefits should be presented on a gross basis unless it is misleading, and that disclosure of related outflows of economic benefits should enable investors and creditors not to be misled. Mr. Bruns argued that netting inflows and outflows of economic benefits would be appropriate when investors and creditors are uninterested in margins for those particular inflows and outflows.

Members of both Boards tentatively agreed that:

1. Distinctions between components of comprehensive income, such as revenues and gains, provide useful information to investors and creditors.
2. The present distinction between revenues and gains is somewhat ambiguous and difficult to operationalize.
3. The present distinctions between different sources of comprehensive income should be sharpened; this may require defining some other type(s) of comprehensive income.

Memorandum 2: Readily Marketable Commodities

Mr. Johnson noted that in current practice, increases in assets from the production of certain readily marketable commodities are recognized as revenues or gains. This is despite the commodities not having been sold or contracted to be sold.

Members of both Boards tentatively agreed that recognized increases in assets resulting from production give rise to a component of comprehensive income. However, they noted that *when such increases in assets should be recognized,* and *whether they should be classified as revenues,* are separate issues.

Ms. Schipper noted that the exceptions in Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* to the principle that customer contracts are a prerequisite for revenues apply when cost is difficult to measure reliably and the selling effort involved is negligible. She observed it would be difficult to avoid ambiguity regarding which production activities would qualify for revenue recognition absent a customer contract.

Messrs. Batavick and Schieneman agreed with Ms. Schipper, and argued that inventory valuation should not give rise to revenues. They noted that recognizing revenues for the production of readily marketable commodities for which little or no selling effort is required could involve recognizing revenues for the production of crude oil, and argued that this would be inappropriate. Mr. Tweedie observed that when an entity sells and delivers its products, it removes its inventory risk, which is important for revenue recognition.

Ms. Barth observed that the memorandums for this meeting propose defining customers as purchasers of the entity's products, and argued that the entity's products are the source of revenues. She argued further that the most useful information for investors and creditors is the *production* of an entity's products and not their sale. Ms. Barth argued that waiting until a sale to a customer occurs implies applying a realization concept. Mr. Stevenson argued that in a fair value model, changes in fair value are more important than exchanges of assets for cash or receivables.

Mr. Leisenring commented that he likes a customer requirement for the existence of revenues. However, if an entity is marking its commodities to market, it needs to do so right up to the point of sale, in which case its revenues and related expenses for goods sold will be equal.

Messrs. Whittington and Bruns proposed to distinguish sales revenues from other revenues, such as gains on assets. Mr. Bruns argued that revenues and expenses should be recognized for the inflows and outflows of economic benefits resulting from production.

Mr. Trott asked the staff to identify what causes inventories to be marked to fair value absent a customer.

Mr. Johnson noted that a reason for undertaking this project is the existence of a mixture of practices regarding the point at which revenue is recognized. Grossing up occurs because information about margins is important to investors and creditors. It enables them to identify which entities are the low cost producers in an industry. He noted it is useful for investors and creditors to be able to distinguish between an entity's production efficiency and its speculative activities (the holding of readily marketable commodities). Mr. Leisenring emphasized that Concepts Statement No. 6, *Elements of Financial Statements,* states that revenues arise from producing certain goods, and, therefore, the staff memorandum is not introducing a new concept.

Mr. Leisenring asked the staff to consider whether the unique aspect of the model in IAS 41, *Agriculture,* for the recognition of revenues or gains from changes in the value of biological assets is that there is only one market for those assets—that is, the model does not involve "jumping markets."

Board members discussed, without reaching agreement, whether it is inappropriate to "double count" revenues and gains when revenues are recognized for the selling price of assets that have been marked to market. Ms. Barth, Ms. O'Malley, and Messrs. McGregor and Upton argued that revenues from selling such assets should be limited to the value added by the entity's selling effort. Mr. Whittington argued that realization matters, and, therefore, the gross value of sales, should be recognized as revenues. Ms. O'Malley noted that requiring cash flow statements to be presented using the direct method would provide information to investors and creditors about realization. Mr. Whittington responded that cash flows do not always coincide with sales. Mr. Paul suggested that this timing difference could be addressed by requiring note disclosure of the amount of sales for the period.

Ms. Seidman proposed a phased approach for addressing the treatment of production income. She proposed that recognition of production income as revenues under existing GAAP should be quarantined and continue to be permitted, while recognition of revenues from other types of production should be prohibited.

Mr. Johnson summarized that Board members identified two separate topics requiring further analysis:

1. How production income should be labeled. The tentative leaning of most Board members seems to be that income arising from production should be recognized under certain conditions and treated as revenues but distinguished from sales revenues.
2. Criteria for when inflows and outflows of economic benefits should be presented on a gross or net basis.

Memorandum 3: Performance by Third Parties

Mr. Kawanishi noted that the memorandum addresses whether the performance by third parties of activities on behalf of the reporting entity gives rise to revenues for the reporting entity. Such performance can take the form of subcontracting (with or without "legal layoff") or outsourcing. Subcontracting occurs only when third parties perform activities that the reporting entity has contracted with a customer to perform. Outsourcing occurs when procurement occurs without a customer contract, as occurs with normal purchases of raw materials.

Mr. Kawanishi noted that at its December 18, 2002 meeting, the FASB tentatively decided that a reporting entity should not recognize revenues for the performance by third parties of its obligations to deliver goods or render services to customers if those obligations are legally assumed by those third parties. He also noted that the IASB tentatively decided the same policy at its meeting on April 21, 2004.

Members of both Boards tentatively agreed that in all other circumstances, performance by third parties of activities on behalf of the reporting entity does give rise to revenues for the reporting entity. The primary focus of discussion was on whether and, if so, how information about outsourcing and subcontracting should be provided in the income statement.

Board members discussed whether outsourcing and subcontracting could or should be distinguished from each other. Messrs. Bruns and Leisenring commented that the distinction was unclear to them. Mr. Upton commented that it would be inappropriate for the presentation of revenues and expenses in income statements to depend on whether the reporting entity uses a just-in-time inventory management system. Members of both Boards generally agreed that entities should not be required to distinguish the effects of outsourcing and subcontracting from each other in income statements.

Mr. Whittington questioned whether information about outsourcing and subcontracting is useful to investors and creditors. He argued that there is no substantive difference between using contractors and employees to provide services to customers.

Members of both Boards tentatively agreed that because the performance by third parties of a reporting entity's obligations to deliver goods or render services to customers does not give rise to revenues for the reporting entity if those obligations are legally assumed by those third parties, amounts originally contracted for with customers and legally laid off to subcontractors should not be reported in income statements. They agreed that the margin between the prices agreed to by the reporting entity with its customer and with its subcontractor in a legal layoff would be recognized as revenues by no later than when the layoff occurs.

Board members discussed, without reaching agreement, whether an entity would be able to determine the fair value of all of the goods and services the provision of which is subcontracted or outsourced to other parties (and, therefore, the margin on those activities). Members of both Boards tentatively agreed that separate disclosure of revenues relating to outsourcing or subcontracting activities should not be required.

Mr. Johnson observed that the real issue raised by the memorandum is whether a line item for expenses for outsourcing and subcontracting activities should be required on the face of the income statement. Members of both Boards generally agreed that such a disclosure should not be required. In addition, they agreed that the disclosure of expenses is outside the scope of this project.

Memorandum 4: Nonreciprocal Transfers and Refining the Definition of Revenues

Mr. Paul noted that the memorandum addresses whether nonreciprocal transfers received, other than investments by owners, should be classified as revenues or in a different component of comprehensive income, and the related implications of the latter conclusion for the definition of revenues.

Ms. Schipper stated she disagrees with the proposed definition of a "nonreciprocal transfer received" (namely, "a transaction in which an entity receives an asset or cancellation of liabilities without directly giving value in exchange"). She observed that fund-raising activities often involve transactions in which the contributors receive some value in exchange but that value is less than the fair value of the contributed assets and might not be reliably measurable.

Mr. Leisenring argued that sometimes the fair value of the reciprocal and nonreciprocal components of transactions involving contributions can be identified. However, he does not regard the distinction between exchange transactions and nonreciprocal transfers to be useful to investors and creditors.

Ms. O'Malley noted that it can be difficult to apply the concept of *directly* giving value in exchange because in transactions involving more than two parties, different interpretations can be made of which parties are the recipient(s) of economic benefits.

Ms. Schipper observed that donations made to an educational institution are made in connection with the institution's production of goods and services, but the students are not customers of the institution. She argued that nonreciprocal transfers such as contributions should not be excluded from revenues.

The Boards tentatively decided that nonreciprocal transfers received should not be excluded from revenues and should be disclosed as a separate line item in income statements.

Follow-up Items:

The staffs were requested to undertake further analysis of:

1. How income arising from production should be labeled and the implications of that label for the treatment of nonreciprocal transfers received.
2. Criteria for when inflows and outflows of economic benefits should be presented on a gross or net basis.

General Announcements:

None.