Reconsidering Revenue Recognition  
November 30-December 1, 2007

**Primary Reading Materials**

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MEMO #1: SAB 104
SECURITIES AND EXCHANGE COMMISSION Corrected Copy
17 CFR Part 211
[Release No. SAB 104]
Staff Accounting Bulletin No. 104
AGENCY: Securities and Exchange Commission.
ACTION: Publication of Staff Accounting Bulletin.
SUMMARY: This staff accounting bulletin revises or rescinds portions of the interpretative
guidance included in Topic 13 of the codification of staff accounting bulletins in order to
make this interpretive guidance consistent with current authoritative accounting and auditing
guidance and SEC rules and regulations. The principal revisions relate to the rescission of
material no longer necessary because of private sector developments in U.S. generally
accepted accounting principles.
This staff accounting bulletin also rescinds the Revenue Recognition in Financial Statements
Selected portions of that document have been incorporated into Topic 13.
DATE: December 17, 2003

Pages 9-11

Topic 13: REVENUE RECOGNITION

A. Selected Revenue Recognition Issues
1. Revenue recognition - general
The accounting literature on revenue recognition includes both broad conceptual discussions
as well as certain industry-specific guidance. If a transaction is within the scope of specific
authoritative literature that provides revenue recognition guidance, that literature should be
applied. However, in the absence of authoritative literature addressing a specific arrangement
or a specific industry, the staff will consider the existing authoritative accounting standards as
well as the broad revenue recognition criteria specified in the FASB's conceptual framework
that contain basic guidelines for revenue recognition.
Based on these guidelines, revenue should not be recognized until it is realized or realizable
and earned. Concepts Statement 5, paragraph 83(b) states that "an entity's
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1 The February 1999 AICPA publication "Audit Issues in Revenue Recognition" provides an overview of
the authoritative accounting literature and auditing procedures for revenue recognition and identifies
indicators of improper revenue recognition.

2 Concepts Statement 5, paragraphs 83-84; ARB 43, Chapter 1A, paragraph 1; Opinion 10, paragraph 12.
The citations provided herein are not intended to present the complete population of citations where a
particular criterion is relevant. Rather, the citations are intended to provide the reader with additional
reference material.
revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues" [footnote reference omitted]. Paragraph 84(a) continues "the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery)" [footnote reference omitted]. In addition, paragraph 84(d) states that "If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes."

The staff believes that revenue generally is realized or realizable and earned when all of the following criteria are met:

- Persuasive evidence of an arrangement exists,

\footnote{Concepts Statement 2, paragraph 63 states "Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent." The staff believes that evidence of an exchange arrangement must exist to determine if the accounting treatment represents faithfully the transaction. See also SOP 97-2, paragraph 8. The use of the term "arrangement" in this SAB Topic is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.}
• Delivery has occurred or services have been rendered,  

• The seller's price to the buyer is fixed or determinable, and  

• Collectibility is reasonably assured.

Some revenue arrangements contain multiple revenue-generating activities. The staff believes that the determination of the units of accounting within an arrangement should be made prior to the application of the guidance in this SAB Topic by reference to the applicable accounting literature.

4 Concepts Statement 5, paragraph 84(a), (b), and (d). Revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.

5 Concepts Statement 5, paragraph 83(a); Statement 48, paragraph 6(a); SOP 97-2, paragraph 8. SOP 97-2 defines a "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties." Paragraphs 26-33 of SOP 97-2 discuss how to apply the fixed or determinable fee criterion in software transactions. The staff believes that the guidance in paragraphs 26 and 30-33 is appropriate for other sales transactions where authoritative guidance does not otherwise exist. The staff notes that paragraphs 27 through 29 specifically consider software transactions, however, the staff believes that guidance should be considered in other sales transactions in which the risk of technological obsolescence is high.

6 ARB 43, Chapter 1A, paragraph 1 and Opinion 10, paragraph 12. See also Concepts Statement 5, paragraph 84(g) and SOP 97-2, paragraph 8.

7 See EITF Issue 00-21 paragraph 4 for additional discussion.
MEMO #2 REVENUE RECOGNITION: AN ASSET AND LIABILITY APPROACH

Purpose of this memo

1. This memo describes why the Boards decided not to pursue a revenue recognition model based on notions of realization and an earnings process. It also describes why the Boards have instead pursued a model based on changes in assets and liabilities. Finally, this memo explains the Boards’ initial effort to define revenue in terms of one specific asset or liability—an entity’s contract with a customer.1

Introduction

2. From their first childhood visit to the corner shop, people learn that buying chocolate requires handing over cash to a shopkeeper. Most people thereafter consider revenue to be the amount of cash the shopkeeper receives for giving chocolate to the customer, and this child-like view serves most transactions well. Indeed, any model of revenue recognition that altered this outcome for such simple transactions would be suspect.

3. Unfortunately, this child-like view is easily confused by situations in which a customer pays cash at a time different from when goods or services are received or in which an entity provides multiple goods or services over extended periods of time. To deal with these common complicating factors, the accounting profession has employed a model in which revenue is recognized when payment or promise of payment is received from a customer and the goods or services promised by the

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1 Throughout this memo, the word contract is used to represent an enforceable arrangement between two parties. Although the definition of contract, the mechanisms of enforcement, and the operation of law will vary across jurisdictions, the word contract is simply meant to capture the enforceable terms to which the two parties have agreed (implicitly or explicitly).
entity have been provided. That is, revenue is recognized when payment is realized or realizable and the earnings process is complete, as described in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* and, to a lesser extent, in the IASB *Framework for the Preparation and Presentation of Financial Statements*.

**What Is Wrong with the Earnings Process Model?**

4. As simple as this model appears, its application has led to more than 200 pieces of guidance on revenue and gain recognition in the United States alone, much of which is industry-specific and often conflicting. This is largely because the notion of an earnings process is not defined precisely anywhere in the literature, and people often disagree on what the earnings process is in particular situations.

5. For example, consider a cable TV provider. Does its earnings process involve *only* the provision of a cable signal to the customer over the subscription period? Or does the process of hooking the customer up to the cable TV network represent its own separate earnings process? Some argue that the earnings process cannot begin until the customer starts to receive the service for which it contracted—the actual cable signal. Others argue that in contracting for the cable service, the customer implicitly contracts for the hookup, which represents a separate earnings process. With no clear definition of what an earnings process is, the FASB decided in Statement No. 51, *Financial Reporting by Cable Television Companies*, to treat cable TV hookup services as a separate earnings process and to recognize revenue to the extent of direct selling costs incurred by the provider.

6. In contrast to the cable TV provider, consider an exercise gym that gives its members access to hundreds of sites across the country in exchange for an upfront, non-refundable membership fee plus regular monthly fees for usage. Does the gym’s earnings process involve *only* the provision of working gym facilities over the membership period? Or does the process of creating gym membership cards and entering member information into the country-wide database represent its own separate earnings process? Although this scenario is
economically similar to that of a cable TV provider, the U.S. Securities and Exchange Commission (SEC) concluded in Staff Accounting Bulletin (SAB) 104 that such setup efforts do not constitute a separate earnings process, and thus, upfront non-refundable membership fees cannot be recognized as revenue upfront.

7. As another example, consider the earnings process of a travel agent and an airline company. A travel agent helps a customer purchase an airline ticket and recognizes revenue for its commission at the point the customer purchases the ticket. Some argue that revenue recognition is appropriate because the earnings process of the travel agent—helping the customer make travel plans and arrangements—is largely completed once the customer purchases the ticket. In contrast, an airline that provides the same upfront service with its own in-house sales force cannot recognize revenue for these services because the airline’s earnings process is incomplete until the flight itself is provided. Why do similar services provided by companies with different overall business models constitute an earnings process for one company and not for the other?

8. As one final example, separately priced extended warranties result in revenue recognition over the warranty period under both U.S. GAAP and IFRS because the earnings process of warranty providers is said to span the warranty period. In contrast, warranties that are not priced separately from the warranted good do not result in revenue recognition over the warranty period, even though the efforts undertaken to service such warranties (that is, the earnings process associated with those warranties) clearly span the warranty period.

9. Many more examples like these can be found throughout today’s revenue recognition literature, both in U.S. GAAP and IFRS. The fact that the earnings process model is applied inconsistently across similar transactions calls into question the usefulness of that model. Although some argue that the IASB literature does not contain as many such inconsistencies as U.S. GAAP, anecdotal evidence suggests that preparers who report under IFRS often look to U.S. GAAP
when IFRS does not provide sufficient guidance, which is frequently the case for revenue recognition situations. Thus, the inconsistencies resulting from the application of an earnings process model are often just as pervasive under IFRS as they are under U.S. GAAP.

Conflicts with Definitions of Assets and Liabilities

10. In addition to these inconsistencies, the earnings process model also creates conflicts with the definitions of assets and liabilities in the FASB and IASB frameworks. This is because, in some instances, the application of an earnings process model leads to the recognition of deferred debits and deferred credits that do not meet the definitions of assets and liabilities. For example, the decision not to recognize revenue for upfront, non-refundable gym membership fees results in deferred revenue for those fees, even though the expected future sacrifice of economic resources by the gym is less than future monthly gym usage fees.

11. In effect, the earnings process model attempts to account for revenue directly without considering how assets and liabilities arise and change throughout the exchange with the customer. Because assets and liabilities are ignored, deferred debits and credits sometimes arise that do not meet the definitions of assets and liabilities. Because assets and liabilities are the cornerstone elements in the FASB and IASB frameworks—indeed, the current definitions of revenue depend on assets and liabilities—the Boards have questioned the conceptual usefulness of the earnings process model.

What Is Wrong with IAS 18 Revenue?

12. Given the shortcomings of the earnings process model, which is largely a product of U.S. GAAP, some have questioned why the Boards do not simply adopt a general standard akin to IAS 18 Revenue. The Boards decided not to take such an approach for two reasons. First, as already alluded to in paragraph 9, the guidance in IAS 18 is inconclusive on matters such as multiple-element arrangements. Because almost all revenue transactions can be thought of in terms of a multiple
element arrangement, this is a fundamental weakness of IAS 18. Second, and much more importantly, the underlying principles in IAS 18 are too inconsistent or vaguely described to provide a conceptual basis on which to develop a revenue recognition standard. (Indeed the risk and reward principles in IAS 18 sometimes seem to conflict with the definitions of assets and liabilities.) The Boards thought that if a general standard was to be coherent and capable of subsequent interpretation, they would need to describe the underlying principles more clearly than IAS 18 did. Hence, they decided to start this project from first principles.

AN ASSET AND LIABILITY MODEL

13. Given the shortcomings of the earnings process model and the flaws in IAS 18, the Boards decided to pursue a revenue recognition model founded on the recognition and measurement of assets and liabilities. Although this so-called asset and liability model would be a departure from the current standards-level guidance, which is dominated by an earnings process model, it is consistent with the existing definitions of revenue in both the FASB and IASB literature:

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity’s ongoing major or central operations (SFAC 6, paragraph 78)

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants (IAS 18, paragraph 7).

14. Both definitions base revenue on increases in assets, settlements of liabilities, or some combination of the two. Thus, revenue is a residual from recognizing and measuring increases in assets and decreases in liabilities. Instead of an independent evaluation of how much revenue has been “earned” and can therefore be recognized, an asset and liability model focuses on the changes in assets and liabilities themselves to determine how much revenue to recognize. Revenue itself is not measured directly.
15. Because the asset and liability model relies on the recognition and measurement of assets and liabilities, the Boards think it can be applied more consistently across industries and transactions than an earnings process model. That is, the Boards think there will be more agreement on whether an asset has increased or a liability has decreased than there is currently on what an earnings process is and whether it is complete. Moreover, an asset and liability model does not recognize deferred debits and credits that do not meet the definitions of an asset and liability. As a result, this model is more likely to lead to a faithful and consistent depiction of the underlying economics of transactions than the earnings process model has done.

16. The Boards acknowledge that some so-called deferred debits and credits that arise from applying existing revenue recognition guidance may turn out to meet the definitions of assets and liabilities. Where this is the case, adopting an asset and liability model would not change practice with respect to whether they should be recognized. However, the asset and liability model may lead to changes in how the recognized assets and liabilities are described, which in turn may lead to changes in how the assets and liabilities are measured. For example, changing from recognizing a liability for “deferred revenue” to recognizing a liability to provide services may lead to changing from a measure based on the proceeds received to a measure of the services to be provided (that is, an explicit measure of the contractual liability). The Boards think such an analysis of measurement attributes under an asset and liability model is likely to improve the consistency and representational faithfulness with which revenue is depicted across industries and transactions.

**Which Assets and Liabilities?**

17. If revenue is to be defined in terms of increases in assets and decreases in liabilities, the model needs to be clear about the assets and liabilities to which it refers. The existing definitions of revenue provide few clues in this regard, except to focus on the assets and liabilities that arise in connection with the provision of
goods or services that constitute an entity’s ordinary, ongoing, or central activities. However, many assets and liabilities arise in connection with such activities.

18. Consider the following example:

A customer enters into a contract with a manufacturing entity in which the entity promises to deliver a standard good in six months. The entity manufactures its own goods, usually over a six month period. The customer pays for the good in advance.

19. In this example, there are a number of assets and liabilities that arise in connection with making and delivering the standard good. Perhaps the most obvious of these is the cash received from the customer. An increase in this asset (when the customer pays) would give rise to revenue in a simple asset and liability model that focuses solely on cash. Such a model would ignore whether the entity had actually transferred the good and thus settled any liability with the customer because the model’s focus would be strictly on one asset—the cash received from the customer.

20. Another asset in this example is the good itself that the entity is manufacturing. An increase in this asset (as the entity acquires materials and applies labor to those materials throughout the manufacturing process) would give rise to revenue in an asset and liability model that focuses solely on the good being manufactured. Such a model would ignore whether any liability had decreased or whether any other asset (such as cash) had increased. Revenue would arise strictly from the enhancement in the value of the good being produced.

21. In this example, there is also a liability (after the customer prepays) because the entity must sacrifice economic resources to manufacture and deliver the good in six months. A decrease in this liability (when the entity delivers the good to the customer) would give rise to revenue in an asset and liability model that focused solely on the satisfaction of such liabilities. Such a model would ignore whether
assets (such as cash or the good being manufactured) increased. Revenue would arise only upon the satisfaction of liabilities to the customer.

22. Any of the assets or liabilities identified in this example could feasibly be the focus of an asset and liability revenue recognition model. Indeed, there is no conceptually right or wrong answer about which assets or liabilities should affect revenue. At best, the Boards can only select the set of assets and liabilities that they think are most likely to result in recognized revenue that is decision-useful to financial statement users.

Decision Usefulness of One General Definition of Revenue

23. It should be noted here that by defining revenue in terms of only one particular set of assets and liabilities, the Boards assume that the decision usefulness to financial statement users across all industries can be achieved by defining revenue in terms of the same assets and liabilities. In other words, by aiming for one general standard on revenue recognition in which revenue arises from changes in a defined set of assets and liabilities, the Boards assume financial statement users across all industries will consider the resulting recognized revenue to be decision useful. If this is not the case, then some users of financial statements will be adversely affected by this effort to create one general revenue recognition standard.

24. For example, in the timber industry (and other agricultural industries), users may think the most useful definition of revenue is one that captures the changes in the value of the growing timber itself. That is, financial statement users in this industry might prefer an asset and liability model of revenue that focuses on the good being produced (an asset). As the timber grows, revenue is recognized. Although sales to customers—which occur many years after trees begin to grow—would also be important to users in this industry, they may in fact prefer a top-line revenue number that reflects the changing value of the timber as it grows. This is because the timber (or the land with the timber that is growing on it) could be sold to others in the timber industry. A general standard that defines revenue in
terms of an asset (such as cash) and/or the satisfaction of a liability (such as on delivery of timber to the customer) would preclude labeling the increases in the value of timber as it is growing as revenue.

25. There are likely to be other industries with differences in what users think revenue should capture, and a general standard on revenue recognition that attempts to define the assets and/or liabilities that give rise to revenue will preclude these differences from being reported. While this would make the resulting standard more consistently applicable across industries and transactions, the decision usefulness of the reported revenue for a particular industry or for a particular transaction may be diminished.

CONTRACTS WITH CUSTOMERS

26. With the foregoing discussion in mind, the Boards decided to focus the revenue recognition model on the asset or liability that arises directly from a contract with a customer. The Boards decided to focus on the contract itself for two main reasons. First, contracts to provide goods and services are important real world economic phenomena. In fact, they are the lifeblood of companies. They represent an exchange of promises between an entity and a customer which gives rise to assets and liabilities. Moreover, given the pervasiveness of contracts with customers, any revenue recognition model has to at least consider the contract as a starting point.

27. Second, most of today’s revenue recognition literature focuses exclusively on contracts with customers. For instance, SAB 104 provides four criteria for revenue recognition and the first criterion requires that persuasive evidence of an arrangement exists. Transactions within the scope of IAS 18 envisage a customer, and any customer transaction either explicitly or implicitly involves a contract. Because the objective is to develop a model that can supplant much of the existing literature, that model needs to encompass at least as broad a scope as the existing literature.
28. By initially focusing on the contract itself, the Boards do not intend to preclude the possibility that revenue might also be recognized outside contracts with customers. Indeed, the Boards recognize that some constituents (for example, constituents in the agricultural industry as noted above) might argue that their revenue arises long before an exchange with a customer is contemplated. But for initial purposes in this paper, the Boards decided to focus strictly on the asset or liability that arises directly from the contract with a customer. In other words, the *contract* with the customer is the economic phenomenon to be accounted for. Hence, the changes in the assets and liabilities giving rise to revenue would be the changes arising *directly* from the contract between the entity and its customer.

**A Tentative Definition of Revenue**

29. A tentative definition of revenue based on an asset and liability model that focuses specifically on the contract with a customer could be as follows:

   Revenue is an *increase* in a contract asset or a *decrease* in a contract liability (or a combination of the two) that results from providing goods and services to a customer.

30. First and foremost, this definition highlights that revenue arises from a change in assets and liabilities—the contract asset or liability. This definition also highlights that the assets and liabilities referred to arise *from* the contract between the entity and its customer. This limits which assets and liabilities are considered in the model to just the contract itself. For example, the good being constructed for ultimate delivery under the contract is not an asset that arises *from* that contract. Finally, this definition highlights that the change is related to providing goods or services to customers. This acts as a filter to distinguish revenue-generating contracts from other contracts.

31. Note that there are some important issues that this definition does not address. For instance, it does not explain whether changes in the contract asset or liability that result from performance by third parties (for example work undertaken by a subcontractor) should be revenue. The reference to goods and services could also
benefit from clarification so as to address questions such as whether a sale of an item of property, plant, or equipment previously used to generate revenue should be treated as a revenue-generating contract. This is important because many users assign different valuation multiples to components of income that are persistent (that is, recur from period to period) from those that are not. However, these issues can be considered later.

32. This, of course, is just a tentative definition. It is simply a first attempt to explain what revenue is by defining it in terms of a particular set of assets and liabilities—those that arise from the contract itself. It does not explain when an increase in an asset or a decrease in a liability from providing goods or services occurs. But to explore this issue first requires an explanation of how and why contracts with customers give rise to assets and liabilities and how those assets and liabilities change as both the entity and customer perform under the contract.

**How an Asset or Liability Arises from a Contract**

33. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises impose *obligations* on the entity to transfer economic resources (in the form of goods and services) and convey *rights* to receive consideration from the customer in exchange.

34. The rights and obligations in the contract are inextricably linked because neither would be enforced without the other also being enforced. As a result, the combination of the rights and obligations is treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. Thus, at any given point in time, a contract is treated as an asset if the remaining rights exceed the remaining obligations. Similarly, a contract is treated as a liability if the remaining obligations exceed the remaining rights. This asset or liability reflects the entity’s net position in the contract with respect to the remaining rights and obligations.2

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2 The Boards have decided that in contracts with the legal remedy of specific performance, which requires both parties to fulfill the promises made in the contract, the entity’s rights should be presented gross as
35. The notion of a net position in a contract is not new. Forward contracts for financial instruments are already treated as assets or liabilities in existing accounting literature. In a forward contract, two parties agree to exchange a fixed amount of consideration for a financial instrument at some future date. The parties report their respective positions in the contract based on the relationship between the promised consideration and the current price of the financial instrument. If the promised consideration exceeds the current price of the financial instrument, the party that promised the consideration treats the contract as a liability because the settling of the contract would result in a net outflow of economic resources. At the same time, the party that promised the financial instrument treats the contract as an asset because the settling of the contract would result in a net inflow of economic resources.

36. In this same way, a revenue contract can be treated as an asset or liability depending on the relationship between the remaining rights and obligations in the contract. Consider again the example in paragraph 18, in which a manufacturing entity contracts to deliver a machine in six months and the customer pays in advance. Immediately after the customer makes payment, the manufacturing entity has no remaining rights in the contract. Instead, all that is left is an unfulfilled obligation. As a result, the entity’s net position in the contract is a liability. To release itself from the remaining obligations in the contract, it would have to satisfy the obligation by delivering the machine, refund the customer’s original payment plus any required penalty, or pay another party to legally assume the obligation to deliver the machine.

37. That a prepaid contract would be treated as a liability is perhaps not surprising, but now consider the same example immediately before the customer makes payment. At this point, the manufacturing entity has a right to the customer’s payment and an obligation to deliver the machine in six months. If the right to assets and its obligations should be presented gross as liabilities. For purposes of this paper, revenue would arise from the same circumstances, regardless of whether the rights and obligations are recognized gross or net in the balance sheet. For simplicity, the discussion in this paper assumes contracts do not require the remedy of specific performance.
payment exceeds the obligation to deliver the machine, the entity’s net position in
the contract would be an asset. Such an asset position might be evidenced by a
third party’s willingness to pay the entity for that remaining set of rights and
obligations. In contrast, if the obligation to deliver the machine exceeds the right
to payment, the entity’s net position in the contract would be a liability. This
liability position might be evidenced by a third party that would require payment
from the entity to take on the remaining rights and obligations.

38. It is important to note that the focus on the contract takes in only the rights and
obligations in that contract. This focus would not include any future cash flows
from the customer that are likely to occur simply because the entity and the
customer have formed a potentially lasting relationship. The focus on the contract
is solely on the rights and obligations in that particular contract, and the unit of
account is the entity’s net position in the remaining rights and obligations in that
contract only (or some collection of contracts, if they are deemed to be related—
an issue not discussed in this paper).

39. In summary, a contract to deliver goods and services to a customer can be either
an asset or a liability, depending on the remaining rights and obligations in the
contract. Consider now how a contract changes as both parties fulfill their
promises.

How a Contract Asset or Liability Changes

40. An entity’s net position in a contract can change due to its own performance or
the performance of the customer (among other things). For example (as noted
above), when a customer performs by paying its promised consideration in
advance, the entity’s net position in the contract (whether an asset or liability
before that time) decreases because the entity no longer has any remaining rights
in the contract. An entity’s contract asset would decrease or its contract liability
would increase because the rights to the customer’s payment no longer exist.
Importantly, neither a decrease in a contract asset nor an increase in a contract
liability would meet the tentative definition of revenue, which requires instead an
increase in a contract asset or a decrease in a contract liability. Thus, performance by the customer in and of itself does not lead to revenue recognition.

41. An entity’s net position in a contract also changes when the entity provides its promised goods or services. Once these goods or services are provided, the entity no longer has this particular obligation in the contract. As a result, its net position in the contract (whether an asset or liability before that time) increases. Note that this change would meet the tentative definition of revenue because the entity’s contract asset would increase or its contract liability would decrease when its obligation to provide goods or services ceases to exist.

The Importance of Asset Transfer

42. According to the tentative definition of revenue, revenue arises because goods and services are provided, which ultimately leads to an increase in a contract asset or a decrease in a contract liability. Given the pivotal role that the provision of goods or services plays in this definition of revenue, it is important to understand when a good or service is actually provided or transferred to a customer. That is, in an asset and liability model in which revenue arises from the provision of goods or services, there must be some principle or criterion to suggest when a good or service has actually been transferred to the customer. Additionally, this principle must be applied consistently across the model.

43. Essentially, this is a question of asset transfer—whether an entity has transferred or provided an economic resource to the customer. For example, once a good is transferred to a customer (that is, the customer has the ability to direct the use and benefit of the good), there can be no remaining obligation for the entity to transfer that good to the customer. The entity may have a different obligation associated with a potential return of that good, but that is not the same as an obligation to deliver that good. Thus, upon transferring a good to the customer (and derecognizing the asset if it was previously recognized), a contractual obligation is satisfied, leading to either an increase in a contract asset or a decrease in a contract liability—in other words, revenue.
44. In contrast to a good, determining when a service has been provided to a customer is often simpler. For example, when a cleaning company provides one day of office cleaning in a 30-day cleaning contract, the cleaning service is clearly provided to the customer on that day. There is no asset for the entity to derecognize because the benefit created by the entity’s activities immediately transfers to the customer. That the cleaning service provides a benefit to the customer each day indicates that an obligation under the contract is satisfied each day, and thus revenue arises each day.

45. Unfortunately, determining when a service provides a benefit to the customer is not always so simple. Consider a contract in which a consulting company promises to deliver a final report to the customer, and delivers nothing to the customer except that final report. The consulting work done prior to the delivery of the report has the appearance of being a service, but the work itself does not provide any benefit or asset to the customer until the final report is compiled and delivered. In effect, the entity is creating an intangible product that it plans to transfer to the customer once all knowledge is gathered together into the final report. In this situation, what appears to be a service effort turns out to be the production of an intangible asset. The customer receives no benefit from the consulting work until the report is actually delivered.

46. These simple situations highlight the importance of identifying when a resource or benefit transfers to a customer and thus satisfies an obligation in a contract-based definition of revenue. In fact, focusing on the time at which a benefit or resource transfers to the customer may provide a workable solution for identifying separate promises to deliver goods and services within a multi-element arrangement. In other words, if the criteria for determining when a benefit or resource transfers to the customer can be clearly articulated, those same criteria can be used to identify separate obligations in multi-element arrangements.

47. Although a satisfactory analysis of the asset transfer issue is beyond the scope of this paper, it is important to note the primary role asset transfer plays in a
contract-based revenue recognition model. Both revenue recognition models developed by the Boards must deal with the question of when a good or service is transferred or provided. In fact, the Boards decided in October 2007 that both models must utilize a similar set of criteria for determining when an asset has transferred to a customer and thus satisfied an obligation. In essence, the Boards decided that there is no reason the two models should differ in their conclusions of when an asset or resource has been provided to the customer and thus gives rise to revenue by satisfying a contractual obligation.

48. Of course, this is easier said than done. Board members differ strongly in their views on when an asset or resource actually transfers to a customer, and this project cannot hope to resolve that issue within the next few months before publishing a due process document. Therefore, this paper simply highlights the importance of asset transfer, and will highlight in later chapters any instance in which this question surfaces and how it is dealt with in that moment. The paper cannot completely ignore this issue because constituents who want to understand how the two models would affect their current practice will need to know when revenue would be recognized under those models. And, as pointed out above, asset transfer primarily determines when obligations are satisfied and revenue is recognized.

49. In summary, the notion of asset transfer is pivotal in a contract-based focus of revenue recognition because it is the transfer of assets or resources to customers that satisfies the obligations in a contract. This is perhaps the most difficult aspect of an asset and liability revenue recognition model that focuses solely on the contract with the customer. Such a focus places tremendous pressure on determining whether an asset or resource has actually been provided to the customer. Both revenue recognition models developed by the Boards have to deal with this issue.
EXAMPLES OF REVENUE ARISING FROM CHANGES IN CONTRACTS

50. The previous section explains how the remaining rights and obligations in an enforceable contract with a customer give rise to a contractual asset or liability. That section also explains at a high level how changes in this contract asset or liability can lead to revenue recognition according to the tentative definition of revenue. This section uses a few simple examples to illustrate more concretely the relationship between changes in contracts and revenue recognition.

51. The examples illustrate how a contract asset or liability changes over the duration of the contract. Because measurement has not yet been discussed, the examples are intended to illustrate only when changes in the contract occur as a result of the entity providing goods or services. By illustrating how revenue would result from such changes, this section is meant to illustrate more generally how revenue would arise under a contract-based definition of revenue.

A contract to deliver a single good

52. Consider the following facts in which an entity promises to deliver a single good in the future:

A customer enters into a contract with a retailer in which the retailer promises to deliver a standard good in six months in exchange for CU10. The customer pays for the good in advance. The retailer acquires the good at a cost of CU6.

53. In this scenario, a contract asset or liability would arise at contract inception, depending on the relationship between the underlying rights and obligations in the contract. Immediately before the customer pays, the retailer would have a contract asset if the rights to the customer payment exceeded the obligation to deliver the good in six months time. In contrast, the retailer would have a contract liability if the obligation to deliver the good in six months exceeded the rights to the customer payment. Finally, the retailer would have neither an asset nor a liability if the right to the customer’s payment were judged to be equal to the obligation to deliver the good. For purposes of this example, assume that the measure of the
obligation is equated to the measure of the rights, so no asset or liability arises at inception.

54. Immediately after the customer makes payment, the retailer would have a contract liability because it would have no remaining rights in the contract. Given that no contract asset or liability was recorded at inception, the customer’s payment of CU10 would be recorded as follows:

\[
\begin{align*}
\text{Dr cash} & \quad 10 \\
\text{Cr contract liability} & \quad 10
\end{align*}
\]

55. Six months later, when retailer delivers the promised good, there are no remaining rights or obligations in this contract. As a result, the contract liability would decrease and thus give rise to revenue. As a result, the retailer would make the following entry:

\[
\begin{align*}
\text{Dr contract liability} & \quad 10 \\
\text{Cr revenue} & \quad 10 \\
\text{Dr cost of goods sold} & \quad 6 \\
\text{Cr inventory} & \quad 6
\end{align*}
\]

**A Contract to Deliver Multiple Goods at Different Times**

56. Consider the following facts in which an entity promises to deliver two goods in the future:

A customer enters into a contract with a retailer in which the retailer promises to deliver two standard goods, one in three months and another in six months in exchange for CU10 each. The retailer acquires each good at a cost of CU6. The customer makes payment for both goods upon the second delivery.

57. In this scenario, a contract asset or liability would arise at contract inception, depending on the relationship between the underlying rights and obligations in the contract. The retailer would have a contract asset if the rights to the customer payment exceeded the obligation to deliver the goods over the next six months. In contrast, the retailer would have a contract liability if the obligation to deliver the
goods exceeded the rights to the customer’s payment. Finally, the retailer would have neither an asset nor a liability if the right to the customer’s payment were judged to be equal to the obligation to deliver the goods. For purposes of this example, assume that the measure of the obligations is equated to the measure of the rights, so no asset or liability arises at inception.

58. Three months later, when retailer delivers the first promised good and derecognizes that asset, this obligation is satisfied. There is now only one remaining obligation and a remaining right to the customer’s payment. As a result, a contract asset would be created and give rise to revenue. The retailer would make the following entry:

\[
\begin{array}{ll}
\text{Dr contract asset} & 10 \\
\text{Cr revenue} & 10 \\
\text{Dr cost of goods sold} & 6 \\
\text{Cr inventory} & 6 \\
\end{array}
\]

59. After another three months, when retailer delivers the second promised good and derecognizes that asset, there are no remaining obligations, only the remaining right to the customer’s payment. This decrease in obligations would lead to another increase in contract assets, recorded as follows:

\[
\begin{array}{ll}
\text{Dr contract asset} & 10 \\
\text{Cr revenue} & 10 \\
\text{Dr cost of goods sold} & 6 \\
\text{Cr inventory} & 6 \\
\end{array}
\]

60. Finally, after receiving the second good, the customer makes payment to the retailer, which satisfies the only remaining right in the contract. The retailer would thus reduce its contract asset to CU0 and record the receipt of cash, as follows:

\[
\begin{array}{ll}
\text{Dr cash} & 20 \\
\text{Cr contract asset} & 20 \\
\end{array}
\]
CONCLUSIONS

61. This memo explains why the Boards favor an asset and liability model over an earnings process model, and describes a contract-based definition of revenue that is consistent with an asset and liability model. This memo also explains how a contract gives rise to an asset or a liability that represents an entity’s net position in the contract, depending on the remaining rights and obligations in the contract. Finally, this memo describes how the entity’s net position in the contract changes as the entity and the customer fulfill their contractual promises, and which of these changes would lead to the recognition of revenue.

62. At this point, there are two primary questions that still need to be addressed—how to measure the rights and obligations in the contract and how to determine that a good or service has actually been provided. The two revenue models described in the following chapters both deal specifically with these questions, and in the process propose a more refined definition of revenue that is consistent with their respective views on these two questions.
INTRODUCTION

Overview

63. This paper summarises the measurement model of revenue recognition. In this model, revenue arises from recognising and explicitly measuring increases in specified assets and decreases in specified liabilities, rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by considering how much assets and liabilities change in a period. Because the model is predicated on explicit measurements of the assets and liabilities, it is described as the measurement model.

64. The specified assets and liabilities in this model are those that arise directly from enforceable contracts with customers. The contract asset or liability is measured at its current exit price. This is the price that a market participant would pay (or require) to obtain (or assume) the remaining rights and obligations in the contract. The contract is measured this way at inception and subsequently. [Paragraphs 79–86]

65. Because the model focuses on the contract asset and liability, revenue is defined as an increase in a contract asset or a decrease in a contract liability that results from the provision of goods and services to a customer. [Paragraph 68] Hence, revenue is recognised when:
• an entity obtains a contract in which the underlying rights exceed the underlying obligations (because this would result in a new contract asset). [Paragraphs 89–94]

• the entity subsequently satisfies its obligations in the contract by providing goods or services to the customer (because this would either increase a contract asset or decrease a contract liability). [Paragraphs 95–108]

66. The amount of revenue that is recognised is derived from the increase in the exit price of the contract asset or decrease in the exit price of the contract liability. [Paragraph 98]

A cautionary note

67. In illustrating the measurement model, simple examples are often used. However, if this model was adopted in practice, it would not alter the current accounting for many straightforward revenue transactions. For instance:

• the model would not affect many point-of-sale contracts unless those contracts result in material obligations to customers that are not satisfied at the point of sale, such as return rights or warranties;

• no revenue would be recognised until the entity had an enforceable contract. Hence, in the case of an executory contract that can be cancelled without penalty by either party before the entity performs, no assets or liabilities would be recognised, and, thus, no revenue would be recognised either.

WHAT IS REVENUE?

68. Revenue is an increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to the customer.
69. This definition of revenue is linked to changes in a narrow set of assets and liabilities: those arising directly from an enforceable contract with a customer to provide goods and services. These assets and liabilities are discussed below in paragraphs 33–78. Revenue is not affected by changes in assets such as inventory. Said simply, revenue reflects the increase in the entity’s net position in an enforceable contract with a customer from obtaining that contract and subsequently providing goods and services to customers.

**HOW ASSETS OR LIABILITIES ARISE FROM AN ENFORCEABLE CONTRACT**

70. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises impose obligations on the entity to transfer economic resources (in the form of goods and services) and convey rights to receive consideration from the customer in exchange.

71. The rights and obligations in the contract are inextricably linked because neither would be enforced without the other also being enforced. As a result, the combination of the rights and obligations is treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. Thus, at any given point in time, a contract is treated as an asset if the remaining rights exceed the remaining obligations. Similarly, a contract is treated as a liability if the remaining obligations exceed the remaining rights. This asset or liability reflects the entity’s net position in the contract with respect to the remaining rights and obligations in the contract.

72. Accordingly, if the customer performs first by prepaying in full, then the entity has a contract that is a liability to it. This is because it only has contractual obligations remaining. In this case, as the entity satisfies its obligations by transferring economic resources to the customer, the contract liability decreases. In other words, the entity’s net position in the contract increases.
Suppose Engineering Co enters into a contract to deliver and install a machine. If the customer prepays, then immediately after contract inception Engineering Co has no remaining contractual rights. Therefore, the remaining contractual obligations give rise to a contract liability.

After transferring the machine to the customer, Engineering Co’s remaining obligations have decreased, because it needs only to install the machine. Therefore, the contract liability decreases, ie Engineering Co’s net position in the contract increases.

If the customer does not prepay, then the remaining rights and obligations may result in the entity having a contract that is an asset or a liability to it. This will in part depend on the measurement of those rights and obligations (see paragraphs 79–86). In this case, as the entity satisfies its obligations, the asset will *increase* or the liability decrease (or the contract that was a liability will become an asset). This is because the rights remain unchanged but the obligations have decreased. In other words, the entity’s net position in the contract *increases.*

Suppose that in the above example payment is due on completion of the installation of the machine. In this case, on contract inception Engineering Co has both remaining rights and obligations. Suppose that the combination of these rights and obligations initially results in a contract asset, because the value of the rights is greater than the obligations.

After transferring the machine to the customer, the remaining rights in the contract remain unchanged. However, Engineering Co’s remaining obligations have decreased, because it needs only to install the machine. Therefore, the contract asset (which is the combination of the remaining rights and obligations) increases. As in the above example, Engineering Co’s net position in the contract increases.

*Relationship of the contract asset or liability to work in progress or inventory*

The contract asset or liability arising from the remaining contractual rights and obligations is separate and distinct from any underlying assets to be sacrificed by the entity and transferred to the customer (eg an item of inventory). Hence it is not the *production* of goods and services that results in the satisfaction of an obligation; rather it is the *transfer* of those goods and services to the customer.
Which rights and obligations are included in the contract asset or liability?

75. The rights include the enforceable rights to consideration under the contract or the enforceable rights to the customer’s promise to pay that consideration that is contingent upon the entity’s performance under the contract.

76. The obligations include all of the obligations to the customer that arise from entering into the contract. This includes explicitly stated obligations to transfer economic resources to the customer. It also includes those obligations stemming from the promises that are implied by the entity’s customary business practices if a court would enforce those promises. For instance, these may include obligations to accept returns that are not required under the explicit terms of the contract.

77. Obligations to transfer economic resources to customers include obligations that require the entity to stand ready to perform. For instance, an entity that is providing a guarantee on a loan is providing a service (of guaranteeing the loan) to its customer for the duration of the guarantee, even though ultimately it might not have pay any cash if the borrower does not default.

78. Note that the contractual obligations include those obligations that are sometimes referred to as ‘post-performance’ obligations, such as a manufacturer’s standard warranty and a return or cancellation right (i.e., the remaining obligations that an entity has after providing the main deliverable in the contract). In other words, all obligations (explicit or implicit) that would require the entity to transfer an economic resource to the customer as a result of entering into a contract with the customer would result in contractual obligations.

HOW IS THE CONTRACT MEASURED?

79. The contract asset or liability (that is, the combination of the entity’s remaining contractual rights and obligations) is measured at its current exit price. This is the amount that the entity would expect to receive or pay to
transfer its remaining contractual rights and obligations to a market participant at the reporting date.

Why use a current exit price attribute?

80. A current exit price measure provides several benefits:

- It reflects the contractual rights and obligations that remain at the reporting date, no more or less. This is because an exit price is the price that the entity would have to pay another party to (a) take over full responsibility for performing all of the remaining obligations in the contract and (b) assume any remaining rights. The exit price notion therefore explicitly captures all remaining aspects of the contract, but no more and no less. In particular, the measurement does not implicitly capture cash flows that relate to activities that have already been completed.

- It reflects the circumstances that exist on the reporting date. A current exit price reflects these circumstances by depicting what the entity would have to pay market participants to assume the entity’s remaining contractual rights and obligations at the reporting date. It therefore depicts how real world events (such as changes in prices and circumstances) affect the contract and reports the effects of those events when they occur. This provides relevant information about the amount and timing of the cash flows that will arise from the contract, which is particularly important in contracts of a longer duration. In particular,

  - it should provide more immediate reporting of loss-making or onerous contracts. This is because unfavourable changes in circumstance are reported immediately in profit or loss rather than in future periods.

  - it results in subsequent measurements that are more neutral. This is because both favourable and unfavourable changes in circumstances are reported as they arise.
• It explicitly requires a margin on all of the remaining obligations, including ‘post-performance’ obligations such as a return right, because a market participant would require a margin for fulfilling an obligation. Therefore (assuming the contract is profitable) profit is reported over the entire duration of the contract (and not, for instance, just on delivery of the main deliverable in the contract).

• It would improve the comparability of reported information. A current exit price attribute reports economically similar obligations the same regardless of how the entity incurred those obligations. For instance, when an entity sells warranties to its own retail customers and also assumes identical warranties from other retailers for less money, a current exit price would measure those identical warranties at identical amounts.

• Although an entity may not intend (or may not be able) to transfer the contract to a third party, a current exit price attribute provides a clear objective for measuring the rights and obligations that is based on economic attributes of those rights and obligations. Therefore, a current exit price attribute makes it easier to answer the question ‘how much revenue (and profit) to recognise’ by explicitly determining how much the asset or liability has actually changed in the period (particularly in contracts in which obligations are satisfied over time rather than discretely).

81. The above measurement approach treats the transaction price as an input into the measurement of the rights in the contract asset (or liability). This transaction price does not override the determination of the price a market participant would charge to assume the remaining rights and obligations in the contract. Two potential drawbacks about this measurement approach should be noted:

• It relies on a complete identification of all of the obligations in the contract. This is because if obligations that are present in the contract are not identified, they obviously will not be included in the measurement. This will therefore result in errors in the amount of revenue and profit recognised in profit or loss.
until such time as the omitted obligations are satisfied. In that regard, there is no ‘cushion’ against the possibility of omitting obligations on initial recognition of the contract asset or liability as there is with many current revenue recognition models.

- Any errors in the initial measurement of the contract will be reported in profit or loss. In other words, any revenue and profit or loss recognised on contract inception will include the effects of any errors in the initial measurement of the contract.

*What is included in the measurement?*

82. If the customer has prepaid in full, the measurement of the contract liability reflects the price that the entity would have to pay to transfer its remaining contractual obligations to a market participant at the reporting date. In other words, it is the amount that the entity would have to pay to lay off its obligations. Said simply, it is the price a market participant would charge to fulfil all of the remaining obligations in the contract with no anticipated payments from the customer. This price would reflect any express or implied rights of return and refund, allowances, rebates, discounts, and credits, etc.

83. The exit price will not typically be observable, so it will need to be estimated. The objective is to arrive at the price a market participant would charge, so inputs into the estimate should be consistent with that objective. However, an entity could use its own inputs if it has no evidence to suggest that they would be inconsistent with those that a market participant would use.

84. For example, in some cases, the amount may be derived from the price a subcontractor would currently charge for providing the goods and services underlying the obligations in the contract. This price would then need to be adjusted for the estimated amount a market participant would demand for managing the contract and the price for guaranteeing the performance of the subcontractor.
85. The exit price can also be estimated by using a ‘building block’ approach. In this approach, the price is estimated by considering the following three components:

- the cash flows a market participant would expect to incur in providing all of the goods and services in the contract (ie the direct and indirect costs involved in fulfilling the obligations). When there is uncertainty about the cash flows, the estimate reflects the full range of possible outcomes, weighted by their respective probabilities.
- the margins a market participant would demand for providing the goods and services (including the margin for bearing uncertainty about the future cash flows).
- the time value of money.

86. If the customer has not prepaid, the measurement of the contract asset (or liability) also reflects the enforceable expected cash flows from the customer, taking into account the effects of credit risk and the time value of money.

ACCOUNTING FOR THE CONTRACT WITH THE CUSTOMER

Before contract inception

87. Revenues cannot arise before a contract with a customer exists.

88. This may seem self-evident, but it is important to emphasise that under the definition in paragraph 68 above, revenues could not arise until a contract, which by definition is enforceable, exists. Before a contract exists, the entity does not have any contractual rights or contractual obligations. It is these contractual rights and obligations that are fundamental to the existence of contract assets and liabilities and hence revenue.
At contract inception

89. When an entity becomes party to a contract with a customer to provide goods and services, the entity recognises a contract asset or a contract liability from the combination of its rights and obligations in the contract.

90. If the entity recognises a contract asset that increase in contract assets is recognised as revenue. If the entity recognises a contract liability that increase in contract liabilities is recognised as a loss.

91. In a contract in which the exit price of the underlying contractual rights exceeds the exit price of the underlying contractual obligations, the entity recognises a contract asset when it becomes party to the contract. That increase in the contract asset meets the definition of revenue in paragraph 68. If the exit price of the underlying contractual obligations exceeds the exit price of the underlying contractual rights, the entity recognises a contract liability when it becomes a party to a contract. That increase in the contract liability does not meet the definition of revenue in paragraph 68 and would be recognised as a contract loss.

92. In some contracts, immediately after contract inception, the customer pays in advance in full. Hence, the rights in the contract are satisfied, but obligations still exist, so that the entity’s net position in the contract immediately becomes a liability. Although two events have occurred (the entity has obtained a contract and then the customer has performed fully), it typically would not be necessary to separately account for these events. Instead, the amount of any revenue to be recognised at contract inception could effectively be determined as the excess of the cash (or other consideration) obtained from the rights in the contract over the current exit price of the entity’s contract liability. Conversely, if the exit price of the contract liability is more than the cash (or other consideration) obtained from the rights in the contract, the entity recognises the excess as a contract loss.

93. Revenue recognised at contract inception is the revenue that arises from obtaining a contract with a customer. This revenue does not necessarily result in reporting a
corresponding amount of *profit*. This is because the entity will have incurred expenses in obtaining the contract (although some of these may have been recognised in prior reporting periods). Note that in this model there is no need to defer pre-contract expenses such as sales commissions or other direct costs of obtaining a contract. This is because some revenue would potentially be recorded at contract inception.

94. Recognising the value attributable to obtaining the contract does not mean that the entire profit expected from the contract is recognised at contract inception. Profit that a market participant would require for providing the goods and services in the contract will be recognised only as those goods and services are provided. Put another way, the revenue that is recognised at contract inception reflects the fact that if the contract was immediately transferred to a market participant, that market participant would not need to obtain the customer; it would need only to fulfil the contract.

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Suppose Retailer enters into an enforceable contract with a customer on 30 June for the sale of a good for CU150. The customer prepays and the good will be provided to the customer on 10 July.

All things being equal Retailer would expect to pay less than CU150 at 30 June to transfer the contract liability to a market participant. This is because Retailer incurs expenses in obtaining the contract, ie all of the (direct and indirect) expenses associated with its selling activities (sales commission, staff wages, rent of retail facilities, etc). Retailer implicitly charges the customer for *all* of these activities. In other words, the customer pays for more than just the good itself. Therefore Retailer would expect to be compensated by the market participant for these activities if it transferred its contractual obligations. And the market participant would be prepared to compensate Retailer because it would not need to incur those costs itself: the customer is in place, it would only need to fulfil all of the contractual obligations.
After contract inception

*Changes in the contract from providing goods and services*

95. **Revenue is recognised after contract inception as the entity satisfies the obligations in the contract with the customer, thus increasing the contract asset or decreasing the contract liability (or a combination of the two).**

96. If the customer has prepaid, the contract liability decreases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would have to pay a market participant to assume the remaining obligations in the contract would decrease. The resulting decrease in the contract liability meets the definition of revenue.

Suppose Engineering Co enters into a contract to deliver and install a machine. The customer prepays the contract price of CU1,000. Immediately after contract inception the exit price of the contract liability is CU900 and hence revenue of CU100 is recognised.

Suppose that after transferring the machine to the customer, the exit price of Engineering Co’s contract liability decreases to CU200, representing the amount a market participant would charge to install the machine. The decrease in the contract liability of CU700 (ie CU900 – CU200) is recognised as revenue.

97. If the customer has not prepaid, the contract asset increases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would expect to receive from a market participant to transfer the remaining rights and obligations in the contract would increase. The resulting increase in the contract asset meets the definition of revenue.

Suppose that in the above example payment is due on completion of the installation of the machine. The exit price of the contract asset on inception is CU100 and hence revenue of CU100 is recognised.
Suppose that after transferring the machine to the customer, the exit price of Engineering Co’s contract asset increases to CU800, representing the amount a market participant would pay for the customer’s promise of CU1,000 less the amount it would charge to install the machine of CU200. The increase in the contract asset of CU700 (ie CU800 – CU100) is recognised as revenue.

98. The amount of revenue recognised is derived from the increase in the exit price of the contract asset or the decrease in the exit price of the contract liability (or combination of the two). Revenue therefore reflects the value of the goods and services that have been provided to the customer at the date they are provided.

*When are contractual obligations satisfied?*

99. **In the usual situation in which an entity satisfies its obligations by providing goods and services to the customer, a contractual obligation cannot be considered satisfied until the entity cedes control of the economic resources called for in the contract. This will be when the entity no longer has the ability to direct the use and benefit of those resources.**

100. Contractual obligations are satisfied when an entity no longer has a present obligation to transfer an economic resource in the future. This occurs when the entity either transfers the economic resources called for in a contract (whether a good, service, or refund of the original consideration), when the entity is forgiven or otherwise relieved of the obligation by the customer or court action, or when the entity legally lays off the obligation whereby the customer no longer has any claim against the entity. Typically, an entity will satisfy its obligations to a customer by transferring the goods and services called for in the contract, thereby ceding control of those economic resources.

101. In that regard, there is often a direct connection between the point at which an entity’s obligation is satisfied and the point at which the entity derecognises an asset. This is because in some cases the obligation is satisfied by transferring an economic resource to the customer that was previously a recognised asset of the entity.
102. Generally an obligation to provide a good is satisfied when the entity passes possession of the good to the customer. This is because the entity cedes control of the good so that it is no longer the entity’s asset. In some cases, the entity may retain physical possession of the good even though the good no longer is an asset of the entity. For instance, in a ‘genuine’ bill and hold arrangement, the customer might be regarded as controlling the asset because it controls the right to use the asset, even though it does not currently have physical possession of the asset. In contrast, the entity might be regarded as having ceded control of the asset because it no longer has the ability to direct the use and benefit of the good. The entity cannot, for instance, use the good to fulfil other contracts. In effect, the entity would be providing custodial services to the customer over the customer’s asset.

103. In the case of many contracts to provide services, an obligation is satisfied continuously as the entity renders the services. This is because the entity is continuously transferring economic resources (in the form of services) to its customer.

Suppose that on 31 December 2007, Cleaning Co enters into a contract that requires it to clean a customer’s offices each work day for a year.

This contractual obligation is satisfied continuously as Cleaning Co provides the cleaning services. For instance on 31 March 2008, Cleaning Co has an obligation to provide cleaning services for nine months rather than an obligation to provide services for a year. Hence, the contractual obligation is satisfied continuously over 2008.

104. Some of the more troublesome examples in revenue recognition are contracts in which an entity is creating an asset for a customer under contract. In some cases, the entity is producing the asset (eg manufacturing a good) for eventual transfer to the customer. In such cases, the entity does not cede control of the asset until the asset is actually transferred to the customer. This is because the entity is largely free to direct the use and benefit of the good until it delivers the good to the customer.
Suppose that on 1 May Engineering Co enters into a contract with a customer for the provision of a machine. The contract specifies that the machine will be transferred to the customer on 1 August, which is when payment is due. Engineering Co manufactures the machines to fulfil specific customer orders, and has partly completed the manufacturing on 30 June.

On 30 June, Engineering Co has:

- a contract asset from its remaining unperformed rights (to the customer’s promise of payment) and obligations in the contract (to provide a machine)
- an inventory asset in the process of production.

Between 1 May and 1 August, there is no change in the remaining unperformed rights and obligations in the contract. This is because the output from entity’s manufacturing process does not transfer to the customer and therefore satisfy the entity’s obligation until 1 August.

105. The point to note in this example is that Engineering Co’s production process does not in itself satisfy its contractual obligation. Therefore, when the machine is partly constructed, the obligation is not partly satisfied. The obligation is satisfied only when Engineering Co cedes control or otherwise ceases to direct the use and benefit of the machine by transferring it to the customer on 1 August.

106. In other cases, assets transfer to the customer throughout the production process so that the contractual obligation is satisfied continuously.

Suppose that on 1 May Builder enters into a contract to build an extension to a building on the customer’s land. The contract is expected to be completed on 30 September. The customer is required to prepay.

On 30 June, Builder has:

- a contract liability from its remaining unperformed obligations in the contract.

In this case the outputs from Builder’s production processes are transferred continuously to the customer because they become the customer’s property as they are installed on its land. Therefore, the contractual obligation changes continuously. For instance, the contract liability at 30 June arises from Builder’s obligation to provide the remaining construction materials and services.

107. The point to note in this example is that, in contrast to the previous example, Builder cedes controls of assets (construction materials and services) throughout
the period of 1 May to 30 September. Hence, its obligation is satisfied continuously.

108. The foregoing paragraphs have only briefly discussed the issue of when a contractual obligation is satisfied. Nonetheless, they highlight the importance of this issue in a contract-based revenue recognition model and therefore that a prerequisite to implement this model would be guidance to assist entities in determining when contractual obligations are satisfied.

Non-performance changes in the contract

109. **Changes in the exit price of the contract asset or liability for reasons other than the entity providing goods and services to the customer are reported outside of revenue.**

110. At each reporting date, the contract asset or liability is measured at its current exit price. This measure can change for reasons other than the entity providing goods and services to the customer (ie satisfying the obligations). For instance, the exit price of the contract asset or liability may change because of a change in the price of the underlying goods and services yet to be provided to the customer. To assist users in understanding the reasons for changes in the exit price of contract assets and liabilities, such changes are reported outside of revenue.

| Suppose Retailer enters into a contract with a customer to provide a widget in three months time for which the customer prepays in full CU100. Suppose that the initial measurement of the contract liability is CU90 and hence revenue of CU10 (ie CU100 – CU90) is recognised. Suppose that after one month there is an increase in the price of widgets and that as a result, a market participant would now require CU95 to assume Retailer’s obligation to provide a widget. Retailer increases the contract liability to CU95 and recognises the resulting loss of CU5 in profit or loss outside of revenue. When Retailer satisfies its obligation by providing the widget to the customer, it extinguishes its contract liability. The resulting decrease in the contract liability of CU95 is recognised as revenue. This revenue reflects the value of the good being provided to the customer at the date that it is provided. |
Note that in this example because the amount of revenue was derived from the decrease in the exit price of the contract liability, the total amount of revenue recognised over the duration of the contract was CU105 (ie CU10 + CU95), which is greater than the payment actually received from the customer.

111. There are a number of options for displaying the changes in the contract asset and liability in the financial statements. Some of these display options can accommodate reporting an additional revenue line that reports the amount of the customer consideration as revenue. However, discussion and illustration of these options are outside the scope of this summary.

ACCOUNTING FOR A BROADER SET OF ASSETS AND LIABILITIES

112. The revenue recognition model described above only accounts for a narrow set of assets and liabilities, namely those that arise from an enforceable contract with a customer. However, in some cases, the profit or loss (and statement of financial position) that results from such a narrow focus on the contract might fail to faithfully represent the economic circumstances of an entity. There are two main situations in which this might occur.

Accounting mismatches arising in profit or loss

113. After contract inception, but before fulfilment of the contract, the market price of a contractual obligation to provide a good to a customer may increase. This will decrease (increase) the measurement of the contract asset (liability) and result in the recognition of a contract loss. If the entity has already acquired or manufactured the good that will be used to satisfy the obligation (thereby having effectively hedged its position), but this good is not remeasured to reflect its current value, then recognising the increased market price of the obligation will result in an incomplete and potentially misleading depiction of how the price change has affected all the entity’s assets and liabilities.
Suppose Oil Co enters a fixed-price contract on 1 January with a customer to deliver 1000 gallons of oil in four equal instalments starting on 31 March. Suppose the customer pays in full in advance and Oil Co recognises a contract liability of CUS3,000. Oil Co purchased all of the oil required to fulfil this contract on 1 January and measures its oil inventory at cost.

On 1 March 2007, the price of oil increases by 10%. Suppose that this increase in the price of oil results in the exit price of the contract liability increasing to CUS3,300 and therefore that Oil Co recognises a contract loss of CUS300. If Oil Co does not reflect any corresponding increase in the carrying amount of its oil inventory, then profit or loss depicts Oil Co as if it was economically identical to an entity that had not obtained any oil to fulfil the contract. In other words, it depicts Oil Co as if it was fully exposed in its contract to changes in market prices of oil.

**Incomplete depiction of the changes in the entity’s assets and liabilities throughout the contract**

114. An entity may create an asset under an enforceable contract for eventual transfer to the customer. In such a contract, until the asset (eg an item of inventory) is transferred to the customer, there will be no change in the entity’s contractual obligation and, hence, no revenue will arise. Furthermore, if the asset is measured at accumulated cost, profit or loss will not reflect any increase in the entity’s assets from *creating* the asset until it is transferred to the customer. Hence, profit or loss may give an incomplete depiction of the changes in the entity’s assets and liabilities *throughout* the contract.

Homebuilder is developing an estate of 10 houses. On 31 March 2007, it enters into a contract with a customer for the sale of House 2 of the development for the fixed price of CUS250,000. At the time the contract is entered into, Homebuilder has not commenced work on House 2 (ie the house is sold to the customer ‘off plan’).

On entering into the contract the customer pays Homebuilder a non-refundable deposit of CUS25,000. The remaining amount of the consideration (CUS225,000) is due when the Homebuilder transfers the completed house to the customer. Assume that this occurs on 31 January 2008. Assume that the exit price of the obligations on 31 March is CUS240,000 and the initial measurement of the contract liability is CUS15,000 (ie remaining rights of CUS225,000 – remaining obligation of CUS240,000).
Following the principles in paragraphs 87–111, revenue of CU10,000 is recognised on 31 March (ie cash obtained of CU25,000 less contract liability incurred of CU15,000) and revenue of CU240,000 recognised on 31 January 2008.

Between 31 March 2007 and 31 January 2008, Homebuilder recognises its costs in building House 2 as an item of inventory. House 2 is derecognised and an expense is recognised on 31 January 2008. Homebuilder’s margin attributable to building House 2 is therefore not reported in profit or loss until 31 January 2008 when revenue and the building expenses are recognised in profit or loss.

115. Some think that the second situation described above highlights a weakness with the proposed definition of revenue in paragraph 68. They think that the source of an entity’s revenues is the activities it undertakes in producing goods and services for customers rather than the contract itself. In other words revenue can arise from producing goods (eg from creating or enhancing inventory assets) even if this revenue is then precluded from recognition until a contract with a customer exists. They would therefore broaden the definition of revenue to capture increases (decreases) in assets (liabilities) that arise from the entire process of producing, selling, and delivering goods and services to customers.

116. To address these concerns, an alternative revenue recognition model might focus on a broader set of assets and liabilities beyond those that arise directly from the contract alone. In particular, it also might include inventory assets (when they are the subject of a contract).

117. However, instead of broadening the definition of revenue, the model described in paragraphs 68–111 could be extended as follows. In a contract in which an entity is creating or enhancing an asset to fulfil contractual obligations, the increase in the exit price of that asset over the costs incurred in bringing the asset to its present location and condition could be reported in profit or loss as a separate component of income—production income. Hence, in such contracts an entity would recognise:

- **production income** as it created or enhanced assets
• revenue when it transferred those assets to the customer.

118. The profit attributable to creating or enhancing the asset would be recognised as those activities occur. The profit that would be recognised when revenue is recognised would relate only to contract completion activities (because the assets would be carried at their exit price at the date of transfer to the customer).

Continuing with the Homebuilder example in paragraph 114.

Suppose that Homebuilder incurs costs of CU175,000 in building House 2 and that the exit price of House 2 on completion is CU240,000. Applying paragraph 117, Homebuilder would recognise production income of CU65,000 (ie CU240,000 – CU175,000) over the period 31 March 2007 to 31 January 2008. And the carrying amount of House 2 immediately before the contract liability is satisfied would be CU240,000.

When Homebuilder satisfies its obligation and recognises revenue of CU240,000 on 31 January 2008, it also derecognises House 2 and recognises a corresponding expense of CU240,000. Therefore no margin is reported on 31 January 2008 because the margin attributable to building House 2 was recognised as production income over the construction period.
INTRODUCTION

119. This paper summarises the customer consideration model of revenue recognition. In this model, revenue arises from recognising increases in specified assets and decreases in specified liabilities rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by how much assets and liabilities change in a period. The specified assets and liabilities in this model are those that arise directly from enforceable contracts with customers.

120. To measure the contract, the underlying rights in the contract are measured at inception at the amount promised by the customer (often referred to as the customer consideration). That amount is then allocated to the separate performance obligations identified within the contract based on the sales price of the good or service underlying each performance obligation. Therefore, the sum of the identified performance obligations always equals the customer consideration at inception. Because the model is predicated on this allocation of customer consideration to the performance obligations, it is described as the customer consideration model.

121. Because the customer consideration amount is allocated to the identified performance obligations, the sum of these performance obligations and the measure of the rights are equal at inception. Thus, the measure of the contract at inception is typically zero—neither an asset nor a liability arises at contract inception.
122. As each performance obligation identified in the contract is satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

WHAT IS REVENUE?

123. Revenue is an increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from the satisfaction of performance obligations to provide goods or services to a customer.

124. Performance obligations are the enforceable promises an entity makes within a contract to provide goods and services to a customer. The change in the contract asset or liability that results from the satisfaction of these performance obligations gives rise to revenue. This satisfaction takes place when the goods and services specified by the contract are transferred to the customer.

WHAT ASSETS AND LIABILITIES ARISE FROM AN ENFORCEABLE CONTRACT?

125. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises convey rights to the entity and impose obligations on it.

126. The entity’s rights under the contract represent the customer’s promise to pay the consideration specified in the contract. The entity’s obligations under the contract represent the customer’s rights to goods or services from the entity.

127. The combination of the rights and obligations gives rise to a contract asset (where the value of the remaining unperformed rights exceeds the value of the remaining unperformed obligations) or a contract liability (where the value of the remaining unperformed obligations exceed the value of the remaining unperformed rights) that reflects the entity’s net position in the contract. Increases in this asset or
decreases in this liability, which result from the satisfaction of performance obligations, give rise to revenue as a residual.

**Identifying the performance obligations in a contract**

128. **The contract with the customer should be disaggregated into its separate performance obligations based on the goods and services being transferred under the contract.**

129. A good or service promised represents a potentially separate performance obligation if it could be bought and sold separately. Hence, if a contract requires the provision of a number of goods, each good potentially represents a separate performance obligation if that good could be bought or sold separately. Similarly, where a range of services is promised, each service potentially represents a separate performance obligation if it could be bought or sold separately.

130. The settlement of the obligations within a contract can occur at different times over the period of the contract. Separation of the obligations allows recognition of revenue when each separate obligation is satisfied. To be identified as a separate performance obligation, the underlying good or service must be transferred at a different time from other goods or services promised in the contract. That is, the risks and rewards associated with a good or service must transfer to the customer at a different time than other goods and services. There will be situations in which a potential performance obligation is not separately satisfied because the risks and rewards of the underlying good or service are not transferred separately.

131. For example, an entity may contract with a customer to deliver a particular gravel. To fulfil its obligations, the entity must find the specific type of gravel for the customer and wash and grade it prior to delivery. While finding, washing, and grading the gravel are all services that could be sold separately as finding services, washing services, or grading services, *in this particular contract*, these services do not transfer any separate benefit to the customer. They all transfer upon delivering the gravel to the customer. Therefore, in this example, there is
only a single performance obligation (or unit of account): delivery of special, washed and graded gravel.

Which obligations are not performance obligations?

132. Under this model performance obligations are restricted to those obligations agreed upon by the entity and its customer, or those that are imposed on the arrangement by the operation of law. For example, a customer loyalty program that is affected by a transaction with a customer would be treated as a performance obligation in that contract. This is because the entity and the customer have previously agreed to the terms of the customer loyalty program and how it applies to future transactions. As another example, a statutory warranty imposed by the operation of law would be treated as a performance obligation even though it is not mentioned in the terms of the customer contract.

133. In contrast, other obligations may be incurred at the same time as a customer contract that would not be treated as performance obligations. The primary class of obligations that would not be treated as performance obligations are those related to future transactions with the customer. These include offers for discounts on future transactions and other similar options granted to customers. These offers are typically outside of the contract with the customer, which is to say, their terms are not part of the negotiations between the entity and the customer. Such offers are also typically unrelated to the good or service being provided in the contract. Because these offers are meant only to entice the customer to transact in the future, and generally the customer will be providing new consideration in those transactions, such offers are not treated as performance obligations. They may give rise to liabilities, but these liabilities would not be treated as a performance obligation under this model.

134. Another class of obligations that would not be treated as performance obligations are promises to allow customers to return merchandise for a refund. Granting such a promise is equivalent to recognising that some sales to customers will ultimately fail. Permitting the customer to return a good or service for a refund is not on its
own a separate performance obligation, but instead a reversal of a sale. Although these promises may result in recognition of a liability, those liabilities would represent refund obligations and would not be treated as separate performance obligations.

135. These classes of obligations are referred to as ancillary obligations in this model. If recognised as liabilities, they would follow the prescribed guidance in IAS 37 Provisions, Contingent Assets and Contingent Liabilities or FAS 5 Accounting for Contingencies in accordance with local practice.

MEASUREMENT OF THE RIGHTS AND OBLIGATIONS

136. The contract rights are measured at the amount of contract consideration stated in the contract. This takes into account the customer’s credit risk as well as the time value of money. This amount is referred to as the customer consideration.

137. The contractual obligations are not measured directly. Instead, the customer consideration is allocated to the individual performance obligations pro rata based on the separate selling prices of each underlying good or service. As a result, the total remaining performance obligations at contract inception are measured at an amount equal to the customer consideration.

Why allocate the customer consideration amount to performance obligations?

138. In any exchange between two willing, rational parties, it is assumed that the parties are giving and receiving items of equal value. This is the assumption with this model. However, some of what the entity gives, and the customer receives, occurs before contract inception. In the exchange with the customer, the entity provides benefits both before (for example, through knowledgeable sales demonstrations) and after contract inception. The amount of consideration promised by the customer takes into account these services because the selling price includes an amount to recover pre-contract costs and post-contract overhead costs (even if the customer is unaware of this fact).
139. However, this consideration is not allocated to any of the pre-contractual activities because it is difficult to determine a reliable selling price for which these activities might be sold separately. Moreover, it is not clear which pre-contractual activities actually provide a benefit to the customer. For example, a sales demonstration service might be a clearly identified pre-contractual service, but would the design of a sales brochure also represent a separate service? Given these difficulties, the customer consideration amount is allocated only to the performance obligations that arise from the contract.

Allocation of consideration

140. The allocation of consideration should be based on the most reliable information available of how a selling price is or would be calculated for the separate performance obligations. The purpose of the allocation exercise is to allocate the customer consideration to performance obligations based on the entity’s own sales price for each separate underlying good or service.

141. In some rare cases this sales price will be separately available outside the entity. This will occur, for example, in the case of a commodity traded in an active market. The entity’s sales price, and that of all other participants, does not need to be estimated; it is the market fair value of the commodity.

142. Where a separate sales price needs to be determined for a performance obligation, an entity should rely on the following hierarchy of entity-specific entry prices, from most reliable to least reliable:

   a) Level 1 - Current sales price charged by the entity itself in an active market
   b) Level 2 - Current sales price charged by the entity in an inactive market
   c) Level 3 - Current sales price of competitors in an active market
   d) Level 4 - Estimates of sales prices using entity inputs that reflect the entity’s own internal assumptions

143. Once the sales price of each performance obligation is assessed, any difference between the sum of the obligations and the total contract value needs to be
allocated across the obligations. This residual amount is allocated to each
performance obligation pro rata based on the estimated sales price of the
performance obligation as a proportion of total customer consideration.
Obligations to provide commodities for which a sales price has already been
determined are measured at fair value and no residual is allocated to them.

144. As the full amount of customer consideration is fully allocated to the identified
performance obligations, there is no initial unallocated customer consideration.
Therefore, no contract asset or liability is recognised, and no revenue arises at
contract inception.

*No re-measurement of performance obligations*

145. **Performance obligations are subsequently reported at the amount of the
customer consideration allocated to them at contract inception. They are not
re-measured, except when the contract is onerous.**

146. The customer consideration amount is only observable at contract inception. After
that point, the price for the remaining obligations in the contract would rarely be
observable and, therefore, could not be ascertained.

*Loss making contracts*

147. Both at inception and where economic circumstances have changed, there would
need to be an onerous contract test to ensure that the performance obligations are
not understated.

**ACCOUNTING FOR THE CONTRACT WITH THE CUSTOMER**

**At contract inception**

148. **At contract inception the contract as a whole is measured at zero.**
At inception, the rights and obligations are both equal to the total customer consideration amount, so no contract asset or contract liability is recorded at contract inception unless the contract is judged to be onerous.

After contract inception

Revenue is recognised when the contract liability decreases, or the contract asset increases, as a result of the entity satisfying its performance obligations.

As the contract progresses, sales invoices are issued in line with the terms of the contract. The contract right is converted into a receivable or debtor, which is, in turn, converted into cash as the invoices are paid. These changes in this right do not give rise to revenue.

The performance obligations identified in the contract are satisfied individually as the contract progresses. At each reporting period, the entity will need to ascertain whether the obligations have been satisfied or not. As these obligations are satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

Identifying when goods and services transfer

The performance obligations are satisfied when goods and services transfer from the entity to the customer.

The obvious, clear indicator that transfer has taken place occurs when legal title transfers. This is an absolute indicator that the rights and obligations of ownership have transferred. However, for many transactions the risks and rewards of a particular good will transfer in advance of legal title.

To assess whether the risks and rewards of a good or service have transferred to the customer, an entity needs to consider the following questions:

a. Who has physical possession?

b. Who has the ability to use?
c. Who can control or direct the benefit?
d. Who bears the insurance risk?
e. Who has the ability to pledge?
f. Who bears technical or obsolescence risk?
g. Who bears the risk of loss or destruction?
h. Who bears the risk of price changes?

156. Generally speaking, the risks and rewards alluded to in these questions reflect an everyday idea of ownership or control. The answers to these questions will form the basis to judge whether the risks and rewards of a particular good or service have passed to the customer. Where the majority of risks and rewards of a good or service has transferred to the customer, the performance obligation will have been satisfied. Where the balanced view is that the majority has not transferred to the customer, the good or service has not transferred and the performance obligation has not been satisfied. In this situation, no revenue is recognised.

157. **Goods.** A principal indicator of the transfer of a good to the customer is physical delivery of the good to the customer’s premises. At this stage the customer usually acquires physical control of the good, the ability to use it, pledge it, and resell it. The entity, in turn, can be seen as having satisfied its performance obligation.

158. **Services.** The benefit of a service provided to the customer transfers as the service is rendered by the entity.

159. Where a service is rendered on the customer’s goods, the transfer of benefit is immediate and revenue is recognised as the obligation is progressively satisfied by performance. In a building construction contract on the customer’s site, a small increment of the obligation is satisfied as each brick is laid. The performance obligation is not being re-measured as it is satisfied, but rather may be thought of as a series of tiny, identical obligations, each of which is measured at inception at the same amount and satisfied separately as the benefit transfers.
160. However, where the service is not performed on the customer’s good or directly for the customer, the question arises—is the entity supplying its good to a customer or is it providing a service to the customer to create the customer’s own asset?

161. Indications that a service is being provided, rather than a finished good delivered, would include:

   a) The customer controls the unfinished inventory (work in progress or WIP). Indicators that the entity has transferred control include:

      a. The asset is constructed on land owned by the customer.

      b. The customer has the right to take over the WIP.

      c. In the event of termination, the customer retains the WIP and the entity has the right to be paid for it.

      d. Title passes as the asset is built.

   b) Further indicators that a service is being provided may arise from customisation. It is not customisation per se, however, that suggests the good is the customer’s from the outset. It is the fact that the operation of law or an explicit statement in the contract makes the good the customer’s from the beginning. In the absence of such a statement or operation of law, an entity retains the preponderance of the risks and rewards associated with the customised good.

162. Where a construction service is provided, it will normally be expressed as a number of separate performance obligations, representing how the service as a whole is performed. The construction of a house will include laying the foundations, building the frame, cladding the frame, and fitting the electrics and plumbing. All of these services could be sub-contracted or sold separately. Each is a potential separate performance obligation. As each is satisfied, revenue is recognised.
163. The level of separation the entity goes to will depend on both the sensitivity of timing (for example does the contract span a year end) and on its method of control and management of the contract. Where costing structures and responsibilities are segregated, the disaggregation of performance obligations will reflect that level of separation.

164. In practice, the identification of separate performance obligations and ascertaining their satisfaction will not be burdensome for many contracts. Satisfaction takes place instantaneously in many transactions. For example, in the case of a retail transaction, the transfer of the goods and services and the satisfaction of the obligation is both simultaneous and instantaneous. The existence of the performance obligation is not noted by observers nor is it recorded separately by the retailer.
MEMO #5: REVENUE RECOGNITION: SUMMARY OF THE KEY FEATURES OF THE MEASUREMENT AND CUSTOMER CONSIDERATION MODELS
<table>
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<th><strong>Measurement Model</strong></th>
<th><strong>Customer Consideration Model</strong></th>
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<tbody>
<tr>
<td>What is revenue?</td>
<td><em>An increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to the customer.</em></td>
<td><em>An increase in a contract asset or a decrease in a contract liability (or some combination of the two) that results from the satisfaction of performance obligations to provide goods or services to a customer</em></td>
</tr>
<tr>
<td><strong>Contract Inception</strong></td>
<td><strong>Measurement of contract at inception</strong></td>
<td><strong>Measure the rights in the contract at the amount of consideration received or receivable. The amount of consideration received or receivable is then allocated to the identified performance obligations based on the separate selling price of the underlying good or service.</strong></td>
</tr>
<tr>
<td>Measurement of contract at</td>
<td><em>Measure the remaining rights and performance obligations in the contract at their current exit price.</em></td>
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<td>inception</td>
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<tr>
<td>Identifying the separate performance obligations</td>
<td><strong>Measurement Model</strong></td>
<td><strong>Customer Consideration Model</strong></td>
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<tr>
<td>At any reporting date, the entity measures all of the remaining performance obligations in the contract.</td>
<td>All obligations to a customer arising from the contract are included in the measurement of the contract (including obligations such as warranties and return rights).</td>
<td>The identified performance obligations are restricted to those obligations agreed upon by the entity and its customer, or those that are imposed on the arrangement by the operation of law.</td>
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<td></td>
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<td>‘Ancillary obligations’ (such as discount offers on future transactions or rights of return) may arise directly from the contract, but these are not considered performance obligations. No consideration is allocated to ancillary obligations.</td>
</tr>
<tr>
<td>Can some revenue arise at contract inception?</td>
<td>Yes (if current exit price of rights obtained &gt; current exit price of obligations incurred).</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td><strong>Measurement Model</strong></td>
<td><strong>Customer Consideration Model</strong></td>
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<tr>
<td>Can some <strong>profit</strong> arise at contract inception?</td>
<td>Yes (if current exit price of rights obtained less current exit price of obligations incurred &gt; contract acquisition expenses).</td>
<td>No</td>
</tr>
<tr>
<td>Can some <strong>loss</strong> arise at contract inception?</td>
<td>Yes (if the contract acquisition expenses &gt; current exit price of rights obtained less current exit price of obligations incurred; or if current exit price of obligations incurred &gt; current exit price of rights obtained).</td>
<td>Yes (for all the contract acquisition expenses. An additional loss will also arise if the contract is judged to be onerous.)</td>
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**After Contract Inception**
<table>
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<tr>
<th>Measurement of contract after inception</th>
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<th>Customer Consideration Model</th>
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<tbody>
<tr>
<td><strong>Measurement Model</strong></td>
<td>Measure remaining rights and obligations in the contract at their current exit price.</td>
<td>Measure remaining rights at the amount of remaining consideration receivable.</td>
</tr>
<tr>
<td><strong>Customer Consideration Model</strong></td>
<td>Measure remaining obligations at the amount of consideration that was allocated to those obligations at contract inception unless those obligations are judged to be onerous. If onerous, recognise an additional liability.</td>
<td></td>
</tr>
<tr>
<td>When is revenue recognised?</td>
<td><strong>Measurement Model</strong></td>
<td><strong>Customer Consideration Model</strong></td>
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<td></td>
<td><em>As performance obligations are satisfied (i.e. as goods and services transfer to customer).</em></td>
<td><em>As performance obligations are satisfied (i.e. as goods and services transfer to customer).</em></td>
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<th>How is the amount of revenue determined</th>
<th><strong>Measurement Model</strong></th>
<th><strong>Customer Consideration Model</strong></th>
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<td></td>
<td><em>By reference to the current exit price of the obligations that have been satisfied—i.e. current price of goods and services provided in the period.</em></td>
<td><em>By reference to the contract consideration that was initially allocated to the obligations that have been satisfied—i.e. amount of contract consideration attributed to goods and services provided in the period.</em></td>
</tr>
</tbody>
</table>
165. This paper illustrates the Measurement and Customer Consideration models relative to current practice using the following four examples:

- A television sold with an extended warranty
- A house painting arrangement
- The purchase of a boat
- A widget sold with a right of return.

166. The first three examples are similar to those presented to the Boards for the October 2007 joint Board meeting with the FASB and the IASB. The principal difference, however, is that a section has been added for comparison to current practice.

TELEVISION WITH AN EXTENDED WARRANTY

167. Consider the following facts and assumptions:

On December 31, 2007, 20 customers purchase the same model of television from an electronics retailing entity (Retailer) for CU2,300 cash each. Retailer includes a one-year warranty with the sale of all its televisions, as required by consumer protection laws in the country in which Retailer operates. However, each of the customers also chooses to buy an extended two-year warranty (i.e. to increase the warranty period to a total of three years).

Retailer normally sells the television (inclusive of the statutory one-year warranty) for CU2,000 and the extended two-year warranty for CU400. As part of a year-end sale, however, it offers its customers the option of buying the television and extended warranty at the reduced price of CU2,300.
When a warranty claim arises, Retailer processes the claims and repairs or replaces the television itself. Its prior experience with this type of television suggests a 20 percent likelihood that a claim will be filed during the three years of warranty coverage. Hence, Retailer expects four claims to arise from these 20 contracts, with one of these claims being filed in Year 1, another in Year 2, and two of them in Year 3. Actual claims filed during 2008, 2009, and 2010 were one, two, and two, respectively. The total cost of servicing and administering each claim was CU400. All claims were serviced in the same year they were filed and processed.

Retailer incurs various costs for activities to obtain the contracts, including a direct sales commission of CU30 per extended warranty. Retailer also incurs costs in administering the warranties; however, these are not directly attributable to the contracts and are excluded from the illustration. The carrying amount of each television in Retailer’s inventory immediately prior to sale was CU1,600.

To simplify the example, assume that the customers do not have the right to return the televisions and cannot cancel the warranties. The time value of money is ignored for simplicity. Retailer reports annually.

168. The staff chose this example for the following reasons:

- A warranty is a common feature of many contracts and accounting for warranties is often cited as an example of inconsistency in current revenue recognition guidance.

- A warranty contract is analogous to many other service contracts in that it features a continuous transfer of economic resources to the customer over multiple reporting periods. In other words, the contractual obligation is partially extinguished on a daily basis, which highlights the need for an entity to identify and measure remaining contractual obligations each reporting period.

- Warranties are often long-term contracts and the circumstances surrounding the warranties can change substantially over the contract term. It is important to explore how the two models address these changes in those circumstances.
Measurement model

Period ended December 31, 2007

169. During the period ended December 31, 2007, Retailer performs various activities to obtain 20 contracts. Shortly after inception of each contract, the customer performs by paying the full amount of consideration (thus extinguishing Retailer’s contractual rights). At the same time, Retailer satisfies part of its obligations by delivering the television to the customer. Therefore, Retailer has a contract liability because the remaining obligations to provide three years of warranty coverage exceed the rights that are fully extinguished upon prepayment by the customer.

170. The contract liability is measured at the amount a market participant would require to assume all of Retailer’s remaining obligations in the contract. This measurement reflects any attributes of the particular contract. For example, a market participant would require a higher price if Retailer has a higher-than-industry average number of warranty claims because of its poor inventory-handling procedures. Suppose that insurance companies will legally assume Retailer’s warranty obligations for CU120 per warranty, so that CU2,400 is the current exit price for the portfolio of all 20 warranty contracts.

171. In this example, revenue can be determined as the excess of cash obtained (CU46,000, i.e., CU2,300 × 20) over the current exit price of Retailer’s remaining contract liability (CU2,400). This revenue arises from obtaining the contract (in which the rights obtained exceeded the obligations incurred) and from partially satisfying an obligation under the contract (by delivering the television). Given the shortness of time over which the customer performs and Retailer partially performs, however, it is not necessary to determine revenue for these events separately. Revenue can instead be recorded as follows:

\[
\begin{align*}
\text{Dr Cash} & \quad 46,000 \\
\text{Cr Contract liability} & \quad 2,400 \\
\text{Cr Revenue} & \quad 43,600
\end{align*}
\]
172. Retailer derecognizes the television inventory when the televisions are transferred to the customer \((20 \times \text{CU}1,600 = \text{CU} 32,000)\).

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 32,000 \\
\text{Cr Inventory} & \quad 32,000 
\end{align*}
\]

173. Retailer also recognizes the direct selling costs incurred of \text{CU}30 per television \((20 \times \text{CU}30 = \text{CU}600)\).

\[
\begin{align*}
\text{Dr Selling expenses} & \quad 600 \\
\text{Cr Cash} & \quad 600 
\end{align*}
\]

*Period ended December 31, 2008*

174. During the period ended December 31, 2008, a single television claim is serviced under warranty. Retailer incurs direct and indirect costs of servicing and administering the claim of \text{CU}400.

\[
\begin{align*}
\text{Dr Warranty expenses} & \quad 400 \\
\text{Cr Cash} & \quad 400 
\end{align*}
\]

175. To determine revenue for the period, Retailer needs to measure the contract liability at its current exit price. This price is not directly observable because the current prices available from the insurance companies are for warranty coverage on new televisions, not on one-year-old televisions.

176. Because directly observable prices for the warranty obligations are not available, Retailer estimates the amount it would need to pay a market participant to assume those obligations. In this case, that price reflects:

a) The number of claims expected to arise under the warranty contracts

b) The direct and indirect costs of satisfying those claims

c) The direct and indirect costs of administering the warranties (e.g. resolution of customer questions and processing of claims)

d) The margin required on warranty work

e) The margin required for bearing uncertainty about the number of claims that might arise and the cost of fulfilling those claims
f) The likelihood of having to refund the consideration due to non-performance.

177. In concept, Retailer should make its estimates from the perspective of a market participant. In practice, however, Retailer could use its own estimates if it does not have reason to believe they would significantly differ from those of other market participants.

178. Retailer estimates a 15 percent chance of a claim arising over the remaining two years of warranty coverage and expects the total cost per claim to be £400.3 The total expected cost per contract is therefore £60 (£400 × 15%). The required margin per contract (for the warranty work and for bearing uncertainty), is £35 per contract. The measurement of each warranty obligation is therefore estimated at £95 (£60 + £35), so that the contract liability for all 20 contracts is measured at £1,900 (£95 × 20).

179. The decrease in the contract liability from £2,400 at inception to £1,900 at December 31, 2008, is recognized as revenue.

\[
\begin{align*}
\text{Dr Contract liability} & \quad 500 \\
\text{Cr Revenue} & \quad 500
\end{align*}
\]

Period ended December 31, 2009

180. During the period ended December 31, 2009, two television claims are serviced under warranty. The total costs of servicing and administering the claims are £800.

\[
\begin{align*}
\text{Dr Warranty expenses} & \quad 800 \\
\text{Cr Cash} & \quad 800
\end{align*}
\]

181. At contract inception, Retailer expected to service 4 televisions during the life of these 20 warranty contracts. Retailer serviced three televisions during the first two years, which, based on the original expectation, suggests that at the end of 2009 only one claim would be expected to arise in the third year (i.e. there would be a 5

---

3 The cost estimate has been simplified in the example for illustrative purposes. In practice, this estimate would likely use a probability weighted average calculation to reflect the likelihood of different cash flow scenarios. The calculation would also estimate the cash flows associated with administering the warranties and the possibility of having to refund amounts to the customer.
percent probability of a claim arising). However, Retailer determines at December 31, 2009, that the probability of servicing a claim during the third year is 10 percent due to an unexpected increase in the number of claims filed for this particular television model.

182. Hence, in estimating the amount a market participant would now require to assume the remaining obligations, Retailer updates the probability of a claim arising. Since it does not expect the total cost per claim to change, the total cost per contract is CU40 (CU400 × 10%). The required margin per contract (for the warranty work and for bearing uncertainty) decreases to CU20 per contract because there is now only one year of coverage remaining.4 The measurement of each warranty obligation is therefore CU60 (CU40 + CU20), so that the total contract liability for all 20 contracts is CU1,200 (CU60 × 20).

183. The contract liability has therefore decreased from CU1,900 at December 31, 2008, to CU1,200 at December 31, 2009. The full amount of this decrease (CU700) could be recognized as revenue. However, there are two reasons for the decrease in the contract liability.

---

4 Note that this margin has not reduced proportionately. Although there has been no change in the price demanded for bearing risk since December 31, 2008, the amount of risk in the contracts does not reduce evenly over the life of the contracts. In other words, there is more uncertainty about the number of claims that might arise in the later periods of the contract than during the earlier periods.
First, Retailer provided warranty coverage and service repairs in the period (i.e. the obligation was partly extinguished in the period). Secondly, there has been a change in the expected amount of claims and that affects the price a market participant would demand for assuming the remaining obligations. Separately identifying these two effects may provide more useful information to users. For instance, suppose Retailer estimates that the contract liability would have been measured at CU800 if there had been no change in future anticipated repairs. One way in which the decrease in the contract liability could be presented is as follows:

\[
\begin{align*}
\text{Dr Contract liability} & \quad 700 \\
\text{Dr Contract loss} & \quad 400 \\
\text{Cr Revenue} & \quad 1100
\end{align*}
\]

The income statement would therefore display the loss from the change in circumstances during the period separately from the value of services provided to the customer during the period.

*Period ended December 31, 2010*

During the period ended December 31, 2010, two television claims are serviced under warranty. The total costs of servicing and administering the claims are CU800.

\[
\begin{align*}
\text{Dr Warranty expenses} & \quad 800 \\
\text{Cr Cash} & \quad 800
\end{align*}
\]

Retailer measures its remaining contract liability at zero because it has fulfilled its obligations under the 20 contracts. The CU1,200 decrease in the contract liability during the period is recognized as revenue.

\[
\begin{align*}
\text{Dr Contract liability} & \quad 1,200 \\
\text{Cr Revenue} & \quad 1,200
\end{align*}
\]
188. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>43,600</td>
<td>500</td>
<td>1,100</td>
<td>1,200</td>
<td>46,400</td>
</tr>
<tr>
<td>Cost of sales (expenses)</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty expenses</td>
<td>-</td>
<td>(400)</td>
<td>(800)</td>
<td>(800)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>-</td>
<td>(400)</td>
<td>-</td>
<td>(400)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>11,000</td>
<td>100</td>
<td>(100)</td>
<td>400</td>
<td>11,400</td>
</tr>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>2,400</td>
<td>1,900</td>
<td>1,200</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>11,000</td>
<td>11,100</td>
<td>11,000</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>

189. As a result of the remeasurement in 2009 (Year 2), total revenue does not equal the contract consideration. This is because revenue reflects the value of the goods and services provided to the customer at the date they were provided, rather than at contract inception. Various options exist for presenting the changes in the contract liability arising from the changes in price and circumstances. Some of these would result in Retailer reporting revenue of CU46,000 (i.e. the amount of the contract consideration). However, illustration of these options goes beyond the objective of this paper.

**Customer Consideration model**

*Period ended December 31, 2007*

190. Under the Customer Consideration model, no contract asset or liability is recognized at inception because the measurement of the rights is allocated to the performance obligations. The amount of rights changes throughout the contract according to the contractual billing terms, but it is the satisfaction of the performance obligations that gives rise to revenue.

191. The television and both warranties represent potential performance obligations because they are goods and services capable of separate delivery or benefit to the customer. The total customer consideration amount must therefore be allocated
among these performance obligations based on their relative selling prices at contract inception.

192. The observable prices at contract inception are CU2,000 for the television (inclusive of the statutory warranty) and CU400 for the extended warranty. Because the statutory warranty was not priced separately, Retailer uses its own estimate to determine that CU25 of the television’s CU2,000 selling price was for the statutory warranty. That is, CU25 is the entity’s best estimate of a standalone selling price for the statutory warranty. This estimate would be built up by projecting future cash flows and adjusting them for the margins required by the entity. The CU100 discount is then allocated to each performance obligation according to their relative prices as follows (rounded to the nearest whole dollar):

<table>
<thead>
<tr>
<th>Performance Obligation</th>
<th>Base Price</th>
<th>Weighted Average Discount</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television</td>
<td>1,975</td>
<td>(82)</td>
<td>1,893</td>
</tr>
<tr>
<td>Statutory warranty coverage</td>
<td>25</td>
<td>(1)</td>
<td>24</td>
</tr>
<tr>
<td>Extended warranty coverage</td>
<td>400</td>
<td>(17)</td>
<td>383</td>
</tr>
<tr>
<td>Total</td>
<td>2,400</td>
<td>(100)</td>
<td>2,300</td>
</tr>
</tbody>
</table>

193. Once the performance obligations are identified and the total customer consideration is allocated to them, revenue is then recognized as each obligation is satisfied. For the television, the obligation is satisfied upon delivery to the customer when the rights and benefits associated with the television transfer. The statutory warranty obligation is satisfied over the first year and the extended warranty obligation is satisfied over the following two years. Revenue is not necessarily recognized on a straight-line basis, however, because the increments of time may be quantified differently to better approximate the selling price of each increment based on its relative risk and cost.

Period ended December 31, 2007

194. During the year ended December 31, 2007, Retailer recognizes the cash consideration received from the customers (CU46,000). This total amount is then allocated to each performance obligation in the contract. Based on this allocation, CU37,860 (CU1,893 per television × 20 televisions) is allocated to the obligation
to deliver the television, CU480 (CU24 \times 20) to the statutory warranty, and
CU7,660 (CU383 \times 20) to the extended warranty.

\[
\begin{align*}
\text{Dr Cash} & \quad 46,000 \\
\text{Cr Contract liability – televisions} & \quad 37,860 \\
\text{Cr Contract liability – statutory warranty} & \quad 480 \\
\text{Cr Contract liability – extended warranty} & \quad 7,660
\end{align*}
\]

195. At December 31, 2007, Retailer has fulfilled its obligation to deliver the television
and recognizes revenue in the amount of consideration originally allocated to that
obligation.

\[
\begin{align*}
\text{Dr Contract liability – televisions} & \quad 37,860 \\
\text{Cr Revenue} & \quad 37,860
\end{align*}
\]

196. In practice, the entries shown in paragraphs 194 and 195 are likely combined into
a single entry. The entries are shown separately here to illustrate the process of
identifying the relevant rights and obligations in an arrangement and allocating
the customer consideration to the performance obligations.

197. Retailer also derecognizes the television inventory when the televisions are
delivered to its customers.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 32,000 \\
\text{Cr Inventory} & \quad 32,000
\end{align*}
\]

198. Finally, Retailer recognizes the direct selling costs incurred of CU30 per
warranty.

\[
\begin{align*}
\text{Dr Selling expenses} & \quad 600 \\
\text{Cr Cash} & \quad 600
\end{align*}
\]

**Period ended December 31, 2008**

199. In the period ended December 31, 2008, Retailer satisfies the statutory warranty
obligation which gives rise to revenue in the amount of customer consideration
allocated to that obligation at contract inception.

\[
\begin{align*}
\text{Dr Contract liability – statutory warranty} & \quad 480 \\
\text{Cr Revenue} & \quad 480
\end{align*}
\]

71
200. During the period ended December 31, 2008, Retailer incurs direct and indirect costs of CU400 for servicing and administering one television under the statutory warranty. These costs are charged to warranty expenses as incurred.

\[
\begin{align*}
\text{Dr Statutory warranties expense} & \quad 400 \\
\text{Cr Cash} & \quad 400
\end{align*}
\]

Periods ended December 31, 2009 and 2010

201. In these periods, Retailer recognizes extended warranty services revenue of CU2,553 and CU5,107 based on the satisfaction of the performance obligation to provide warranty coverage during these years. Retailer also incurs actual warranty expenses each year of CU800. The revenue amounts represent the satisfaction of the performance obligation as determined at contract inception by the allocation of customer consideration to each time period. In other words, the consideration allocated to the extended warranty was CU7,660, of which one third was recognized in Year 2 and two thirds in Year 3 (due to the original expectation of servicing one of the three additional warranty claims in Year 2 and the remaining two claims in Year 3).

202. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>37,860</td>
<td>480</td>
<td>2,553</td>
<td>5,107</td>
<td>46,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty costs</td>
<td>-</td>
<td>(400)</td>
<td>(800)</td>
<td>(800)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>5,260</td>
<td>80</td>
<td>1,753</td>
<td>4,307</td>
<td>11,400</td>
</tr>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Statutory warranties liability</td>
<td>480</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Contract liability – Extended warranties</td>
<td>7,660</td>
<td>7,660</td>
<td>5,107</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>5,260</td>
<td>5,340</td>
<td>7,093</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>

Current practice (U.S. GAAP and IFRS)

203. The principles of revenue recognition under IFRS are similar to revenue recognition principles of U.S. GAAP and therefore often results in the same accounting treatment. However, significant differences in practice may arise for
various reasons such as the fact that IFRS is generally not as prescriptive as U.S. GAAP. Differences may also arise in terms of the means by which the same outcome is achieved. The objective of this paper is not to explore these differences between U.S. GAAP and IFRS but rather to illustrate the Measurement and Customer Consideration models relative to the underlying principles of current practice. For this reason, these examples assume that the results are the same under U.S. GAAP and IFRS. All paragraphs in this paper under the Current practice (U.S. GAAP and IFRS) section should be read with this objective in mind.

204. Under current practice, revenue recognition is based largely on the criteria that revenue must be realized or realizable and earned (that is, the earnings process must be complete or substantially complete). Because the customer pays in advance for the television and warranty, the realization criterion has been met. Revenue is then recognized as the earnings process is completed. Assessing completion of the earnings process, however, is complicated by the existence of multiple deliverables in the same arrangement.

205. Multiple deliverables in a single arrangement require an analysis to identify the unit (or units) of account. In this case, Retailer allocates the CU100 contract discount between the television (including the statutory warranty) and the additional warranty. Current practice would likely use a relative fair value method to do this allocation.

206. When identifying the separable units of account, current practice looks for objective and reliable evidence of a standalone selling price in order to recognize revenue for each deliverable independently of the others.5 In this case, the statutory warranty does not have an observable selling price on a standalone basis because it is never sold separately from the television. In other words, the statutory warranty is considered to be an integral part of the television and is not

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5 EITF Issue No. 00-21 addresses this topic under U.S. GAAP. IFRS does not have comparable literature dealing with revenue arrangements with multiple deliverables but does often follow similar principles when determining the unit of account.
therefore accounted for separately. But the television and the additional warranty are priced and sold separately and are therefore treated as separate units of account. The standard selling prices of the television (CU2,000) and warranty (CU400) serve as the basis to determine revenue associated with each deliverable. Hence, the CU100 discount is applied to the deliverables of each contract as follows:

<table>
<thead>
<tr>
<th>Deliverable</th>
<th>Base Price</th>
<th>Weighted Average</th>
<th>Allocated Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Television (and statutory warranty)</td>
<td>2,000</td>
<td>(83.33)</td>
<td>1,917</td>
</tr>
<tr>
<td>Extended warranty coverage</td>
<td>400</td>
<td>(17.67)</td>
<td>383</td>
</tr>
<tr>
<td>Total</td>
<td>2,400</td>
<td>(100)</td>
<td>2,300</td>
</tr>
</tbody>
</table>

207. Based on the above allocation and the relevant guidance for each deliverable, revenue for the television and statutory warranty is recognized once the television is delivered to the customer while revenue for the warranty is recognized over the period in which the warranty coverage is provided. Warranty coverage revenue is recognized on a straight-line basis over the contract period except when sufficient historical evidence indicates that the costs of performing services under the contract are incurred on another basis. At the commencement of the warranty, Retailer expects to service one television under statutory warranty, one television in the first year of the extended warranty, and two televisions in the last year of the extended warranty. This expectation is based on previous experience with similar warranties on similar products. Revenue for the extended warranty would follow this expected pattern of claims servicing over only the last two years of the total warranty coverage period (i.e. one third of the extended warranty revenue in Year 2 and two thirds in Year 3).

*Period ended December 31, 2007*

208. During the period ended December 31, 2007, Retailer receives full payment of CU46,000 and delivers the televisions. Based on the allocation of contract consideration, television revenue of CU38,340 (CU1,917 × 20) is recognized along with deferred revenue of CU7,660 (CU383 × 20). This deferred revenue
represents the realization of customer consideration in excess of the revenue Retailer has earned.

\[
\begin{array}{lc}
\text{Dr Cash} & 46,000 \\
\text{Cr Revenue} & 38,340 \\
\text{Cr Deferred revenue} & 7,660 
\end{array}
\]

209. At inception of the contract, Retailer recognizes a liability for the statutory one-year warranty obligation. Suppose this amount is CU400.

\[
\begin{array}{lc}
\text{Dr Warranty expenses} & 400 \\
\text{Cr Warranty liability - statutory} & 400 
\end{array}
\]

210. Retailer recognizes cost of sales for the televisions delivered to the customers.

\[
\begin{array}{lc}
\text{Dr Cost of sales} & 32,000 \\
\text{Cr Inventory} & 32,000 
\end{array}
\]

211. Retailer recognizes the direct selling expenses incurred of CU30 per warranty. Assume these expenses are not eligible for deferral.

\[
\begin{array}{lc}
\text{Dr Selling expenses} & 600 \\
\text{Cr Cash} & 600 
\end{array}
\]

Period ended December 31, 2008

212. In the period ended December 31, 2008, Retailer does not recognize any revenue because no revenue has been deemed to be earned. Retailer does, however, service one television under the statutory warranty and thereby extinguishes its liability that was set up at contract inception.

\[
\begin{array}{lc}
\text{Dr Warranty liability - statutory} & 400 \\
\text{Cr Cash} & 400 
\end{array}
\]

Periods ended December 31, 2009 and 2010

213. During Years 2 and 3, Retailer recognizes extended warranty services revenue of CU2,553 (one third of CU7,660) and CU5,107 (two thirds of CU7,660) and incurs warranty expenses of CU800 (CU400 \times 2) and CU800 (CU400 \times 2), respectively. The revenue amounts represent the amortization (based on expected claims servicing) of the deferred revenue balance at inception. In other words, Retailer allocated consideration of CU7,660 to the extended warranties and had an expectation of servicing one television in Year 2 and two televisions in Year 3.
One third of the revenue is therefore recognized in Year 2 with two thirds being recognized in Year 3.

### 214. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>38,340</td>
<td>-</td>
<td>2,553</td>
<td>5,107</td>
<td>46,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(32,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(32,000)</td>
</tr>
<tr>
<td>Warranty expenses</td>
<td>(400)</td>
<td>-</td>
<td>(800)</td>
<td>800</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>(600)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(600)</td>
</tr>
<tr>
<td>Margin</td>
<td>5,340</td>
<td>-</td>
<td>1,753</td>
<td>4,307</td>
<td>11,400</td>
</tr>
<tr>
<td>Cash</td>
<td>45,400</td>
<td>45,000</td>
<td>44,200</td>
<td>43,400</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td>(32,000)</td>
<td></td>
</tr>
<tr>
<td>Warranty liability – statutory</td>
<td>400</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>7,660</td>
<td>7,660</td>
<td>5,107</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>5,340</td>
<td>5,340</td>
<td>7,093</td>
<td>11,400</td>
<td></td>
</tr>
</tbody>
</table>

### Illustration summary

215. Comparing the table above in paragraph 214 to the tables in paragraphs 188 and 202 reveals key differences between current practice and the Measurement and Customer Consideration models in this example. At inception of the contracts, revenue (and margin) is significantly higher under the Measurement model than under the other models. One reason for this difference is that the Measurement model recognizes revenue from obtaining the contracts as well as from delivery of the television whereas current practice and the Customer Consideration model only recognize revenue from delivery of the television.

216. The Measurement and Customer Consideration models treat the statutory warranty as a separate unit of accounting for revenue recognition whereas current practice does not. This means that if only the expected costs of that warranty are accrued, then the entire margin from selling the television with the statutory warranty is recognized when the television is delivered to the customer although Retailer has not performed any of its warranty servicing obligations under the statutory warranty. In other words, had there been no extended warranty in this example, the pattern of profit recognition might have been more conservative under the Measurement model than under current practice.
217. The measurement of the remaining contractual obligations is also significantly different. Under current practice and the Customer Consideration model, the measurement of remaining obligations at each reporting date is based on the original allocation of customer consideration to those separable deliverables of the contract. That allocation is unaffected by subsequent changes in circumstances such as an increase in the expected number of claims (as occurs in this example) unless the contract is deemed onerous. In contrast, under the Measurement model, if the change in circumstances results in a change in the current exit price (as occurs in this example), then the change in circumstances is reflected in the measurement of remaining obligations.

218. As a result of the change in circumstances, total revenue under the Measurement model does not equal the contract consideration. Revenue reflects the value of the goods and services provided to the customer at the date they were provided. In contrast, under current practice and the Customer Consideration model, total revenue is equal to the contract consideration because the extended warranties obligation was not remeasured for the change in circumstances.

219. The CU100 discount given to each customer for buying the television and the extended warranty is treated differently under the three models. Under current practice, the discount reduces the amount of revenue that otherwise would have been attributed to the obligations to provide the television and the extended warranty. Under the Customer Consideration model, the discount reduces the amount of revenue that otherwise would have been attributed to the television, the extended warranty and also to the statutory warranty. Under the Measurement model, however, the discount reduces the revenue that is recognized at contract inception because it does not affect the exit price of the warranty liability.
HOUSE PAINTING

220. Consider the following facts and assumptions:

| PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer on June 25 to paint the customer’s house for CU3,000. The price is inclusive of all paint, which PainterCo obtains at a cost of CU800. PainterCo’s cost for labor and other painting materials is CU1,600. The customer is given the right to obtain its own paint, although the customer does not opt to do so in this example and instead purchases the paint and painting services jointly. All paint necessary to complete the contract is delivered to the customer’s house on June 30. PainterCo renders the painting services continuously from July 1 through July 3. In accordance with the contract terms, the customer pays in full upon completion of the house painting. The time value of money is ignored for simplicity. PainterCo reports monthly. |

221. The staff chose this example for the following reasons:

- Although it is a simple illustration, it is similar to construction-type contracts in that the entity provides materials and utilizes those materials in the satisfaction of a subsequent obligation.
- This example highlights the relationship between satisfying obligations in a contract and the derecognition of assets that are transferred to a customer to satisfy those obligations.

Measurement model

Contract inception

222. Upon contract inception, PainterCo incurs obligations to perform according to the terms of the contract and also obtains rights to consideration from the customer in exchange. These remaining contractual rights and obligations are recognized net as either a contract asset or a contract liability. This contract asset or liability is measured at its current exit price, which is the amount that PainterCo would
expect to receive or pay to transfer all of its remaining rights and obligations in the contract to a market participant.

223. In this example, the measurement of the contract asset or liability reflects the following:

a) The price a market participant (e.g. a subcontractor) would charge for providing the paint and the painting services (which includes its costs and its margin)

b) The price a market participant would charge to manage the contract (e.g. for engaging the subcontractor and dealing with the customer) and to guarantee a subcontractor’s performance

c) The expected consideration from the customer (adjusted for risk of non-payment).

224. Assume that at contract inception, PainterCo estimates that a subcontractor would provide the paint and the painting services for CU2,800. In addition, PainterCo estimates that a market participant would charge CU100 for managing the contract and for providing performance guarantees. Ignoring the risk of non-payment, a contract asset and revenue of CU100 is recognized (rights of CU3,000 less obligations of CU2,800 and CU100).

Dr Contract asset 100
Cr Revenue 100

225. The contract asset reflects the fact that PainterCo would expect to be compensated by a market participant for obtaining this contract. In other words, a market participant would be prepared to pay PainterCo CU100 for the remaining rights and obligations because it only needs to fulfill the contract and does not need to incur the costs of obtaining the contract.

226. In that regard, note that the revenue recognized at contract inception would not result in the recognition of a corresponding amount of margin. This is because PainterCo also incurs costs in obtaining the contract. However, because these
costs are unlikely to be costs directly attributable to this particular contract, they are excluded from this illustration.

\[\text{Period ended June 30}\]

227. PainterCo acquires the paint for CU800 and records it as inventory.

\[
\begin{array}{ll}
\text{Dr Inventory} & 800 \\
\text{Cr Cash} & 800 \\
\end{array}
\]

228. At June 30, PainterCo measures the contract asset at the amount it would expect to receive on that date if it transferred all of its remaining contractual rights and obligations to a market participant.

229. In this example, it could be argued that PainterCo’s remaining obligations at June 30 are to provide painting services only. This is because the paint has already been delivered to the customer’s premises and a market participant would be able to use this paint to fulfill the contract. Although in this example the customer would be likely to be able to return the paint if the painting services were not provided, the risk of the paint being returned can be viewed as part of the obligations a market participant would be required to assume on June 30 if the contract was transferred. Furthermore, it could be argued that it is appropriate for PainterCo to derecognize the paint because it could not compel the customer to return the paint. In other words, it no longer controls the paint. (It could not, for instance, use the paint for other contracts).

230. Assume that PainterCo estimates that a subcontractor would provide the painting services for CU2,000 (for simplicity, the price for bearing the risk of the paint being returned is ignored). In addition, PainterCo now estimates that a market participant would charge CU75 for managing the contract and for providing performance guarantees. Since there has been no change in the rights, the contract asset is now measured at CU925 (CU3,000 – CU2,000 – CU75). Therefore, as a
result of satisfying obligations in the contract (that is, delivering the paint to the customer and providing some contract management services), the contract asset has increased by CU825, which is recognized as revenue.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 825 \\
\text{Cr Revenue} & \quad 825
\end{align*}
\]

231. The revenue recognized reflects the value of the paint provided to the customer as well as the value of the services provided (i.e. obtaining and delivering the paint).

232. PainterCo also recognizes the cost of the paint when it is taken out of inventory and delivered to the customer’s premises.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 800 \\
\text{Cr Inventory} & \quad 800
\end{align*}
\]

233. PainterCo also incurs other costs associated with delivering the paint; however, these are not separately identified in this illustration.

Period ended July 31

234. During the period ended July 31, PainterCo completes painting the house and receives payment in full for these services. At this point, PainterCo does not have any remaining rights or obligations. The following entry is therefore recorded to reflect the cash payment and to derecognize the contract asset. The difference is recognized as revenue.

\[
\begin{align*}
\text{Dr Cash} & \quad 3,000 \\
\text{Cr Contract asset} & \quad 925 \\
\text{Cr Revenue} & \quad 2,075
\end{align*}
\]

235. PainterCo also recognizes the costs of providing the painting services:

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 1,600 \\
\text{Cr Cash} & \quad 1,600
\end{align*}
\]

236. The painting services are provided during a single reporting period. If, however, the services straddled multiple reporting periods, then the revenue recognized in a particular reporting period would be determined by estimating the amount a market participant would require to complete the painting services.
237. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>100</td>
<td>825</td>
<td>2,075</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td>(800)</td>
<td>(1,600)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>100</td>
<td>25</td>
<td>475</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
<td>(800)</td>
<td>600</td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract asset</td>
<td>100</td>
<td>925</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>100</td>
<td>125</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

Customer Consideration model

238. The Customer Consideration model recognizes revenue when a performance obligation is satisfied by transferring goods or services to a customer. The contract contains two potential performance obligations—the promise to provide paint and to provide painting services. Both are capable of separate delivery to the customer. However, it is uncertain in this case whether the paint itself is delivered separately from the painting services. Although PainterCo physically delivers the paint to the customer, PainterCo will utilize the paint in the subsequent service and therefore substantially retains the risks and rewards of ownership of the paint. For these reasons, paint is not treated as a performance obligation separate from painting services.

239. Note that the Customer Consideration model would not always preclude the recognition of revenue for the delivery of paint. If the contract (or operation of law) made it clear that the risks and rewards of paint ownership passed to the customer upon physical delivery of the paint, the Customer Consideration model would treat the delivery of paint as a separate performance obligation, the satisfaction of which would give rise to revenue.

Period ended June 30

240. At contract inception, PainterCo has the right to the customer’s performance (measured at CU3000) and allocates this entire measurement to a single performance obligation. As discussed above, the paint is not considered a separate
performance obligation, which is why the total consideration is assigned to the combined painting services obligation. PainterCo’s net position in the contract is zero because the rights and obligations are equal.

241. PainterCo pays CU800 to obtain the paint that is recorded in inventory.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Inventory</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>Cr Cash</td>
<td></td>
<td>800</td>
</tr>
</tbody>
</table>

*Period ended July 31*

242. During the reporting period ended July 31, PainterCo completes the house painting services and receives payment in full for those services. The payment of cash satisfies PainterCo’s right to the customer’s future performance and the completion of the painting service satisfies PainterCo’s remaining performance obligation.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Cr Revenue</td>
<td></td>
<td>3,000</td>
</tr>
</tbody>
</table>

243. PainterCo also recognizes the costs of providing the painting service, including the cost of the paint sold.

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cost of sales (expense)</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>Cr Cash</td>
<td></td>
<td>1,600</td>
</tr>
<tr>
<td>Cr Inventory</td>
<td></td>
<td>800</td>
</tr>
</tbody>
</table>

244. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th>Account</th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>-</td>
<td>(2,400)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>(800)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>800</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

**Current practice (U.S. GAAP and IFRS)**

245. Under current practice, the elements of this arrangement (that is, the paint and the painting services) are considered separate units of accounting because the *paint* can be sold separately (by PainterCo or by other suppliers) and PainterCo often
sells the painting service separately. However, none of the arrangement consideration is allocated to the paint for revenue recognition because the payment terms of the contract suggest that payment for the paint is contingent on successful completion of the painting service.6 Even if consideration was allocable to the paint, it is possible that revenue may have been recognized upon delivery because it is unclear whether PainterCo has relinquished significant risks and rewards of owning the paint (that is, it can be argued that PainterCo does not earn the related revenue at the time of delivery).

*Reporting period ended June 30*

246. Upon signing the contract, no revenue is recognized because no revenue is considered to have been earned and realized. In this case, revenue is earned as the painting services are rendered. No painting services were performed at contract inception; so revenue is not recognized.

247. During the reporting period ended June 30, the paint is delivered. But PainterCo does not recognize any revenue for this delivery because none of the contract consideration was originally allocated to this element of the arrangement. That is, revenue was determined to arise from the painting service and no painting services have been rendered at this point.

248. PainterCo records the following entry to reflect the costs of acquiring the paint and delivering it on June 30.

\[
\begin{array}{ccc}
\text{Dr} & \text{Inventory} & 800 \\
\text{Cr} & \text{Cash} & 800 \\
\end{array}
\]

6 EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverable*, Example 10 and Paragraph 14
Reporting period ended July 31

249. PainterCo rendered the painting service during the month of July and also received payment in full from the customer. Because realization has occurred and the earnings process is complete, the full amount of consideration received from the customer is recognized as revenue.

\[
\begin{align*}
\text{Dr Cash} & \quad 3,000 \\
\text{Cr Revenue} & \quad 3,000 
\end{align*}
\]

250. PainterCo also recognizes the corresponding cost of sales.

\[
\begin{align*}
\text{Dr Cost of sales} & \quad 2,400 \\
\text{Cr Inventory} & \quad 800 \\
\text{Cr Cash} & \quad 1,600 
\end{align*}
\]

251. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>June 30</th>
<th>July 31</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>-</td>
<td>(2,400)</td>
<td>(2,400)</td>
</tr>
<tr>
<td>Margin</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td>600</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>(800)</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>-</td>
<td>800</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>-</td>
<td>-</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

Illustration summary

252. In this example, revenue recognition under current practice (see paragraph 251), the Measurement model (paragraph 237) and the Customer Consideration model (paragraph 244) is different in a few key regards. First, current practice and the Customer Consideration model do not recognize any revenue at contract inception. The Measurement model, on the other hand, recognizes revenue at inception because the obligations are measured at an amount that is less than the rights to the customer’s performance. Whether this generates any margin depends on the expenses that PainterCo incurred in obtaining the contract.

253. Another key difference concerns the different conclusions under each model regarding when an obligation has been satisfied (or when delivery occurs as termed in current practice). Current practice does not consider any revenue to
have been earned upon delivery of the paint because PainterCo has a significant remaining obligation to provide the painting service. Similarly, the Customer Consideration model concludes that PainterCo has substantially retained the risks and rewards associated with the paint and therefore does not consider its physical delivery to satisfy a performance obligation. The Measurement model, however, derecognizes the paint at June 30 (and triggers revenue for satisfying the related obligation) because it concludes that PainterCo no longer controls the paint after physical delivery to the customer. Hence, the measurement of the contract after this point explicitly reflects the price to provide the painting services, but not the paint itself.

BOAT

254. Consider the following facts and assumptions:

On September 30, 2007, a customer contracts with a boat builder (Entity) for a boat to be delivered to the customer on April 1, 2008, for a fixed price of CU50,000. Under the terms of the contract, the customer is not obligated to pay Entity until delivery of the boat, at which point the title to the boat transfers to the customer. If the customer chooses to cancel the contract prior to delivery, payment must be made to Entity for any work completed up to that time.

The boat is a standard design offered by Entity as well as other boat builders. However, Entity does not typically hold boats in inventory (that is, all boats are built to fulfill specific customer orders).

Entity incurs direct contract acquisition costs of CU1,000. Entity also incurs other costs associated with obtaining the customer and the contract, but these costs are ignored in this example because they are not tied directly to the contract. Entity’s expected and actual costs to build the boat are CU36,000, which consist of raw materials of CU20,000 and labor costs of CU16,000.

The raw materials are all purchased on October 1, 2007. The labor costs are incurred, and the raw materials are consumed, evenly over the period October 1 to March 31. That is, the boat is 50 percent complete at December 31.

The time value of money is ignored for simplicity and Entity reports quarterly.
255. The staff chose this example for the following reasons:

- This example is similar to construction type contracts in that the entity provides materials and utilizes those materials in the satisfaction of a subsequent obligation. This scenario highlights the difficulty in identifying (for accounting purposes) whether a contract is for the delivery of a good or for a service.

- This example also highlights the relationship between satisfying obligations in a contract and the derecognition of assets as they are transferred to a customer to satisfy those obligations. This example strains this relationship more so than in the paint example because the inventory is being built for the customer on Entity’s site (as opposed to the painting example that featured delivery of paint and painting services on the customer’s site).

**Measurement model**

*Period ended September 30, 2007*

256. During the period ended September 30, 2007, Entity performs various activities that result in it obtaining a contract with a customer. As a result of the contract, Entity promises to provide the customer with a boat and in exchange receives the promise of cash consideration of CU50,000.

257. Assume that Entity estimates that a market participant (i.e. another boat builder) would charge CU45,500 on September 30, 2007, to provide a boat on April 1, 2008. In addition, it estimates that the price for managing the contract and the performance guarantee is CU500. In practice, if Entity has no evidence to suggest that its estimates would be inconsistent with market participants, it could use its own inputs.

258. For simplicity, assume that a market participant would not make any adjustments to the consideration due from the customer for the risk of non-payment. Hence, on
contract inception, Entity recognizes a contract asset measured at CU4,000 (CU50,000 rights less obligations of CU45,500 and CU500). Entity therefore records the following entry.

\[
\begin{array}{ll}
\text{Dr Contract asset} & 4,000 \\
\text{Cr Revenue} & 4,000 \\
\end{array}
\]

259. Entity also incurs direct contract acquisition expenses of CU1,000.

\[
\begin{array}{ll}
\text{Dr Contract acquisition expense} & 1,000 \\
\text{Cr Cash} & 1,000 \\
\end{array}
\]

*Period ended December 31, 2007*

260. On October 1, 2007, Entity purchases all of the materials required to build the boat.

\[
\begin{array}{ll}
\text{Dr Inventory (raw materials)} & 20,000 \\
\text{Cr Cash} & 20,000 \\
\end{array}
\]

261. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labor costs of CU8,000. These amounts increase the work-in-process (WIP) boat inventory account.

\[
\begin{array}{ll}
\text{Dr Boat (WIP)} & 18,000 \\
\text{Cr Cash} & 8,000 \\
\text{Cr Inventory (raw materials)} & 10,000 \\
\end{array}
\]

262. Entity also remeasures its contract asset at this reporting date by considering the remaining rights and obligations in the contract. Entity still has a right to the customer’s promise of cash consideration of CU50,000. However, assume that because of increases in the price of raw materials, Entity now estimates that another boat builder would currently require CU46,000 rather than CU45,500 to provide the boat. Entity’s CU500 estimate for contract management and performance guarantees does not change.

263. Therefore, the contract asset is now measured at CU3,500 (CU50,000 rights less obligations of CU46,000 and CU500). In other words, a market participant would now be willing to pay CU500 less than at September 30 for the remaining rights
and obligations in the contract. The CU500 decrease in the contract asset is recognized as a contract loss.7

\[
\begin{align*}
\text{Dr Contract loss} & \quad 500 \\
\text{Cr Contract asset} & \quad 500 
\end{align*}
\]

**Period ended March 31, 2008**

264. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labor costs of CU8,000. These amounts increase the work-in-process (WIP) boat inventory account.

\[
\begin{align*}
\text{Dr Boat (WIP)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000 
\end{align*}
\]

265. Assume that the contract asset is measured at the same amount as it was for the previous quarter.

**Period ended June 30, 2008**

266. Entity transfers the boat to the customer on April 1 and therefore derecognizes the boat from inventory.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 36,000 \\
\text{Cr Boat (WIP)} & \quad 36,000 
\end{align*}
\]

267. Upon delivery of the boat, Entity also satisfies its contractual obligation of CU46,500, which increases the contract asset and therefore results in the recognition of revenue.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 46,500 \\
\text{Cr Revenue} & \quad 46,500 
\end{align*}
\]

268. The net contract asset of CU50,000 then comprises only the right to the customer’s performance, which is settled upon payment from the customer.

\[
\begin{align*}
\text{Dr Cash} & \quad 50,000 \\
\text{Cr Contract asset} & \quad 50,000 
\end{align*}
\]

---

7 An alternative approach might treat this as negative revenue but discussion of this approach is outside the objective of this paper.
269. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,000</td>
<td>-</td>
<td>-</td>
<td>46,500</td>
<td>50,500</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(36,000)</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Margin</td>
<td>3,000</td>
<td>(500)</td>
<td>-</td>
<td>10,500</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Boat (WIP)</td>
<td>-</td>
<td>18,000</td>
<td>36,000</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Contract asset</td>
<td>4,000</td>
<td>3,500</td>
<td>3,500</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,000</td>
<td>2,500</td>
<td>2,500</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

270. Revenue arises from obtaining the contract and then from satisfying the contractual obligations. Note that the revenue recognized from satisfying these obligations represents the value of the goods and services provided to the customer at the date they were provided rather than the amount the customer was implicitly charged in the contract for those goods and services.

Broadening the model

271. The boat example highlights the two issues noted in the summary of the Measurement model.

- First, profit or loss for the period ended December 31, 2007, gives an incomplete depiction of how the increase in raw materials prices has affected the entity’s assets and liabilities. This is because the contract loss reflects how that increase has affected the price a market participant would demand for fulfilling the obligation to provide a boat. However, profit or loss does not reflect how that increase may affect the price of the raw materials in inventory or how it might increase the amount the entity would demand from a market participant for the partially completed boat on that date. Said more simply, the contract loss depicts Entity as if it had not started building the boat.

- Secondly, because the boat is measured at accumulated cost, profit or loss does not reflect the increase in the value of Entity’s assets from producing the boat until it is transferred to the customer.
272. Suppose that Entity could sell the partially completed boat to a market participant for CU20,000 and CU46,000 at December 31, 2007, and March 31, 2008 respectively. If the WIP was measured at these amounts, and the amount that exceeded the costs incurred was recognized in profit or loss as production income, then the above summary would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,000</td>
<td>-</td>
<td>-</td>
<td>46,500</td>
<td>50,500</td>
</tr>
<tr>
<td>Production income</td>
<td>-</td>
<td>2,000</td>
<td>8,000</td>
<td>-</td>
<td>10,000</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(46,000)</td>
<td>(46,000)</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>(500)</td>
<td>(500)</td>
<td>-</td>
<td>-</td>
<td>(500)</td>
</tr>
<tr>
<td>Margin</td>
<td>3,000</td>
<td>1,500</td>
<td>8,000</td>
<td>500</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Boat (WIP)</td>
<td>-</td>
<td>20,000</td>
<td>46,000</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Contract asset</td>
<td>4,000</td>
<td>3,500</td>
<td>3,500</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>3,000</td>
<td>4,500</td>
<td>12,500</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

273. The point to note is that in comparison to the previous table, the margin attributable to building the boat is recognized as the boat is constructed. This more faithfully depicts the changes in a broader set of the entity’s assets and liabilities throughout the contract.8

**Customer Consideration model**

274. Revenue arises when the contractual performance obligation is satisfied through a transfer of goods or services to the customer. In this case, a performance obligation arises for the construction and delivery of a boat. The contract must be reviewed to determine whether this particular contract is in the form of the delivery of a finished good, or is in the nature of a contract to provide boat constructing services. The boat (or the “good”) would not transfer until it is completed and delivered; the services obligation would be satisfied continuously.

---

8 Note that the raw material inventory was not remeasured at December 31, 2007. However, discussion of this accounting mismatch is outside the objective of this paper.
This contract states that Entity is entitled to payment if the customer cancels the contract prior to delivery of the boat. The Customer Consideration model assumes that this guaranteed compensation for the WIP indicates that the boat is essentially the customer’s throughout the contract. Thus, Entity promises to provide a service on the customer’s boat. That performance obligation is satisfied as the benefit of the service transfers to the customer (i.e. as the rights to the WIP continuously transfer to the customer).

Period ended September 30, 2007

At contract inception, Entity identifies and measures its rights and obligations under the contract. Entity has a right to the customer’s future performance measured at CU50,000. Entity also has an obligation for boat construction services that is measured at the same amount as the consideration promised from the customer. The amount of rights and obligations are equal, so no contract asset or liability is recognized at inception.

Entity also incurs direct contract acquisition expenses of CU1,000 that are expensed as incurred.

<table>
<thead>
<tr>
<th>Dr Contract acquisition expense</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Cash</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Period ended December 31, 2007

On October 1, 2007, Entity purchases all of the materials required to build the boat.

| Dr Inventory (raw materials) | 20,000 |
| Cr Cash                     | 20,000 |

Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account.

<table>
<thead>
<tr>
<th>Dr Boat (WIP)</th>
<th>18,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr Cash</td>
<td>8,000</td>
</tr>
<tr>
<td>Cr Inventory (raw materials)</td>
<td>10,000</td>
</tr>
</tbody>
</table>
280. Based on the work completed to date, Entity determines that half of the performance obligation has been satisfied by transferring ownership rights to the WIP to the customer. The total performance obligation was measured at CU50,000 at inception and this amount is not subsequently remeasured. The satisfaction of half this obligation is measured in the amount of CU25,000. This transfer thereby reduces the performance obligation for the same amount and generates revenue. Reducing the contract obligations while the rights remain unchanged gives rise to a contract asset.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000
\end{align*}
\]

281. If the risks and rewards of ownership of the boat have transferred to the customer, then the WIP boat balance is derecognized.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 18,000 \\
\text{Cr Boat (WIP)} & \quad 18,000
\end{align*}
\]

*Period ended March 31, 2008*

282. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account.

\[
\begin{align*}
\text{Dr Boat (WIP)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000
\end{align*}
\]

283. Based on the work completed to date, Entity also determines that the remaining CU25,000 of the performance obligation has been satisfied as ownership rights to the boat have transferred to the customer. This transfer of rights reduces the performance obligation and generates revenue.

\[
\begin{align*}
\text{Dr Contract asset} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000
\end{align*}
\]

284. As the ownership rights to the boat have transferred to the customer, the remaining boat balance is derecognized.

\[
\begin{align*}
\text{Dr Cost of sales (expense)} & \quad 18,000 \\
\text{Cr Boat (WIP)} & \quad 18,000
\end{align*}
\]
Upon delivery of the boat, no entry is required to derecognize the boat because this model assumes that the customer already had full ownership rights while the boat was constructed. The satisfaction of the performance obligation, while the rights have remained unchanged, has given rise to a contract asset equal to the measurement of the rights at inception (CU50,000). The contract rights are satisfied on payment by the customer and the contract asset is derecognized.

\[
\begin{align*}
\text{Dr Cash} & \quad 50,000 \\
\text{Cr Contract asset} & \quad 50,000
\end{align*}
\]

Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
<td>-</td>
<td>50,000</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>-</td>
<td>(18,000)</td>
<td>(18,000)</td>
<td>-</td>
<td>(36,000)</td>
</tr>
<tr>
<td>Direct contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Margin</td>
<td>(1,000)</td>
<td>7,000</td>
<td>7,000</td>
<td>-</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Boat (WIP)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract asset</td>
<td>-</td>
<td>25,000</td>
<td>50,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(1,000)</td>
<td>6,000</td>
<td>13,000</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

**Current practice (U.S. GAAP and IFRS)**

Under U.S. GAAP, this contract qualifies for percentage-of-completion (POC) accounting under the AICPA’s Statement of Position No. 81-1, which provides guidance for construction-type and other production-type contracts. Likewise, this contract qualifies as a construction contract under IFRS (IAS 11) that recognizes revenue and expenses under the POC method.

The POC method results in the recognition of revenue (and related costs) as Entity performs under the contract and makes progress toward the completion of the contract. In this case, assume Entity uses an input method to determine progress toward completion. This method is based on costs incurred to date as a
proportion of total costs expected to be incurred. This ratio yields the percentage of total revenue recognized during each reporting period.

Period ended September 30, 2007

289. At contract inception, Entity has not done any work under the contract and has not made any progress toward completion of the contract. In other words, Entity has not earned any revenue.

290. Entity incurs direct contract acquisition costs of CU1,000. Assume these costs are not included as inputs in the POC calculation because they are selling-related and do not relate to contract performance (see paragraph 50 of SOP 81-1 and paragraph 20 of IAS 11).

\[
\begin{array}{ll}
\text{Dr Contract acquisition expense} & 1,000 \\
\text{Cr Cash} & 1,000 \\
\end{array}
\]

Period ended December 31, 2007

291. On October 1, 2007, Entity purchases materials required to build the boat.

\[
\begin{array}{ll}
\text{Dr Inventory (raw materials)} & 20,000 \\
\text{Cr Cash} & 20,000 \\
\end{array}
\]

292. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

\[
\begin{array}{ll}
\text{Dr Cost of sales (boat-in-process)} & 18,000 \\
\text{Cr Cash} & 8,000 \\
\text{Cr Inventory (raw materials)} & 10,000 \\
\end{array}
\]

293. The CU18,000 of costs directly assigned to the boat-in-process are included as the inputs to the POC calculation. In other words, CU18,000 of costs have been incurred relative to total expected costs of CU36,000. Based on these amounts, Entity has progressed 50 percent toward contract completion and should therefore recognize 50 percent of the total consideration as revenue.

\[
\begin{array}{ll}
\text{Dr Accounts receivable (unbilled)} & 25,000 \\
\text{Cr Revenue} & 25,000 \\
\end{array}
\]
Period ended March 31, 2008

294. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

\[
\begin{align*}
\text{Dr Cost of sales (boat-in-process)} & \quad 18,000 \\
\text{Cr Cash} & \quad 8,000 \\
\text{Cr Inventory (raw materials)} & \quad 10,000 \\
\end{align*}
\]

295. Entity finishes the boat and therefore recognizes the remaining 50% of the total contract consideration as revenue.

\[
\begin{align*}
\text{Dr Accounts receivable (unbilled)} & \quad 25,000 \\
\text{Cr Revenue} & \quad 25,000 \\
\end{align*}
\]

Period ended June 30, 2008

296. On April 1, Entity bills the customer and delivers the boat. The customer pays in full at which point Entity derecognizes the outstanding receivable. For simplicity, this entry ignores the reclassification from unbilled to billed accounts receivable.

\[
\begin{align*}
\text{Dr Cash} & \quad 50,000 \\
\text{Cr Accounts receivable} & \quad 50,000 \\
\end{align*}
\]

297. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>Inception</th>
<th>Dec 31</th>
<th>Mar 31</th>
<th>Jun 30</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>-</td>
<td>25,000</td>
<td>25,000</td>
<td>-</td>
<td>50,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Contract acquisition expense</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Contract loss</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Margin</td>
<td>(1,000)</td>
<td>7,000</td>
<td>7,000</td>
<td>-</td>
<td>13,000</td>
</tr>
<tr>
<td>Cash</td>
<td>(1,000)</td>
<td>(29,000)</td>
<td>(37,000)</td>
<td>13,000</td>
<td></td>
</tr>
<tr>
<td>Inventory (raw materials)</td>
<td>-</td>
<td>10,000</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-</td>
<td>25,000</td>
<td>50,000</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(1,000)</td>
<td>6,000</td>
<td>13,000</td>
<td>13,000</td>
<td></td>
</tr>
</tbody>
</table>

Illustration summary

298. In this example, total revenue under current practice (see paragraph 297 above) and under the Customer Consideration model (paragraph 286) is less than total revenue under the Measurement model (paragraph 269). This difference arises because total revenue under current practice is equal to the customer
consideration while total revenue under the Measurement model represents the value of the goods and services provided to the customer at the time they are provided.

299. Another difference concerns derecognition of the boat. Current practice and the Customer Consideration model derecognize the boat as it is built because it concludes that the risks and rewards of owning the boat transfer to the customer throughout the construction process. Thus, the obligation to provide boat-building services on the customer’s boat is satisfied as those services are rendered. The Measurement model, however, does not derecognize the boat inventory because Entity controls the boat and does not satisfy the related obligation until the boat is delivered. The measurement of the contract at current exit price therefore reflects the price a market participant would require to take on the obligation to construct and deliver a boat.

300. To be clear, just as in the painting example, the outcome of the Measurement model here differs from current practice and the Customer Consideration model both because of the different measurement approaches and also because of the different conclusions reached about when the boat actually becomes the customer’s.

301. Comparing current practice to the broader Measurement model summarized in paragraph 272 is also instructive. First, some revenue and profit are recognized in paragraph 272 at contract inception for obtaining the contract. After contract inception, the margin in paragraph 272 is based on an assessment of the entity’s outputs—that is, the increase in the value of the partially completed boat. On the other hand, subsequent performance to date under current practice is assessed on the basis of the entity’s inputs.
WIDGET WITH RETURN RIGHT

302. Consider the following facts and assumptions:

| On December 31, 2007, Entity sells and delivers 100 widgets to 100 customers for CU10 each. These widgets were carried in Entity’s inventory at CU8 each. The customers pay cash at the time of sale but the terms of the contract allow each customer to return the widget within one year for any reason and to receive a full refund of the consideration.  
At contract inception, Entity expects five of the 100 widgets sold to be returned. Any returned widget can be resold but only at a discounted price of CU5. The fair value of a returned widget is CU3.  
Assume five widgets were actually returned during the year.  
Entity reports annually. |

303. The staff chose this example because many contracts for the sale of goods contain a right of return. It is important to illustrate how the Measurement and the Customer Consideration models treat these contracts relative to current practice.

Measurement model

Period ended December 31, 2007

304. During the period ended December 31, 2007, Entity performs various activities that result in it obtaining 100 contracts with customers. At inception of these contracts, Entity has an obligation to provide each customer with a widget (including the right to return the widget within a year for a full refund) and in exchange receives rights to the customer’s performance (payment of cash consideration) measured at CU10 per widget.

305. In this situation, each customer pays cash shortly after inception of the contract and by so doing, relinquishes Entity’s remaining rights under the contract. Entity then partially performs by delivering the widgets to the customers. However, Entity retains an obligation to accept any returns that may arise during the year.
and to refund the contract consideration. This obligation results in a contract liability for Entity.

306. The contract liability is measured at its current exit price—that is, the price that a market participant would require to assume the remaining refund obligation from Entity. Assume for this example that this price is CU50. This measurement of the remaining obligation reflects the amount a market participant would require for:

a) Refunding the consideration on the returns expected to arise during a year (CU50); plus
b) Processing the returns (CU5); plus
c) Bearing uncertainty about the number of returns that may arise (CU10); less
d) Receiving the benefit of any returned widgets (which, for instance, could then be resold at a discounted price) (CU3 \times 5 = CU15).

307. Based on the information above, Entity records the following entry:

\[
\begin{align*}
\text{Dr} & \quad \text{Cash} \quad 1,000 \\
& \quad \text{Cr} \quad \text{Contract liability} \quad 50 \\
& \quad \text{Cr} \quad \text{Revenue} \quad 950
\end{align*}
\]

308. Entity also derecognizes its inventory.

\[
\begin{align*}
\text{Dr} & \quad \text{Cost of sales} \quad 800 \\
& \quad \text{Cr} \quad \text{Inventory} \quad 800
\end{align*}
\]

*Period ended December 31, 2008*

309. During the period ended December 31, 2008, Entity stands ready to accept any returns. Each of the 100 contracts only required these services for a period of one year. Hence, Entity has satisfied its remaining obligations under the contracts by December 31, 2008. Revenue arises from the satisfaction of these obligations and is reported at the amount by which the contract liability has reduced (CU50).

\[
\begin{align*}
\text{Dr} & \quad \text{Contract liability} \quad 50 \\
& \quad \text{Cr} \quad \text{Revenue} \quad 50
\end{align*}
\]

310. Entity also processes five returns as expected. The following entry would be made to record the return of the five widgets and cash refund. For simplicity, the
administrative expenses associated with processing the returns are ignored in the illustration, although they would affect the margin reported for the period. The cost of sales amount represents the expense of providing the return service.

\[
\begin{align*}
\text{Dr Inventory (returns)} & \quad 15 \\
\text{Dr Cost of sales} & \quad 35 \\
\text{Cr Cash} & \quad 50
\end{align*}
\]

311. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>50</td>
<td>1,000</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(800)</td>
<td>(35)</td>
<td>(835)</td>
</tr>
<tr>
<td>Margin</td>
<td>150</td>
<td>15</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>Inventory (less inventory returns)</td>
<td>(800)</td>
<td>(785)</td>
<td></td>
</tr>
<tr>
<td>Contract liability</td>
<td>50</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>150</td>
<td>165</td>
<td></td>
</tr>
</tbody>
</table>

312. Consistent with the description of the model, the revenue recognized in 2007 is derived from the change in the contract liability. However, some think Entity’s revenue should not include the portion of that change that is due to refunding customer consideration. In this case, that amount is CU35 and represents consideration refunded (CU50) less the fair value of returned inventory (CU15). Revenue with respect to the returns would then reflect only the price for bearing risk and servicing the returns. The consideration received and refunded to customers is similar to a deposit, the receipt and repayment of which is not normally recognized as revenue and expense. An alternative presentation might record the journal entries in paragraphs 309 and 310 as follows:

\[
\begin{align*}
\text{Dr Contract liability} & \quad 50 \\
\text{Dr Inventory (returns)} & \quad 15 \\
\text{Cr Cash} & \quad 50 \\
\text{Cr Revenue} & \quad 15
\end{align*}
\]

313. The statement of financial position and margin would be the same under both presentations. However, the total amount of revenue recognized under the alternative above would be CU965 rather than CU1,000.
Customer Consideration model

Period ended December 31, 2007

314. At inception of the 100 contracts, Entity obtains rights to the customers’ consideration. These rights are measured at the amount of consideration expected to be retained. In this example, Entity expects to ultimately retain consideration of CU950 (CU1,000 - CU50) based on the expectation of 5 refunds. Hence, CU950 is allocated to the identified performance obligations.

315. The performance obligations giving rise to revenue in this example are the obligations to deliver widgets to the customers, net of those widgets expected to be returned. These performance obligations are satisfied on December 31, 2007 when the widgets are delivered to the customer, at which point Entity recognizes revenue in the amount of the customer consideration (CU950) that was allocated to these performance obligations.

316. The CU50 (CU10 × 5) consideration that Entity receives but expects to refund to customers, is not allocated to a revenue-generating performance obligation because it represents a failed sale. In other words, this portion of the contracts is expected to be cancelled by the customer. This expected refund amount (CU50) is netted against the CU15 (CU3 × 5) expected value of the future inventory to be returned. That net amount is then recorded as a refund liability.9

317. In this example, the cash received (CU1,000) exceeds the sum of the refund liability (CU35) and the performance obligations (CU950) by CU15 (CU1,000 - CU35 - CU950). This difference represents a reduction of the cost of sales for the widgets Entity expects to be returned (CU3 × 5).

318. Based on the explanations above, the journal entry at this date is as follows:

\[
\begin{align*}
\text{Dr Cash} & \quad 1,000 \\
\text{Cr Refund liability} & \quad 35 \\
\text{Cr Revenue} & \quad 950
\end{align*}
\]

9 Differing views might exist on how to measure this refund liability. Consideration of these views, however, is outside the objective of this paper.
319. The widget inventory of CU800 is de-recognized when it transfers to the customers.

\[
\begin{array}{l}
\text{Dr Cost of sales} \quad 800 \\
\text{Cr Inventory} \quad 800
\end{array}
\]

*Period ended December 31, 2008*

320. During the period ended December 31, 2008, Entity processes five widget returns, refunds the associated customer consideration (CU50), and receives the widgets into inventory at their reduced value (CU15). The refund liability (CU35) created at contract inception is thereby extinguished. The satisfaction of this liability does not give rise to revenue, however, because it was not identified as a revenue-generating performance obligation. Rather, the expected returns were treated as a failed sale at contract inception.

\[
\begin{array}{l}
\text{Dr Refund liability} \quad 35 \\
\text{Dr Inventory} \quad 15 \\
\text{Cr Cash} \quad 50
\end{array}
\]

321. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>-</td>
<td>950</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(785)</td>
<td>-</td>
<td>(785)</td>
</tr>
<tr>
<td>Margin</td>
<td>165</td>
<td>-</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(800)</td>
<td>(785)</td>
<td></td>
</tr>
<tr>
<td>Refund liability</td>
<td>35</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>165</td>
<td>165</td>
<td></td>
</tr>
</tbody>
</table>

**Current practice (U.S. GAAP and IFRS)**

*Period ended December 31, 2007*

322. Under current practice, Entity recognizes revenue upon delivery of the widgets if specific requirements are met.\(^{10}\) One of these requirements states that Entity

\(^{10}\) See FASB Statement No. 48 *Revenue Recognition When Right of Return Exists* and International Accounting Standard No. 18 *Revenue*. 

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must be able to reasonably estimate the future returns and must recognize a liability at the time of sale for those expected returns. Entity is deemed to meet these requirements and therefore recognizes revenue of CU1,000 (CU10 × 100) upon delivery of the widgets.

\[
\begin{align*}
\text{Dr Cash} & \quad 1,000 \\
\text{Cr Revenue} & \quad 1,000
\end{align*}
\]

323. Cost of sales of CU800 (CU8 × 100) is also recognized for the delivered widgets.

\[
\begin{align*}
\text{Dr Cost of sales} & \quad 800 \\
\text{Cr Inventory} & \quad 800
\end{align*}
\]

324. For the units expected to be returned, Entity then reduces revenue by CU50 (CU10 × 5) and recognizes a liability. This liability is measured at CU7 per unit which is the CU10 expected refund less the CU3 fair value of the returned widget.\(^{11}\) Hence the total liability is CU35 (CU7 × 5) and cost of sales is adjusted for the residual CU15 (CU50 - CU35).

\[
\begin{align*}
\text{Dr Revenue} & \quad 50 \\
\text{Cr Refund liability} & \quad 35 \\
\text{Cr Cost of sales} & \quad 15
\end{align*}
\]

*Period ended December 31, 2008*

325. During the period ended December 31, 2008, Entity processes five widget returns, which satisfies the refund liability. Entity also records the returned widgets in inventory at their fair value and refunds the customers’ cash. For simplicity, this example ignores product handling and other incremental administrative expenses that Entity may have incurred.

\[
\begin{align*}
\text{Dr Refund liability} & \quad 35 \\
\text{Dr Inventory} & \quad 15 \\
\text{Cr Cash} & \quad 50
\end{align*}
\]

\(^{11}\) The staff acknowledges that differences in practice might exist between U.S. GAAP and IFRS (and possibly within one or the other) in terms of measuring this liability. For example, some entities might record the liability for the gross amount of consideration expected to be refunded (CU50) rather than the net amount of CU35 (CU50 – CU15) as done here in this example. However, analysis of these differences is outside the scope of this paper.
326. Summarizing the above journal entries results in the following:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>950</td>
<td>-</td>
<td>950</td>
</tr>
<tr>
<td>Cost of sales (expense)</td>
<td>(785)</td>
<td>-</td>
<td>(785)</td>
</tr>
<tr>
<td>Margin</td>
<td>165</td>
<td>-</td>
<td>165</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>950</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>(800)</td>
<td>(785)</td>
<td></td>
</tr>
<tr>
<td>Refund liability</td>
<td>35</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td>165</td>
<td>165</td>
<td></td>
</tr>
</tbody>
</table>

**Illustration summary**

327. Comparing the tables in paragraphs 311, 321 and 326 reveals key differences between the Measurement model and the other two models (Customer Consideration and current practice). The Customer Consideration model and current practice treat the expected returns at inception as a failed sale and therefore exclude their effect from the statement of comprehensive income. The Measurement model, on the other hand, considers the customer’s right to return the widget as a separate contractual obligation whose satisfaction gives rise to revenue. As a result of this difference, total revenue under the Measurement model is equal to the consideration originally received/promised in the contract (CU1,000) while revenue under the Customer Consideration model and current practice is equal to the cash ultimately retained (CU950) after refunding CU50 for the five widgets returned.

328. Another difference is that the total margin under the Measurement model is recognized over the life of the contracts. In particular, note that the margin that is attributable to the service of providing a right of return is recognized over the period that that service is performed. This is different from the Customer Consideration model and from current practice which both recognize total profit upon delivery of the widgets although Entity is providing risk coverage throughout 2007.
REVENUE RECOGNITION: STRENGTHS AND WEAKNESSES OF THE MEASUREMENT AND CUSTOMER CONSIDERATION MODELS

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INTRODUCTION

1. In the coming months, the staff will present memos that examine the strengths and weaknesses of the proposed measurement and customer consideration models in relation to current practice (both U.S. GAAP and IFRS). As a brief summary, the staff presents here a tentative list of the strengths and weaknesses that will be examined. The list is composed of assertions that proponents of the proposed models have voiced at various times. The staff makes little attempt to justify these assertions in this memo and acknowledges that this is an important task that still needs to be addressed before the publication of a discussion paper.

2. The list highlights how both models would represent improvements to current practice. The list then highlights the strengths and weaknesses that are unique to each model when compared to current practice.

COMMON IMPROVEMENTS TO CURRENT PRACTICE

3. The proposed measurement and customer consideration models improve current practice in a number of ways. This first section highlights the ways in which both models improve current practice.

   a. Conceptual consistency. The models provide a conceptual definition of revenue based on changes in assets and liabilities (the contract asset or liability, to be specific). This definition will help standard setters and constituents apply revenue
recognition guidance more consistently across transactions and industries because assets and liabilities have accepted definitions whereas an earnings process does not. This is not to say that the notion of an earnings process is completely abandoned. Instead, the focus on changes in assets and liabilities clarifies what an earnings process is and the points at which the process transfers an economic resource to a customer.

b. **Single Comprehensive Standard.** Because the proposed models create a single, comprehensive standard for revenue recognition, there will be only one primary source of revenue recognition guidance. This will decrease the pressure on preparers, auditors, and regulators to determine the appropriate guidance for a particular transaction.

c. **Convergence.** Adoption of either proposed model leads to a converged standard for U.S. GAAP and IFRS.

d. **Clarification of difference between IAS 11 and IAS 18.** The models make clear why revenue arises during some long-term construction projects (because the underlying obligation is satisfied continuously, thus increasing a contract asset or decreasing a contract liability) but not all such projects (because the obligation is not satisfied until final delivery). Under both models, there is no longer two models of revenue recognition—one for services and one for goods. Instead, there is one model that focuses on how obligations are satisfied by the transfer of economic resources from the entity to the customer.

e. **Guidance on multiple-element arrangements.** Treatment of multiple-element arrangements in IFRS is minimal, and it is spread across a number of different standards under U.S. GAAP. The proposed models provide guidance on identifying performance obligations in a contract by defining performance obligations as the enforceable promises within a contract to transfer an economic resource to the customer. When the economic resource is transferred at a different
time from other economic resources in the contract, the obligation to transfer that resource is treated as a separate deliverable or element for accounting purposes.

f. **No deferred revenue for delivered elements in the United States.** In multiple-element arrangements under U.S. GAAP, revenue for delivered elements is sometimes deferred because there is no objective evidence of the separate selling price of an undelivered element. In some cases, the consequence of such deferrals is that the entity recognizes delivered goods as assets even though it no longer controls those goods. The proposed models allow estimates of a separate selling price or a current exit price for undelivered elements, and thus do not defer revenue for delivered elements on that basis.

It is worth noting that this improvement to current practice also overcomes a potentially important difference that exists today between U.S. GAAP and IFRS. Under IFRS, there is no requirement that objective evidence of a selling price must exist for undelivered items in order to recognize revenue on delivered items.

g. **No need to identify predominant element.** Under both models, there is no need to determine which element in an arrangement is the predominant element. Because the remaining rights and obligations are measured at each reporting date under the measurement model, there is no need to identify a dominant deliverable in an arrangement. Similarly, the customer consideration model provides guidance on how deliverables should be separated, so there is no need to identify a predominant element.

**UNIQUE STRENGTHS AND WEAKNESSES FOR EACH MODEL (COMPARSED TO CURRENT PRACTICE)**

4. Apart from the common improvements noted above, each model has its own unique strengths and weaknesses compared to current practice. This next section provides a tentative list of those strengths and weaknesses. Note that many of these strengths and
weaknesses are simply assertions with little analysis or justification. The Boards have not yet deliberated these assertions, so the list is obviously tentative.

**The Measurement Model**

5. The measurement model offers a number of additional *strengths compared to current practice*.

    a. *Clearer depiction of the underlying economics.* Because the model focuses on assets and liabilities and measures them explicitly, it more faithfully represents the economic phenomenon that is the contract with a customer.

    b. *Better prediction of future cash flows in the income statement.* Because revenue reflects the value of the goods or services on the day they are provided plus any residual revenue from new contracts in a period, total revenue is a better representation of the cash flows a seller can expect to receive on similar contracts with customers in the future.

    c. *Better reporting of margins.* The model requires the measurement of obligations to include the margin required for providing the remaining goods and services (if a market participant would require a margin). This ensures that profit (or loss) is recognized over the entire duration of the contract. The income statement also yields information about the different margins demanded by market participants for different components of the contract.

    d. *Comparability within an entity’s own statements.* The model accounts for similar obligations similarly, regardless of how the obligation is incurred. That is, the history of a particular obligation does not affect its current measurement, so two identical obligations incurred through different means will be reported the same at any point in time.

    e. *Comparability across entities’ statements.* Because the current exit price measurement is based on what a market participant would pay (or require) to
acquire (or assume) the remaining rights and obligations in the contract, to the extent that entities have similar contracts and implement the measurement approach consistently, those contracts will be reported similarly.

f. *No deferred acquisition costs.* The model removes the need to identify which acquisition costs should be deferred because revenue is sometimes recognized at contract formation and can thus offset the acquisition costs. This also decreases the likelihood of recognizing acquisition costs as assets (that is, deferred debits) when those expended costs themselves do not represent a future economic benefit.

g. *No reliance on onerous contract tests.* Because remaining obligations are remeasured each reporting date, there are fewer surprises about an entity’s poor performance under a contract. Current guidance requires onerous contract tests based on total expected cash outflows relative to total expected inflows, and once these two amounts are equal, the contract is remeasured downward to a current exit price. Such steep downward impairments often surprise users.

h. *Unbiased reporting of subsequent changes in circumstances.* Because remaining obligations are measured each reporting date at current exit price, both favorable and unfavorable changes in circumstances are reported. Current guidance recognizes some unfavorable changes (i.e. if the contract is onerous) but ignores most favorable changes.

i. *IAS 37 compatibility.* The measurement model results in measurement of contract liabilities that is more consistent with the measurement attribute required for most other liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* As a result, there is no reason to distinguish performance obligations in a contract with a customer from obligations that exist outside a customer contract.

j. *Multiple contracts.* The measurement model mitigates the need to determine when multiple contracts may actually represent one single contract. Because each contract’s rights and obligations are measured at current exit prices, it does not
matter whether the remaining obligations are combined into one contract or spread across multiple contracts.

6. The measurement model creates a number of additional *weaknesses compared to current practice* (or allows them to persist in current practice).

   a. *Judgment required to measure current exit prices.* The current exit price measurement attribute will often rely on unobservable inputs that are difficult to determine, hard to verify, and allow considerable room for judgment.

   b. *Costly measurement approach.* The need to re-measure performance obligations on a regular basis is burdensome to many preparers, and the resulting improvement in reporting may be inconsequential to users.

   c. *Estimating an amount that doesn’t exist.* If an entity cannot layoff its performance obligations to a third party, then measuring those obligations at a current exit price required by market participants is an attempt to measure an aspect of the performance obligation that does not exist.

   d. *Revenue not equal to consideration received.* Because revenue equals the value of the goods or services on the day they are provided to the customer (as opposed to the value on the day the contract was formed), total revenue over the contract’s life will often be different from total consideration received from the customer. This may trouble users who equate the top line (roughly) with the inflow of assets received from the customer. Various display approaches may help overcome this weakness, but the displays themselves are complicated and may not be worth the cost to produce.

   e. *Poor prediction of likely cash flows on the balance sheet.* If an entity rarely lays off its performance obligations, then measuring those obligations at a current exit price will often be quite different from the actual cash flows that result. It is unclear how much more decision useful it is to have a current exit price
measurement (which includes a profit margin charged by the market) rather than a future most likely cash flow amount (which omits this profit margin).

**The Customer Consideration Model**

7. The customer consideration model does not offer any additional strengths compared to current practice that are not already mentioned as common improvements made by both models. However, the customer consideration model creates a few additional weaknesses compared to current practice (or allows these weaknesses to persist).

   a. **Judgment required to measure selling prices.** The selling price for goods and services never sold separately will often rely on unobservable inputs that are difficult to determine, hard to verify, and allow room for judgment.

   b. **Untimely prediction of future cash flows in the income statement.** Because revenue equals the amount originally allocated to the performance obligations satisfied this period, any changes in the amounts for which the seller can sell these goods and services to customers will not get reflected in the current reporting period.

   c. **Margins are implicit rather than explicit.** The customer consideration model implicitly includes in the measurement of the obligations the margin that the entity required for providing the goods and services specified in the contract. However, the subsequent measurement can be inconsistent as to whether a margin is included or whether that margin is representative of the margin required for the remaining goods and services.

   d. **IAS 37 measurement inconsistency.** The customer consideration model results in measurement of contract liabilities that are inconsistent with the measurement attribute required for most other liabilities in IAS 37.

   e. **Losses at contract inception.** Because this model does not allow recognition of any revenue before performance under the contract occurs, acquisition costs
(which are expensed as incurred) that are associated with a contract would result in losses at contract inception.

f. **Comparability within an entity’s own statements.** The customer consideration model accounts for similar obligations differently depending on how the obligation is incurred. That is, the history of a particular obligation does affect its current measurement, so two identical obligations incurred through different means will often be reported differently at a point in time.

g. **Comparability across entities’ statements.** Because obligations are reported at the amount initially allocated to them, two entities with identical obligations may not report them similarly simply because of the other goods and services that might have been sold in the contract.

h. **Reliance on onerous contract tests.** Because remaining obligations are reported at the amount originally allocated to them, this model would require an onerous contract test. Such tests can lead to sudden and steep increases in liabilities. Furthermore, because the remeasurement is required only by exception, there is the risk of a required remeasurement being overlooked.

i. **Biased reporting of subsequent changes in circumstances.** Because remaining obligations are measured at each reporting based on the amount of consideration initially allocated to those obligations and only remeasured if the contract is onerous, only unfavorable changes that cause the contract to become onerous are reported.

j. **Poor prediction of likely cash flows on the balance sheet.** The measure allocated to performance obligations at contract inception is unlikely to represent the actual cash flows associated with fulfilling that obligation. Because the allocated amount rarely represents actual separate selling prices nor the costs to fulfill the obligations, it’s not clear what cash flows the allocated measure is helping to predict.
CONCLUSION

8. This memo summarizes a list of asserted strengths and weaknesses of the proposed revenue recognition models, without providing an in-depth analysis of these assertions. The staff welcomes any comments and clarifying questions related to any of these assertions. The staff intends to use this feedback as it examines these assertions in more depth in the coming months.