REVISED MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Revenue Recognition Team (McGrath, ext 443)
Subject:	Revised Minutes of the July 26, 2006 Board Meeting
Date:	August 11, 2006
cc:	FASB: Bielstein, Smith, MacDonald, Revenue Recognition Team, Leasing Team, Carney, Gabriele, Sutay, Golden, Allen, Polley, FASB Intranet; IASB: Leisenring, Rees, Hickey, Upton, Knubley, Peerless; AASB: Paul; GASB: Patton

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FASB Staff Position.

Topic:	Revenue Recognition: Application of the Board's Decision on the Meaning of *Performance* to Certain Revenue Contracts
Basis for Discussion:	Memorandums Nos. 83–87
Length of Discussion:	1:15 to 2:15 p.m.
Attendance:	
Board members present:	FASB: Herz, Batavick, Crooch, Linsmeier, Trott, and Young IASB: Leisenring
Board members absent:	Seidman
Staff in charge of topic:	Figgie
Other staff at Board table:	FASB: Bielstein, T. Johnson, McGrath, and Arveseth IASB: Rees (by phone)
Outside participants:	None

<u>Summary of Decisions Reached</u>:

The Board previously decided to explore revenue recognition based on the following criterion:

> Revenue should be recognized if the customer must accept performance to date. That is, the contract's legal remedy for breach is, or is like, specific performance, or in the event of customer cancellation, the customer is obligated to pay damages reflecting performance to date.

At this meeting, the Board discussed the application of that decision to four examples. The Board tentatively decided that revenue should be recognized as the reporting entity performs under the contract and creates (produces) an asset for its customer if, in the event of customer breach, the legal remedy is:

1. Specific performance, which requires both parties to the contract to fully perform as promised;

2. Partial physical settlement, which requires the customer to pay an amount that reimburses the reporting entity for its costs incurred for production to date plus a profit margin and, in exchange for paying those damages, the customer obtains the work in process; or

3. Net cash settlement, which requires the customer to pay damages in an amount sufficient to place the reporting entity in as good a position as it would have been if the contract had been performed.

The Board also tentatively decided that if the contract contains explicit customer acceptance provisions that obligate the customer to compensate the reporting entity for performance to date at certain points during the contract term (and there are no other legal remedies available in the event of customer breach), revenue would be recognized only at those specified acceptance points.

<u>Objective of Meeting:</u>

The objective of this meeting was to further discuss the Board's decision that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Ms. Figgie opened the meeting by stating that the Board previously decided that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. Ms. Figgie stated that the objective of this meeting was to illustrate how that decision would be applied to certain revenue contracts. Ms. Figgie further explained that the Board would be discussing four examples and each explored how the decision would be applied to a specific fact pattern. (Those examples are included in the Board meeting audience handout, which is attached as an appendix to these minutes.) Ms. Figgie pointed out that the IASB Board discussed the four examples at the IASB meeting the previous week and generally agreed that the staff had appropriately applied the decision to the four examples.

Example 1: A Contract That, in the Event of Breach, Requires a Legal Remedy of Specific Performance

2. Ms. Figgie introduced Example 1, which applies the Board's decision to a contract that, in the event of breach, requires a legal remedy of specific performance. Specific performance requires both parties to perform fully as promised in the contract. The Board agreed that if a contract has a remedy of specific performance, revenue would be recognized as the reporting entity performs over the contract period because the customer is required to accept performance to date (and compensate the reporting entity for it).

3. Mr. Trott questioned whether it was necessary to make a distinction between Scenario A (the customer has legal ownership of the work in process) and Scenario B (the reporting entity has legal ownership of the work in process until delivery). He acknowledged that the revenue and expense recognition is the same under the two scenarios but questioned why the balance sheet related journal entries are different based on which party owns the work in process. He noted that, economically, those scenarios are the same (even if they are different from a legal perspective). Mr. Trott stated that the distinction between the two scenarios does not add enough value to justify the added complexity. Mr. Trott suggested that if the reporting entity determines that the contract's legal remedy in the event of breach would be specific performance, the reporting entity should recognize its production process as illustrated in Scenario B (that is, assume that the reporting entity has legal ownership of the work in process).

4. Mr. Leisenring agreed with the revenue recognition in the example but disagreed with the journal entries that are made at contract inception. He stated that although the reporting entity has an asset and liability, it is not appropriate to measure them at the full contract amount.

Example 2: A Contract That, in the Event of Customer Breach, Requires a Remedy of Partial Physical Settlement

5. Ms. Figgie introduced Example 2, which applies the Board's decision to a contract that, in the event of customer breach, requires a legal remedy of *partial physical settlement*. Partial physical settlement requires the customer to pay damages that reimburse the reporting entity for its costs incurred to date plus a profit margin (either on those costs or on the entire contract). In exchange for paying those damages, the customer obtains the work in process. The Board agreed that revenue recognition would be identical to Example 1. That is, if a contract has a remedy of partial physical settlement, revenue would be recognized as the reporting entity performs over the contract period because the customer is required to accept performance to date (and compensate the reporting entity for it).

6. Mr. Trott reiterated his concern that the distinction between Scenarios A and B is unnecessary.

7. Mr. Leisenring asked what would happen if the reporting entity breached the contract. Ms. Figgie responded that all of the examples assumed that the reporting entity was a going concern entity and, therefore, would fulfill its contracts.

Example 3: A Contract That, in the Event of Customer Breach, Requires a Remedy of Net Cash Settlement

8. Ms. Figgie introduced Example 3, which applies the Board's decision to a contract that, in the event of customer breach, requires a legal remedy of net cash settlement. Net cash settlement requires the customer to pay monetary damages in an amount sufficient to place the reporting entity in as good a position as it would have been if the contract had been performed. Ms. Figgie explained that the staff developed two alternatives for Example 3. Under Alternative A, revenue recognition would be identical to Examples 1 and 2. That is, revenue would be recognized as the reporting entity performs over the

contract period. Under Alternative B, the reporting entity would recognize revenue when it fully extinguishes its performance obligation (or the customer breaches the contract).

9. The majority of Board members (Herz, Batavick, Crooch, Linsmeier, and Trott) supported Alternative A. (Ms. Seidman was absent but provided written comments that she supported Alternative A.) Mr. Young supported Alternative B.

10. Mr. Trott noted that revenue recognition under Alternative A is consistent with Examples 1 and 2; however, Alternative B is more consistent with current practice.

11. Mr. Herz agreed that Alternative A is consistent with the Board's decision that revenue should be recognized as the reporting entity performs as long as the reporting entity has an unconditional right to be compensated for that performance. He explained that the primary difference between Example 3 and the previous two examples is not the amount of consideration that the reporting entity will eventually receive but from **which customer** the consideration might flow. Mr. Herz noted that Alternative B is inappropriate because it only considers the consideration from the original customer.

12. Mr. Herz added that buttressing a performance-based model for revenue recognition with a notion of legal remedies might create problems or inconsistencies among different legal jurisdictions. Mr. Batavick added that the proposed Statement on revenue recognition is expected to be applied internationally. He expressed concern about how the Board's decision would be applied in countries with different legal systems, such as those that do not provide legal remedies to compensate the nonbreaching party. Mr. Herz and Ms. Figgie responded that in a jurisdiction that lacked such legal remedies, a reporting entity might default to an extinguishment-based model (such as Alternative B) if the reporting entity does not have an unconditional right to consideration until it fully extinguishes its performance obligation.

13. Mr. Linsmeier stated that he is troubled with Alternative A if the product is not fungible because the reporting entity might be unable to resell the product. Mr. Linsmeier further stated that if the reporting entity is unable to resell the project, it might be inappropriate to recognize revenue and expense because the reporting entity would keep the product and receive a net settlement amount from the breaching customer. Ms. Figgie responded that if the reporting entity could not resell the product, it could collect

the entire contract amount from the original customer and most likely would give the product to the customer.

14. Mr. Leisenring noted that the primary issue is whether a revenue contract gives rise to recognizable assets and liabilities and the second issue is how the reporting entity should measure those assets and liabilities. Mr. Linsmeier stated that the language used to describe when revenue should be recognized should be clearer in its focus on changes in assets and liabilities. That is, the language should not focus on what happens in the event of breach. Mr. Trott stated that the staff's examples focus on assets and liabilities because as the reporting entity performs, it has the right to collect consideration from the customer. That right is measured based on the sum of the production costs incurred to date plus a portion of the contract's profit margin. Mr. Linsmeier agreed but encouraged the staff to be clearer in the words it chooses to explain when revenue should be recognized.

Example 4: A Contract That Has Contractually Stated Customer Acceptance Provisions

15. Ms. Figgie introduced Example 4, which applies the Board's decision to a contract that contains contractually stated customer acceptance provisions. The example assumes that there are no legal remedies for customer breach other than what is included in the customer acceptance provisions. That is, if the customer were to breach the contract before the contractually stated acceptance point, the reporting entity would receive no consideration for its performance because the customer is not obligated to pay anything. The Board agreed that revenue would be recognized only at those explicit customer acceptance points.

16. Mr. Trott questioned whether the facts in Example 4 were realistic. He stated that even if a contract has contractually stated acceptance provisions, the court might enforce another remedy if the customer breaches. Ms. Figgie responded that if a contract specifies a remedy, the court generally will enforce that remedy, unless it is considered egregious. Mr. Trott stated that he is concerned with Example 4 because revenue is not recognized based on performance, which is inconsistent with the first three examples. Rather, revenue in Example 4 is consistent with a completed contract notion. Mr. Trott

stated that some reporting entities might structure contracts to produce desired revenue recognition.

17. Mr. Herz expressed concern about buttressing a performance-based model for revenue recognition with a notion of legal remedies. He questioned whether it was possible or desirable to use legal concepts to determine when revenue should be recognized. Moreover, he stated that the majority of contracts are fulfilled but revenue recognition would consider what happens in the event of breach.

18. Mr. Trott stated that the staff appropriately applied the Board's decision about when revenue should be recognized; however, based on the outcome in Example 4, he is not confident that the approach is workable. He questioned whether another revenue recognition method would be better.

19. Ms. Figgie stated that the staff would use the Board's comments and input to continue to explore and develop the criteria for when revenue should be recognized, including an analysis of multiple-element contracts.

Follow-up Items:

None

General Announcements:

None.

APPENDIX

Financial Accounting Standards Board

Board Meeting Handout

July 26, 2006
Joint Revenue Recognition Project

BACKGROUND

In March 2006, the Board discussed two revenue recognition methods. Under the extinguishment-based method (EBM), revenue is recognized when the obligation to provide goods, services, or other rights is extinguished. Under the performance-based method (PBM), revenue is recognized as the entity's production process creates or enhances assets for customers. In April 2006, the Board continued to discuss revenue recognition methods and agreed that the notion of *customer acceptance* is important in determining when performance has occurred (and, thus, when revenue should be recognized). The Board further decided that customer acceptance means that the entity has obtained an unconditional right to at least some consideration (and, correspondingly, that the customer has incurred an unconditional obligation for at least some consideration) for performance to date. That unconditional right might arise under the contract terms or the operation of the relevant contract law.

The Board instructed the staff to explore revenue recognition based on the following criterion:

> Revenue should be recognized if the customer must accept performance to date. That is, the contract's legal remedy for breach is, or is like, specific performance or in the event of customer cancellation, the customer is obligated to pay damages reflecting performance to date.

PURPOSE OF TODAY'S DISCUSSION

The objective of today's meeting is to further discuss the Board's decision that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for performance to date. The Board will consider how that decision would be applied to certain revenue contracts.

CRITERIA FOR REVENUE RECOGNITION

The Board's decision has been trifurcated into three criteria for revenue recognition. That is, revenue should be recognized for the reporting entity's performance to date when either (a) the contract's legal remedy in the event of breach is specific performance, (b) in the event of customer breach, the customer is obligated to pay monetary damages reflecting performance to date, or (c) the contract contains explicit customer acceptance provisions that unconditionally obligate the customer to compensate the reporting entity for performance to date.

Criterion 1: The Contract's Legal Remedy In The Event Of Breach Is Specific Performance.

The legal remedy of specific performance requires the parties to fully perform as promised under the contract. The seller will perform by providing goods, services, or other rights to the buyer and, in exchange, the buyer will perform by paying consideration to the seller. In other words, in all cases (including breach), the contract will be physically settled in full ('full physical settlement'). Specific performance is awarded when monetary damages are inappropriate or inadequate.

Criterion 2: In the Event of Customer Breach, the Customer Is Obligated to Pay Monetary Damages Reflecting Performance to Date

Most contracts do not require a remedy of specific performance. Rather, the common remedy in the event of breach is monetary damages. Generally, the objective of monetary damages is to place the aggrieved party in as good a position as it would have been in if the contract had been performed fully as promised.

Criterion 2 is bifurcated into two sub-criteria.

Subcriterion A: The customer is required to pay a net cash settlement amount

Subcriterion A represents a one-way flow (of cash) from the buyer to the seller. If the buyer breaches a contract for the sale of a good prior to delivery, the seller may, in making an attempt to mitigate damages, resell the good and recover from the buyer the difference between the contract price and the price at which the seller was able to resell the good (if that resale price is less than the contract price), together with any incidental damages, less any costs avoided because of the buyer's breach.

Subcriterion B: The parties to the contract physically settle it in part ('partial physical settlement')

Subcriterion B represents a two-way flow of resources. That is, this remedy requires the customer to pay an amount that reimburses the reporting entity for the costs incurred for production to date plus a profit margin (either on production to date or on the entire contract). In exchange for paying those damages, the customer obtains the work in process and the title to it. In other words, the parties physically settle the **finished** portion of the contract.

Criterion 3: The Contract Contains Explicit Customer Acceptance Provisions

Some contracts contain explicit customer acceptance provisions that unconditionally obligate the customer to compensate the reporting entity for performance to date at certain points during the contract term. Thus, at those points, the reporting entity obtains an unconditional right to at least some consideration from the customer.

At this meeting, the Board will focus on Criterion 1 (the contract's legal remedy in the event of breach is specific performance) and Criterion 2, Subcriterion B (in the event of customer breach, the parties physically settle the contract **in part**). The appendixes to this handout include preliminary explorations of Criterion 2, Subcriterion A and Criterion 3.

ILLUSTRATIVE EXAMPLE

The following example illustrates the application of the Board's decision on the meaning of performance to certain contracts.

Example Facts

> In Period 1, Company and Customer enter into a contract for a single Product that Company is to produce for $100,000. Company's expected and actual cost to produce the Product will be $60,000. Delivery cost will be zero because Customer will pick up Product at Company's production facility.
>
> Production is 60 percent complete at end of Period 1 and 100 percent complete at the end of Period 2. Customer picks up the Product and pays for it at the beginning of Period 3.

Example 1: The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

Two scenarios are illustrated for each example:

Scenario A: Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.

Scenario B: Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.

Example 1: The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

<table>
<tr><td></td><td>Scenario A: Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.</td><td>Scenario B: Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.</td></tr>
<tr><td><u>Contract inception</u></td><td>Claim against Customer $100,000
    Contract liability $100,000</td><td>Claim against Customer $100,000
    Contract liability $100,000</td></tr>
<tr><td></td><td colspan="2">The Board previously decided that if the contract's legal remedy in the event of breach is specific performance, the unit of account at contract inception should be the assets and liabilities that arise from the contract.</td></tr>
<tr><td><u>End of Period 1</u>
To recognize revenue and costs associated with Company's performance to date; production is 60% complete.</td><td>Production asset $60,000
    Contract revenue $60,000
    ($100,000 × 60%)

Contract expense $36,000
    Accounts payable $36,000
    ($60,000 × 60%)

Contract liability $60,000
    Claim against Customer $60,000

Consideration receivable $60,000
    Production asset $60,000</td><td>Production asset $60,000
    Contract revenue $60,000
    ($100,000 × 60%)

Contract expense $36,000
    Accounts payable $36,000
    ($60,000 × 60%)</td></tr>
<tr><td></td><td>Staff note: As Company manufactures Product and legal title to it transfers to Customer, a portion of the contract has been completed. Therefore, Company extinguishes a portion of its contract liability.

Because Customer obtains legal title to the work in process, Company removes the production asset from its balance sheet to reflect that it has been transferred to Customer and, in exchange, obtains a receivable from Customer for the work in process.</td><td>Staff note: Under this scenario, Company retains legal title to Product until delivery; therefore, the production asset remains on Company's balance sheet.

Moreover, Company neither extinguishes any portion of its contract liability nor obtains a receivable from Customer until Product is tendered to Customer and legal title to it is transferred.</td></tr>
</table>

Example 1: The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

<table>
<tr><td></td><td>Scenario A: Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.</td><td>Scenario B: Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.</td></tr>
<tr><td>Summary of Account Balances—
End of Period 1</td><td><u>Balance Sheet</u>
Claim against Customer $40,000
Consideration receivable 60,000

Contract liability $40,000

Accounts payable 36,000

Retained earnings $24,000

<u>Income Statement</u>
Contract revenue $60,000
Contract expense $36,000</td><td><u>Balance Sheet</u>
Claim against Customer $100,000

Contract liability $100,000
Less: Production asset <u>(60,000)</u> $40,000

Accounts payable 36,000

Retained earnings $24,000

<u>Income Statement</u>
Contract revenue $60,000
Contract expense $36,000</td></tr>
<tr><td></td><td>Staff note: The claim against Customer reflects the contract amount that is attributable to the unfinished portion of the contract. That amount is not due until Company performs. Correspondingly, the contract liability reflects Company's remaining liability to perform the unfinished portion of the contract.

In contrast, the consideration receivable reflects the contract amount that is attributable to the finished portion of the contract that has been transferred to Customer.</td><td>Staff note: At the end of Period 1, the sum of Company's assets (the claim against Customer and the production asset) is $160,000, which exceeds the contract amount ($100,000). As a possible resolution, the staff offsets the contract liability with the production asset because, in all cases, that asset will be used to satisfy the liability upon delivery.</td></tr>
</table>

Example 1: The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

	Scenario A: Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	**Scenario B:** Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
End of period 2 To recognize revenue and costs associated with Company's performance to date; production is 100% complete.	Production asset $40,000 Contract revenue $40,000 ($100,000 × 100% – 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 × 100% – 36,000) Contract liability $40,000 Claim against Customer $40,000 Consideration receivable $40,000 Production asset $40,000	Production asset $40,000 Contract revenue $40,000 ($100,000 × 100% – 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 × 100% – 36,000) Consideration receivable $100,000 Claim against Customer $100,000
Summary of Account Balances— End of Period 2	Balance Sheet Consideration receivable $100,000 Accounts payable $60,000 Retained earnings $40,000 Income Statement Contract revenue $40,000 Contract expense $24,000	Balance Sheet Consideration receivable $100,000 Contract liability $100,000 Less: Production asset (100,000) ---- Accounts payable $60,000 Retained earnings $40,000 Income Statement Contract revenue $40,000 Contract expense $24,000
Beginning of Period 3 Customer picks up the completed Product and pays for it.	Cash $100,000 Consideration receivable $100,000	Cash $100,000 Consideration receivable $100,000 Contract liability $100,000 Production asset $100,000

Example 1: The contract's legal remedy in the event of breach is specific performance. That remedy requires the parties to fully perform as promised under the contract.

	Scenario A: Title of Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	**Scenario B:** Title of Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
Summary of Account Balances— End of Period 3	Balance Sheet Cash $100,000 Accounts payable $60,000 Retained earnings ($100,000 – 60,000) $40,000 Income Statement No activity	

Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

<table>
<tr><td></td><td>Scenario A: Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.</td><td>Scenario B: Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.</td></tr>
<tr><td><u>Contract inception</u></td><td>No entry</td><td>No entry</td></tr>
<tr><td></td><td colspan="2">The Board previously decided that the unit of account for a wholly executory contract in which the legal remedy is monetary damages should be the contract as a whole.</td></tr>
<tr><td><u>End of Period 1</u>
To recognize revenue and costs associated with Company’s performance to date; production is 60% complete.</td><td>Production asset $60,000
    Contract revenue $60,000
    ($100,000 × 60%)

Contract expense $36,000
    Accounts payable $36,000
    ($60,000 × 60%)

Consideration receivable $60,000
    Production asset $60,000</td><td>Production asset $60,000
    Contract revenue $60,000
    ($100,000 × 60%)

Contract expense $36,000
    Accounts payable $36,000
    ($60,000 × 60%)

Claim against Customer $60,000
    Contract liability $60,000

Consideration receivable $60,000
    Claim against Customer $60,000</td></tr>
<tr><td></td><td colspan="2">Staff note: The accounting for performance in this contract generally parallels the accounting illustrated in Example 1 for a contract that requires specific performance. That is because this contract will result in physical settlement of the finished portion of the contract; therefore, Customer is required in all cases to accept the work in process (and compensate the reporting entity for it).

Under Scenario B, the production asset and title to it has not been transferred to Customer; therefore, it remains on Company’s balance sheet. However, because the finished portion of the contract will be physically settled, Company has a liability to transfer Product to Customer and an unconditional right to receive consideration for it.</td></tr>
</table>

Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

	Scenario A: Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	**Scenario B:** Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
Summary of Account Balances— End of Period 1	<u>Balance Sheet</u> Consideration receivable $60,000 Accounts payable $36,000 Retained earnings $24,000 ($60,000 – 36,000) <u>Income Statement</u> Contract revenue $60,000 Contract expense $36,000	<u>Balance Sheet</u> Consideration receivable $60,000 Contract liability $60,000 Less: Production asset (<u>60,000</u>) ------ Accounts payable $36,000 Retained earnings $24,000 ($60,000 – 36,000) <u>Income Statement</u> Contract revenue $60,000 Contract expense $36,000
	Staff note: The account balances for the **performed** portion of the contract are almost identical to the account balances in Example 1. The only difference is in Scenario B. In this example, Company has a receivable from Customer for the finished portion of the contract because that portion of the contract could be physically settled. In contrast, under specific performance, the entire contract would be physically settled; therefore, Company must complete Product before it has a receivable from Customer (Company has a claim against Customer until then). The accounting for the **unperformed** portion of this contact is different from Example 1. That is because the unit of account for the unperformed portion of this contract is the contract as a whole (consistent with the unit of account at the wholly executory stage). That is, the liability to produce the remaining 40 percent of Product and the claim against Customer for that future performance continue to be recognized 'net' (and have a net measurement of zero).	

Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

<table>
<tr><td></td><td>Scenario A: Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.</td><td>Scenario B: Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.</td></tr>
<tr><td><u>End of period 2</u>
To recognize revenue and costs associated with Company’s performance to date; production is 100% complete.</td><td>Production asset $40,000
Contract revenue $40,000
($100,000 × 100% – 60,000)

Contract expense $24,000
Accounts payable $24,000
($60,000 × 100% – 36,000)

Consideration receivable $40,000
Production asset $40,000</td><td>Production asset $40,000
Contract revenue $40,000
($100,000 × 100% – 60,000)

Contract expense $24,000
Accounts payable $24,000
($60,000 × 100% – 36,000)

Claim against Customer $40,000
Contract liability $40,000

Consideration receivable $40,000
Claim against Customer $40,000</td></tr>
<tr><td>Summary of Account Balances—
End of Period 2</td><td><u>Balance Sheet</u>
Consideration receivable $100,000

Accounts payable $60,000

Retained earnings $40,000
($100,000 – 60,000)

<u>Income Statement</u>
Contract revenue $40,000
Contract expense $24,000</td><td><u>Balance Sheet</u>
Consideration receivable $100,000

Contract liability $100,000
Less: Production asset (<u>100,000</u>) ------

Accounts payable $60,000

Retained earnings $40,000
($100,000 – 60,000)

<u>Income Statement</u>
Contract revenue $40,000
Contract expense $24,000</td></tr>
</table>

Example 2: In the event of customer breach, Customer is required to pay an amount that reimburses Company for its costs incurred to date plus the estimated profit margin on those costs. In exchange for paying those damages, Customer obtains the work in process and the title to it.

	Scenario A: Title to Product transfers to Customer as Company performs. That is, Customer has legal ownership of the work in process.	**Scenario B:** Title to Product transfers to Customer upon delivery. That is, Company has legal title of the work in process until delivery.
Beginning of Period 3 Customer picks up the completed Product and pays for it.	Cash $100,000 Consideration receivable $100,000	Contract liability $100,000 Production asset $100,000 Cash $100,000 Consideration receivable $100,000
Summary of Account Balances— End of Period 3	Balance Sheet Cash $100,000 Accounts payable $60,000 Retained earnings ($100,000 – 60,000) $40,000 Income Statement No activity	

Appendix A of the Board Meeting Handout

Preliminary Exploration: Application of the Board's Decision on Performance to Contracts That, in the Event of Customer Breach, Require a Remedy of *Net Cash Settlement*

The Board agreed that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. Moreover, the Board agreed that the reporting entity obtains such an unconditional right for its performance to date if, in the event of customer breach, the customer is required to compensate the reporting entity for that performance.

There may be different views on how to apply that decision to contracts that, in the event of customer breach, require a legal remedy of net cash settlement.

Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date

Under Alternative A, revenue should be recognized over the production period as performance occurs. That is because, in all cases (including customer breach), the reporting entity will ultimately receive the contract amount. If the contract is fully performed by both parties, the reporting entity will collect the contract amount from the customer. If the customer breaches, the reporting entity will resell the product to another customer and will have the right to collect from the original customer the difference between the contract amount and the amount at which the product was resold.

Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract

Under Alternative B, the reporting entity is not viewed as having an unconditional right to any consideration until the contract is completed or the customer breaches the contract. Until that time, the reporting entity's right to consideration is conditioned upon either the completion of the contract **or** the customer's breach. Until either of those events occurs, the entity has not obtained any right to consideration; therefore, revenue should not be recognized until either one of those events occur.

Illustrative Example

The following example illustrates how the Board's decision could be applied to a contract that requires a remedy of net cash settlement. The example facts are the same as the preceding two examples (refer to page 3). Additional facts are as follows:

Additional Example Facts

> In the event of customer breach, Customer would be required to pay monetary damages in an amount that reimburses Company for its 'lost expectations' on the contract; that is, Customer must pay damages in an amount sufficient to place Company in as good a position as it would have been in had the contract been performed.
>
> Product is fungible; therefore, Company thinks that it could resell Product if Customer breaches. However, if Customer breaches and Company has to resell Product, Company may not be able to collect $100,000 from the substitute customer. In that case, consistent with the remedy of monetary damages, Customer would be required to pay the difference between the contract price and the price at which Product was resold.

Example 3: In the event of customer breach, Customer would be required to pay monetary damages in an amount that reimburses Company for its 'lost expectations' on the contract; that is, Customer must pay damages in an amount sufficient to place Company in as good a position as it would have been if the contract had been performed.

	Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date	**Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract**
<u>Contract inception</u>	No entry	No entry
<u>End of Period 1</u> To recognize Company's performance to date; production is 60% complete.	Production asset/Claim against Customer $60,000 Contract revenue $60,000 ($100,000 × 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 × 60%)	Production asset $36,000 Accounts payable $36,000 ($60,000 × 60%)
Summary of Account Balances—End of Period 1	<u>Balance Sheet</u> Production asset/Claim against Customer $60,000 Accounts payable $36,000 Retained earnings $24,000 <u>Income Statement</u> Contract revenue $60,000 Contract expense $36,000	<u>Balance Sheet</u> Production asset $36,000 Accounts payable $36,000 Retained earnings -------- <u>Income Statement</u> No activity
<u>End of period 2</u> To recognize Company's performance to date; production is 100% complete.	Production asset/Claim against Customer $40,000 Contract revenue $40,000 ($100,000 × 100% – 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 × 100% – 36,000)	Production asset $24,000 Accounts payable $24,000 ($60,000 × 100% – 36,000)

Example 3: In the event of customer breach, Customer would be required to pay monetary damages in an amount that reimburses Company for its 'lost expectations' on the contract; that is, Customer must pay damages in an amount sufficient to place Company in as good a position as it would have been if the contract had been performed.

	Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date	**Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract**
Summary of Account Balances—End of Period 2	<u>Balance Sheet</u> Production asset/Claim against Customer $100,000 Accounts payable $60,000 Retained earnings $40,000 <u>Income Statement</u> Contract revenue $40,000 Contract expense $24,000	<u>Balance Sheet</u> Production asset $60,000 Accounts payable $60,000 Retained earnings ------- <u>Income Statement</u> No activity
<u>Beginning of Period 3</u> Customer picks up the completed Product and pays for it.	Cash $100,000 Production asset/Claim against Customer $100,000	Cash $100,000 Contract revenue $100,000 Contract expense $60,000 Production asset $60,000
Summary of Account Balances— End of Period 3	<u>Balance Sheet</u> Cash $100,000 Accounts payable $60,000 Retained earnings $40,000 ($100,000 – 60,000) <u>Income Statement</u> No activity	<u>Balance Sheet</u> Cash $100,000 Accounts payable $60,000 Retained earnings $40,000 ($100,000 – 60,000) <u>Income Statement</u> Contract revenue $100,000 Contract expense $60,000

Appendix B of the Board Meeting Handout

Preliminary Exploration: Application of the Board's Decision on Performance to Contracts that have *Contractually Stated Customer Acceptance Provisions*

The Board agreed that revenue should be recognized if the customer accepts performance to date—*acceptance* meaning that the entity has obtained an unconditional right to consideration from the customer. In a contract in which acceptance arises at discrete points (and assuming no other legal remedies), an unconditional right to consideration only will arise at those discrete acceptance points.

Illustrative Example

The following example illustrates how the Board's decision should be applied to a contract that has contractually stated customer acceptance provisions. The example facts are the same as the preceding three examples (refer to page 3). Additional facts are as follows:

Example Facts

> Production of the Product consists of two distinct phases; thus, there are two customer acceptance points. The first acceptance point is at the end of the first phase when the contract is 75 percent complete and the second customer acceptance point is upon delivery. At those points, Customer is obliged to accept Company's performance to date and becomes unconditionally obligated to pay for that performance. At each acceptance point, title to the work in process transfers to Customer.
>
> The payment attributable to Company's performance in the first phase (that is, up to the first customer acceptance point) cannot subsequently be recovered by Customer if Company fails to complete Product.
>
> As noted, assume that no additional legal remedies are available to Company if Customer breaches.

	Title of Product transfers to Customer on acceptance of each phase. That is, Customer has legal ownership of the work in process.
Contract inception	No entry
End of Period 1 To recognize Company's performance to date; production is 60% complete but Customer **has not** accepted it.	Production asset $36,000 Accounts payable $36,000 ($60,000 × 60%)
Summary of Account Balances—End of Period 1	Balance Sheet Production asset $36,000 Accounts payable $36,000 Retained earnings -------- Income Statement No activity
Period 2—up to point of Customer's acceptance To recognize completion of phase 1; production is 75% complete and Customer **has** accepted it.	Production asset $9,000 Accounts payable $9,000 ($60,000 × 75% – 36,000) Consideration receivable $75,000 Contract revenue $75,000 ($100,000 × 75%) Contract expense $45,000 Production asset $45,000 ($36,000 + 9,000)
Period 2—from point of Customer's acceptance to contract completion To recognize Company's performance; production is 100% complete but Customer has accepted only 75%.	Production asset $15,000 Accounts payable $15,000 ($60,000 × 100% – 45,000)
Summary of Account Balances—End of Period 2	Balance Sheet Production asset $15,000 Consideration receivable $75,000 Accounts payable $60,000 Retained earnings $30,000 Income Statement Contract revenue $75,000 Contract expense $45,000

	Title of Product transfers to Customer on acceptance of each phase. That is, Customer has legal ownership of the work in process.		
<u>Beginning of Period 3</u> Customer accepts and picks up Product and pays for it.	Consideration receivable	$25,000	
	Contract revenue ($100,000 × 100% – 75,000)		$25,000
	Contract expense	$15,000	
	Production asset		$15,000
	Cash	$100,000	
	Consideration receivable		$100,000
Summary of Account Balances—End of Period 3	<u>Balance Sheet</u>		
	Cash		$100,000
	Accounts payable		$60,000
	Retained earnings ($100,000 – 60,000)		$40,000
	<u>Income Statement</u>		
	Contract revenue		$25,000
	Contract expense		$15,000