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To the Board

**Discussion Paper: Preliminary Views on Revenue Recognition in Contracts with Customers**

I support the need for developing more robust criteria for recognising revenue and I support the underlying concept of recognising revenue on the basis of the performance obligation component of contracts with customers.

However, I disagree with the emphasis in chapter 3 on the transfer of assets. While I agree with the discussion in chapter 4 on the guidelines for assessing performance completion, I disagree with emphasis. In chapter 5 and in the examples, the concept of 'net contract' is not as clear as it could be.

In this submission I:

1. Discuss the definition of performance obligation.
2. Re-order the hierarchy of criteria for establishing when performance obligations have been satisfied (i.e. when revenue is recognised).
3. Comment on the use of the term "net contract" in the DP.
4. Discuss the measurement of performance obligations under a contract accounting approach.

Sincerely

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## 1. The definition of performance obligation

I disagree with the definition of performance obligation in 3.2. My preference is:

An entity's performance obligation is a promise in a contract with a customer to transfer assets or provide service to that customer.

The scope should be widened from the transfer of goods to the transfer of assets. The performance obligation might include something other than goods, the transfer of an intangible or a financial asset (e.g., "cash back").

Paragraphs 3.18 to 3.20 require the entity to see whether the customer has acquired control of an asset to decide if the entity satisfies a performance obligation. While the receipt of a performance obligation might be viewed as a momentary asset by the customer (par 3.8 to 3.17), this is a very artificial concept. There are a number of weaknesses with this approach.

First, how the customer accounts for the receipt of goods or services is independent of the entity that has to account for the performance obligation.

Second, the concept of "transferring performance obligation that is a momentary asset of the customer" is unnecessary to provide support for the use of control rather than a risk and rewards approach. (If, indeed, this was the purpose of including this concept to define performance obligation).

Third, if the concept of "transferring performance obligation that is a momentary asset of the customer" was deleted, it would not reduce the substantive meaning behind performance obligation that relates to the delivery of assets or the provision of services. For example, paragraphs 4.2, 4.7, 4.40, 4.48, 5.20, 5.28, refer to the transfers of goods and services and not the transfer of an asset. These paragraphs, and others in the DP that do not use the phrase, demonstrate that the understanding and use of the term performance obligation does not require this concept.

Fourth, the way the concept is used in the DP is confusing. The full phrase is: "transferring performance obligation that is a momentary asset of the customer". In the DP this often gets shortened to the "transfer of an asset" (e.g., paragraph 4.41). However it also gets shortened to "is an asset". For example, paragraph A20 states:

Manufacturer's promises to transfer equipment and to transfer warranty coverage are performance obligations because the promised equipment and warranty coverage are assets.

One of the gauges I use to test clarity of standards is to describe the standard to a class of third year accounting students, of which a significant proportion has English as a second language. Having already taught warranty services as a liability it would be confusing to call this an asset for revenue recognition. It would be confusing and wrong.

Fourth, using the concept of "transferring performance obligation that is a momentary asset of the customer" to define a liability has more fundamental consequences that goes beyond the revenue recognition. Taking the argument to its logical conclusion, it means there will be no need for a definition of liability – the entity will just have to figure out whether somebody else has control of an asset! It is possible that the

definition of liability is faulty, but my preference would be to use the definition of a liability to find out whether the entity has an obligation rather than employ an asset definition.

*In conclusion:*

The notion of a “transferring performance obligation that is a momentary asset of the customer” is a fictional concept which should be deleted. At best it is confusing and at worst it is wrong.

## **2. The hierarchy of criteria or establishing when performance obligations have been satisfied (i.e. when revenue is recognised).**

Chapter 4 is crucial in the DP because it adds the guidance around satisfying the performance obligation. I like most of the features (criteria) in chapter 4 but I think the DP, in using the asset transfer approach, establishes the wrong emphasis.

Here is my attempt to (re)order the hierarchy on revenue recognition guidance, which is based on accounting for the contract.

### Definitions:

An entity's performance obligation is a promise in a contract with a customer to transfer assets or provide services to that customer.

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

### Recognition Criterion:

The entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset or provides a promised service to the customer.

### Recognition Guidance:

The primary reference to whether an asset has been transferred or a service provided to a customer is made by reference to the terms of the customer contract or the operation of law.

### Recognition Guidelines:

For assets, customer acceptance will normally be when control of the asset passes to the customer.

Similarly, to determine when a service is transferred to a customer, an entity assesses whether the customer has received the promised service.

For services, it can be particularly difficult to for an entity to determine whether the customer receives the service over the life of the contract or at the end of the contract. However it is the contract details or the operation of law that defines the entity's rights to receive compensation for partly completed services that determine whether these have been "transferred" to the customer.

*(Paragraph 4.34 is unsatisfactory because it emphasises "customer payment terms". While the "customer payment terms" are negotiated outcomes that form part of the contract they may bear no relation to the performance obligation. What is relevant, are the rights and obligations in the contract or the operation of law for compensation for performance.)*

*(Paragraph 4.43 is unsatisfactory because it emphasises "customers rights to take over the work in progress". I understand the parallel between this criterion and control, but this is only relevant if the entity has the right to compensation).*

In contracts that combine delivery of assets with a service there can be difficulty in determining the when the asset is transferred when it is used in satisfying a service performance obligation or at the end of the contract. In this case a rebuttable presumption is used:

An asset that is used in satisfying another (service) performance obligation of a contract is transferred to a customer when the asset is used in satisfying the other performance obligation.

This presumption would be rebutted if the terms of the contract or operation of law indicate the asset has been transferred to the customer at any other stage of the life of the contract.

*(The advantage of this rebuttable presumption is that it rebutted by the main principle. Note I have rephrased the rebuttal (in 4.56) so that it is not negative – i.e. it says when revenue is recognised not when it is not recognised. Hence, it appears less rules based. Furthermore, I have been less specific than 5.47 which only specifies “before”. If we follow the contract it could be before or after or at any other milestone in between.)*

The following are not to be used as guidance for the recognition criterion:

- Risks and rewards.

*(One advantage of risks and rewards over control is that it applies to both goods and services. But trying to shoehorn everything in a control criterion is not the answer. Focusing on satisfaction of the performance obligation is a significantly better approach).*

- Activities of the entity. It is the transfer of promised assets or the provision of services and not the *activities* of the entity in producing the assets or services that determine when the performance obligation has been satisfied.
- Customer payment terms, the billing of customers or the cash received from customers may bear no resemblance to the performance obligations required under the contract.
- Customer intent. Customer intent is not an appropriate basis for deciding when the performance obligation has been accepted by the customer.

### 3. The concept of a net contract position

First, the definition of contract in paragraph 2.11 is narrow. The following definition is preferable:

A contract is an agreement between two or more parties that creates enforceable rights and obligations.

In some instances, the DP uses the term “net contract” position incorrectly. In accounting, the term “net” usually means the offsetting of debit and credit items. A contract with a customer may be depicted as follows:

Customer contract {performance obligations, rights}

It follows that a net contract position is the difference between the obligations and the rights in the contract. The net position will change as the rights and obligations under the contract change. This consistent with paragraph 2.30 in the DP, which states:

“...when a customer performs by paying, the entity’s net position in the contact decreases...”

However, this is not how “net contact” is used in other places in the DP. Consider Example 1: Multiple-element arrangement.

The net contract position reported in Example 1 is CU1,875. This amount reflects the future performance the entity has to achieve to earn the remaining revenue under the contract. It is not really the net amount of anything (except perhaps the stand alone selling price less the allocation of discount). It is certainly not the net amount “realised” under the contract, because this will depend on how much cash has been received by the entity from the customer.

#### **4. The measurement of performance obligations under a contract accounting approach.**

As noted in the section 3, the DP uses the term “net contract” in different ways. This is symptomatic of not having a clear view of the underlying concepts. In this section of my submission I outline two views of contract accounting and illustrate the consequences.

A contract with a customer may be depicted as follows:

Customer contract {performance obligations, rights }

That is, a customer contract is a bundle of rights and obligations. The contract has a value which is equal to the expected margin. There are, at least, two possible ways of accounting for this contract.

##### *Method One: The net contract approach*

One approach would be to account for the whole contract. This would require estimating the future performance obligation and the future rights (either at present value or on an undiscounted basis). This method would allow day one gains and losses; being the difference between the estimate of the future performance obligations and the future rights.

The best analogy of this method of accounting is a forward exchange contract. At initiation the contract has zero value (excluding transaction costs). As exchange rates move the contract has a net value. However, there is no need to account for the underlying rights and obligations of the contract. Rather the whole of the (net) contract is accounted for at fair value.

##### *Method Two: The contract components approach*

A second approach would be to account for the underlying components (the underlying rights and obligations) of the contract.

The approach under the DP is for the entity to recognise revenue as each performance obligation under the contract is met. At contract inception (and it may only be a microsecond) the contract is executory (equally unperformed). Then as the obligations under the contract are satisfied the rights to revenue under the contract are receivable.

A performance obligation is not a financial obligation, it is an obligation to perform. The performance obligation is never recognized as a liability at the inception, or at any other stage, of the contract. Hence, there is no need to estimate the value or cost of future performance obligations (unless onerous contracts are considered).

For a simple cash/credit exchange the entity hands over goods (performs the obligation) and only then can it recognise the rights under the contract (usually the right to cash). The following example illustrates method two with a more complex customer contract.

## **Example – Contract Components Approach**

### **Fact pattern**

Consider four manufacturers of an identical wig. BitbyBit Limited has the more complex customer contract and will be described first.

When BitbyBit “makes a sale” the details of the customer contract are as follows. No deposit is required on order. The month before construction can start BitbyBit informs the customer, who is then required to pay a deposit of CU30. On receipt of the deposit, BitbyBit allocates materials to the order (which become the property of the customer). BitbyBit also guarantees to complete production within two months of the deposit. When production is complete the customer is informed and is required to pay a further CU80, at which time the wig becomes the property of the customer. On receipt of the second payment, BitbyBit guarantees to deliver and install the wig within one month. At this stage the customer is billed the final amount (CU10) and given one months credit.

UpFront Limited sells an identical wig to BitbyBit but requires CU120 cash when the wig is ordered. On the other hand, BackEnd Limited invoices (one month credit terms) CU130 after the wig has been installed. In both cases the wig becomes property of the customer once it has been installed.

In all the above cases the entity has an enforceable right under the contract to seek compensation from the customer for work done at any stage. Hence, satisfaction of the performance obligation occurs as work on the contract occurs.

OwnStock Limited has identical contract arrangements to BackEnd Limited, with the exception that the OwnStock does not have the right to compensation for work done. That is, Ownstock’s only right to compensation is when the wig is delivered and installed. This case is equivalent to Ownstock Limited manufacturing a wig for its own inventory.

The costs involved in performing the contract are as follows. The materials cost CU20, the manufacturing costs are CU35 in the first month of manufacture and CU30 in the second month. Delivery and installation costs are CU15. The costs are the same for each company.

Alternatively, this example can also be viewed as four different selling plans by the same company. Further assume, that each company reports monthly. Alternatively if the time interval is considered to be a year the example represents a long term construction contract.



### The Accounting

BitbyBit has to allocate the transaction price across the assets transferred and the services provided. If the same margin is earned across all activities then the transaction price can be allocated as follows:

<i>Month</i>		<i>Cost</i>	<i>Contract Revenue<sup>1</sup></i>
		<i>CU</i>	<i>CU</i>
1	Materials allocated	20	24
2	Work in progress	35	42
3	Production complete	30	36
4	Delivery and installation	15	18
	Total	100	120

<sup>1</sup>As the same margin is earned on all performance activities each item of cost is adjusted by 120/100 to arrive at the revenue per activity

Of course if each performance activity has its own margin then the allocation of the contract price of CU120 would be based upon the stand alone price and margin for each activity. At the end of each month the contract revenue is recognized and the contract account is debited. Billings or cash deposits are credited to the contract account.

The same accounting is undertaken by UpFront and BackEnd, although the determination of contract revenue is based on contract price for each contract. For Ownstock the traditional accounting for manufacturing is followed. That is, costs are accumulated within work in progress, transferred to finished goods inventory when production is complete, and transferred to cost of goods sold on sale.

The month by month statements of financial performance and position are provided in Appendix A and the journal entries are reported in Appendix B.

### Discussion

This example raises a number of features that are worth highlighting.

- First, the results in the statements of financial performance are similar for BitbyBit, FrontEnd and Backend. In fact, if the same contract price was used then these three cases would have identical profit in each period. This is to be expected as satisfying the performance obligation is the same for each entity.
- Second, the cash received and invoicing *per se* are irrelevant to the recognition of revenue. Cash is received at the beginning for Upfront Limited and the end for BackEnd Limited. To be sure, cash and invoicing have a balance sheet affect as they impact the net amount of the contract, but no impact on net profit.
- Third, the activity by the entity *per se* is also irrelevant to the recognition of revenue. Ownstock has an identical manufacturing process but the recognition of revenue is very different.
- Fourth, it is the rights and obligations under the contract or the operation of law that are relevant to the recognition of revenue. In particular it is the

satisfaction of performance obligations that creates revenue. This occurs at several points during the contract:

- The raw materials become assets of the customer when they are allocated to the contract.
- During the manufacturing process, the reporting entity has the right to claim for work that has been completed on the contract. Hence revenue would be recognised for each month for the amount of work added to the contract. Presumably if the entity went into receivership the customer has the right to enforce completion of the work or could take the work in progress. However, this is irrelevant. Whether the entity is entitled to compensation for satisfying the performance obligation is the criterion for revenue recognition.
- Deliver and installation triggers another milestone in the satisfaction of a performance obligation.

The “contract” amount reported in the statement of financial performance is the net amount of the revenue recognised arising from satisfaction of the performance obligation and any cash deposits or amounts billed under the contract. This raises two further issues. First, is the net amount of the contract reported in the statement of financial position consistent with the definition and recognition criteria of asset or liability under the *Framework*? Second, should it be reported net?

Some might view the contract components approach as unsatisfactory because it appears to be an “income statement” approach, rather than a “balance sheet” approach. For example, the method focuses on the recognition of revenue with the balance sheet being a residual. However, this argument is less sustainable if it can be shown that the balance sheet amounts represent assets and liabilities under the *Framework*.

Under the contract components approach the balance sheet “contract” account comprises the net difference between cash received or amounts invoiced and the revenue recognised. Consider these two components separately.

### **Cash in advance**

The problem in the DP is that it considers the “contract revenue in advance” as part of the performance obligation. It then has to decide then how to measure the credit balance - at either the original contract amount or the current exit price.

Perhaps a better way of thinking about the credit side of the cash received is that it relates to rights component of the contract and not the performance obligation. It is a non-performance liability (it might be a financial obligation). But it relates to the rights received under the contract and is not a performance obligation and does not determine the recognition of revenue.

The cash received could indicate: (1) that (part) performance of the contract has been accepted by customer, (2) it is act by the customer (possibly random or under the contract as a measure of “good faith”) that does not relate to the satisfaction of the obligation, or (3) a payment in accordance with terms of the contract.

Under (1) revenue is earned because the performance obligation has been satisfied and therefore no liability arises. If (2), then it is unrelated to the performance obligation and hence no revenue arises. If (3) then it relates to the rights not the performance obligation and therefore the issue of measuring the performance obligation does not exist.<sup>1</sup>

The payment in advance that is random or at least not related to a performance obligation creates a new obligation. This obligation can simply be measured at the cash amount received. The balance sheet description “contract revenue received in advance” faithfully represents the underlying balance sheet item.

A fundamental question is does this obligation meet the definition of a liability. Clearly it does if the customer can demand the cash back – then it is a financial liability. If the customer can only demand performance but not a cash refund then this is still a liability relating to the right but it is not the performance obligation.<sup>2</sup>

### **Revenue previously recognised**

The second component of the contract account in the balance sheet re the amounts previously recognised as revenue under the contract.

The fundamental issue is whether this component is an expense or an asset? It arises from a past event. It has future benefits that are expected to flow to the entity. This is part of the contract that has been completed and therefore does not have to be incurred in the future. Is it controlled? This does not fit neatly with the existing definition. However, it could be argued that the costs have been incurred under the control of the entity. Certainly no one else controls them. In terms of recognition, the future benefits arise through the contract. For measurement, cost rather than value would seem appropriate. In any event, value would represent the amounts of revenue recognisable at balance date.

### **Net or Gross**

Should the amounts in the contract account be reported net? This is simply a judgement call. It can be argued that if the contract (or portfolio of contract) is the unit of account the net amount is a faithful representation of the underlying contract. Whether separate disclosure of the gross amounts is necessary is another judgment call,

### **Onerous Contracts**

Under method one, if fair value is used then the concept of an onerous concept does not apply.

Under method two, a performance obligation has to be satisfied before revenue is recognized. Revenue received in advance is recorded as a liability. The performance obligation is not measured on contract initiation nor is it re-measured during the life of the contract. The contract obligation is simply performed. Revenue on the contract arises as performance is satisfied.

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<sup>1</sup> At this stage ignore any onerous obligation.

<sup>2</sup> This may seem like a strange type of liability. But it is no different to (in fact it is the mirror image of) a pre-payment which is neither a tangible, financial, or intangible asset.

Method two recognises gains and losses as they arise, but does not measure future losses. If accounting for onerous contracts (future losses) is considered necessary to provide decision useful information then onerous contract accounting must be overlaid on method two.

To consider onerous contracts would require estimation of the revenue from future rights under the contract and the estimate of future costs to meet performance. Only in the case where estimated future costs exceed estimated future revenue is recognition allowed.

This is a non-neutral approach that requires a future loss on a contract to be recognized but not a future profit. On the other hand if both estimates of future gains and losses are recognized then this will result in method one accounting. Day one gains or losses are created and recognition arises at contract inception not satisfaction of performance obligation.

### **Summary**

The DP does not clearly articulate the two views of contract accounting. It uses the term “net contract” in a variety of ways. In my view the term “net contract” best describes method one. That is, the net contract represents the future performance obligation and rights under the contract.

While many of the principles and guidance in the DP relate to method two, this is not a net contract approach. It uses the rights and obligations within the contract. Method two results in a net contract position in the balance sheet. The asset component of revenue earned to date representing performance obligations that do no longer have to be performed under the contract. The liability component is the cash received. However, there is no necessity for this asset and liability to be reported net, although this seems a reasonable representation of the underlying contract.

**APPENDIX A**

<b>BitbyBit Limited</b>	0	1	2	3	4	5
<b>Financial Performance</b>						
Revenue		24.0	42.0	36.0	18.0	
Expenses		20.0	35.0	30.0	15.0	
Profit		4.0	7.0	6.0	3.0	0.0
<b>Financial Position</b>						
Bank		10.0	(25.0)	25.0	10.0	20.0
Accounts receivable					10.0	
Contract		(6.0)	36.0	(8.0)		
		4.0	11.0	17.0	20.0	20.0
Retained Earnings		4.0	11.0	17.0	20.0	20.0
<b>UpFront Limited</b>						
<b>Financial Performance</b>						
Revenue		23.0	40.2	34.5	17.3	
Expenses		20.0	35.0	30.0	15.0	
Profit	0.0	3.0	5.2	4.5	2.3	0.0
<b>Financial Position</b>						
Bank	115.0	95.0	60.0	30.0	15.0	15.0
Contract	(115.0)	(92.0)	(51.8)	(17.3)		
	0.0	3.0	8.2	12.7	15.0	15.0
Retained Earnings	0.0	3.0	8.2	12.7	15.0	15.0
<b>BackEnd Limited</b>						
<b>Financial Performance</b>						
Revenue		26.0	45.5	39.0	19.5	
Expenses		20.0	35.0	30.0	15.0	
Profit		6.0	10.5	9.0	4.5	0.0
<b>Financial Position</b>						
Bank		(20.0)	(55.0)	(85.0)	(100.0)	30.0
Accounts receivable				110.5	130.0	
Contract		26.0	71.5			
		6.0	16.5	25.5	30.0	30.0
Retained Earnings		6.0	16.5	25.5	30.0	30.0
<b>Ownstock Limited</b>						
<b>Financial Performance</b>						
Revenue					130.0	
Expenses					100.0	
Profit		0.0	0.0	0.0	30.0	0.0
<b>Financial Position</b>						
Bank		(20.0)	(55.0)	(85.0)	(100.0)	30.0
Accounts receivable					130.0	
Work in progress		20.0	55.0	85.0		
		0.0	0.0	0.0	30.0	30.0
Retained Earnings		0.0	0.0	0.0	30.0	30.0

**APPENDIX B**

<i>Month</i>	<b>BitbyBit Limited</b>	<i>DR(CR)</i>
0	no entry <b>contact initiation</b>	
1	Bank Contract	30.0 (30.0)
	Contract Revenue	24.0 (24.0)
	Materials Bank	20.0 (20.0)
	<b>materials allocated</b>	
2	Wages and supplies Bank	35.0 (35.0)
	Contract Revenue	42.0 (42.0)
	<b>work in progress</b>	
3	Wages and supplies Bank	30.0 (30.0)
	Contract Revenue	36.0 (36.0)
	Bank Contract	80.0 (80.0)
	<b>production completed</b>	
4	Wages and supplies Bank	15.0 (15.0)
	Contract Revenue	18.0 (18.0)
	Accounts receivable Contract	10.0 (10.0)
	<b>delivery &amp; installation</b>	
5	Bank Accounts receivable	10.0 (10.0)
	<b>final balance</b>	

<i>Month</i>	<b>UpFront Limited</b>	<i>DR(CR)</i>
0	Bank	115.0
	Contract	(115.0)
	<b>Contract initiation</b>	
<hr/>		
1	Contract	23.0
	Revenue	(23.0)
	Materials	20.0
	Bank	(20.0)
	<b>materials allocated</b>	
<hr/>		
2	Wages and supplies	35.0
	Bank	(35.0)
	Contract	40.3
	Revenue	(40.3)
	<b>work in progress</b>	
<hr/>		
3	Wages and supplies	30.0
	Bank	(30.0)
	Contract	34.5
	Revenue	(34.5)
	<b>production completed</b>	
<hr/>		
4	Wages and supplies	15.0
	Bank	(15.0)
	Contract	17.3
	Revenue	(17.3)
	<b>delivery &amp; installation</b>	
<hr/>		
5	No entry	
	<b>final balance</b>	
<hr/>		

<i>Month</i>	<b>Backend Limited</b>	<i>DR(CR)</i>
0	no entry <b>contract initiation</b>	
1	Contract Revenue	26.0 (26.0)
	Materials Bank	20.0 (20.0)
	<b>materials allocated</b>	
2	Wages and supplies Bank	35.0 (35.0)
	Contract Revenue	45.5 (45.5)
	<b>work in progress</b>	
3	Wages and supplies Bank	30.0 (30.0)
	Contract Revenue	39.0 (39.0)
	<b>production completed</b>	
4	Wages and supplies Bank	15.0 (15.0)
	Contract Revenue	19.5 (19.5)
	Accounts receivable Contract	130.0 (130.0)
	<b>delivery &amp; installation</b>	
5	Bank Accounts receivable	130.0 (130.0)
	<b>final balance</b>	
<i>Month</i>	<b>Ownstock Limited</b>	<i>DR(CR)</i>
0	no entry <b>contract initiation</b>	
1	Work in progress Bank	20.0 (20.0)
	<b>materials allocated</b>	
2	Wages and supplies Bank	35.0 (35.0)



	WIP	35.0
	Wages and supplies	(35.0)
	<b>work in progress</b>	
<hr/>		
3	Wages and supplies	30.0
	Bank	(30.0)
	Work in progress	30.0
	Wages and supplies	(30.0)
	<b>production completed</b>	
<hr/>		
4	Wages and supplies	15.0
	Bank	(15.0)
	Work in progress	15.0
	Wages and salaries	(15.0)
	Inventory	100.0
	Work in progress	(100.0)
	Accounts receivable	130.0
	Revenue	(130.0)
	Cost of goods sold	100.0
	Inventory	(100.0)
	<b>delivery &amp; installation</b>	
<hr/>		
5	Bank	130.0
	Accounts receivable	(130.0)
	<b>final balance</b>	
<hr/>		