MINUTES

Financial Accounting Standards Board

To: Board Members

From: Revenue Recognition Team
(Arveseth, ext. 384)

Subject: Minutes of the March 1, 2006 Board Meeting

Date: March 21, 2006

cc: FASB: Bielstein, Smith, T. Johnson, Tovey, Figgie, Kawanishi, Thuener, Lapolla, Goetsch (2), Arveseth, Carney, Cropsey, Gabriele, Golden, MacDonald, Mahoney, Polley, Sutay, FASB Intranet; IASB: Rees, J. Brown, Hickey, Upton; 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: Wholly Executory Revenue Contracts and Accounting for Performance

Basis for Discussion: Memorandums Nos. 78, 79, 80

Length of Discussion: 10:00 a.m. to 11:30 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Schipper, Seidman, Trott, Young
Board members absent:	None
Staff in charge of topic:	Tovey, Figgie
Other staff at Board table:	Bielstein, T. Johnson, Arveseth
Outside participants:	None

Summary of Decisions Reached:

The Board discussed two topics related to accounting for revenue contracts under the assets and liabilities approach—(1) accounting for wholly executory (or wholly unperformed) revenue contracts and (2) assessing when performance has occurred and, thus, when revenue should be recognized.

The Board tentatively agreed that unconditional rights and obligations in wholly executory revenue contracts would meet the definitions of assets and liabilities. Moreover, the Board agreed that a reporting entity would not recognize any assets or liabilities at the inception of a wholly executory contract for which the legal remedy in the event of breach is monetary damages (and, thus, the unit of account is the contract as a whole). That is because the net measurement of those assets and liabilities at contract inception would be zero under the allocated customer consideration approach. However, the Board agreed that a reporting entity would recognize separate assets and liabilities at the inception of a wholly executory contract for which legal remedy in the event of breach would be specific performance. That is because the unit of account is the individual assets and liabilities arising from the contract.

The Board discussed two methods for assessing when performance occurs under a contract (and, thus, when revenue should be recognized) but did not reach any decisions. The Board directed the staff to further analyze both methods in a variety of different fact patterns.

Objective of Meeting:

The objective of the meeting was to discuss (a) accounting for wholly executory revenue contracts and (b) accounting for performance using the extinguishment-based method and the performance-based method.

Matters Discussed and Decisions Reached:

Accounting for Wholly Executory Revenue Contracts

1. Ms. Figgie opened the meeting by introducing Revenue Recognition Memo No. 78, which addresses the accounting for wholly executory (or wholly unperformed) revenue contracts. Ms. Figgie noted there are two alternative views expressed in the memo and that a third alternative was discussed during the IASB Board meeting on February 22, 2006. Ms. Figgie briefly summarized the three alternatives.

2. Ms. Figgie stated that Alternative 1, or the staff's majority view presented in the memo and in the Board meeting handout (attached to these minutes as an appendix), is that wholly executory revenue contracts give rise to unconditional rights and obligations. Those unconditional rights and obligations meet the definitions of assets and liabilities. A reporting entity would not recognize any assets or liabilities at the inception of a wholly executory contract for which the legal remedy in the event of breach is monetary damages (and, thus, the unit of account is the contract as a whole). That is because the net measurement of those assets and liabilities at contract inception would be zero under the allocated customer consideration approach. However, a reporting entity would recognize separate assets and liabilities at the inception of a wholly executory contract for which legal remedy in the event of breach would be specific performance. That is because the unit of account is the individual assets and liabilities arising from the contract.

3. Ms. Figgie explained that Alternative 2, or the alternative view presented in the memo, is that a wholly executory revenue contract always gives the seller a combined unconditional right and obligation to exchange goods, services, or rights to use for consideration from the customer. The combined unconditional right and obligation to make the exchange always gives rise to a single "contract" asset or liability.

4. Ms. Figgie summarized Alternative 3, which was discussed at the IASB meeting, as a hybrid of Alternatives 1 and 2. Alternative 3 states that the wholly executory revenue contract gives rise to a single "contract" asset or liability if the

legal remedy in the case of breach is monetary damages (consistent with Alternative 2). However, the wholly executory contract gives rise to separate assets and liabilities if the legal remedy in the event of breach is specific performance (consistent with Alternative 1)

5. Ms. Figgie asked the Board which of the three views best reflects the nature of the contractual rights and obligations that arise in wholly executory contracts. The majority of the Board (GJB, GMC, KAS, EWT) supported Alternative 1.

6. Mr. Trott stated that Alternative 1 is the best way to explain and analyze a revenue contract because it identifies all of the rights and obligations that arise from it. He noted that identifying and understanding those separate rights and obligations is important when a contract includes multiple elements. Mr. Trott noted that Alternative 2 ignores at contract inception the separability of the individual rights and obligations in a revenue contract even though those rights and obligations will need to be analyzed at a later date when one of the parties to the contract begins to perform. Analyzing contractual rights and obligations at a later date could be more difficult. Mr. Batavick added that identifying the contractual rights and obligations at contract inception is important to appropriately account for contracts under the allocated customer consideration approach.

7. Ms. Schipper stated that she supports Alternative 1. She does not support Alternatives 2 or 3 because those alternatives may lead an entity to break up a revenue contract based on the way in which the first party begins to perform, rather than based on the underlying assets and liabilities. She noted that it is imperative that revenue contracts are accounted for based on the underlying assets and liabilities.

8. Mr. Herz and Ms. Seidman agreed that wholly executory revenue contracts give rise to individual assets and liabilities and that those assets and liabilities should be identified at contract inception (consistent with Alternative 1). However, Mr. Herz and Ms. Seidman stated that those assets and liabilities should always be offset (that is, they should be recognized “net”). The

presentation of those assets and liabilities should not be based on the legal remedy in the case of breach.

9. Mr. Herz noted that Alternative 1 best discerns the assets and liabilities at contract inception. However, because few contracts ultimately result in breach, he does not think that the accounting at inception should be based on the legal remedy in the case of breach. He stated that a more relevant basis for determining the presentation is the expected outcome of the revenue contract (how the contract is expected to be extinguished). Mr. Herz preferred to present all revenue contracts "net" at contract inception, regardless of the legal remedy.

10. Ms. Seidman agreed that a revenue contract results in separate assets and liabilities, which should be identified at contract inception. However, Ms. Seidman noted that when a contract is wholly executory, the assets and liabilities are interdependent and offsetting; therefore, they should not be recognized. Ms. Seidman stated that the legal remedy should not be the basis for determining the presentation of the assets and liabilities at contract inception. She asserted that the assets and liabilities would be recognized when one of the parties to the contract begins to perform.

11. Ms. Figgie clarified that looking to legal remedies does not assume the contract will result in breach. Rather, the legal remedy provides an indication of what the underlying substance of a revenue contract is at a given point in time (for example, contract inception). That is because the legal remedy indicates how the revenue contract could be immediately settled (that is, through either a single flow of resources or multiple flows of resources).

12. Mr. Young supported Alternative 2. He stated that Alternative 1 is unnecessarily complicated for the vast majority of revenue contracts, which are simple transactions.

Accounting for Performance

13. Mr. Tovey opened the discussion and stated that the objective of Revenue Recognition Memo No. 79 was to identify a conceptual foundation for recognizing revenue in all revenue transactions. He noted that the memo includes two methods for assessing performance: the extinguishment-based method (EBM)

and the performance-based method (PBM). Those methods are explained further in the Board meeting handout.

14. Mr. Trott noted that the extinguishment-based method should not require *legal* extinguishment. He cited an example in which a reporting entity enters into a revenue contract for a tangible good that has an indefinite right of return. He noted that the reporting entity technically may never *legally* extinguish the contract because the right of return is indefinite. He asserted that an accounting proxy for extinguishment (other than legal extinguishment) needs to be considered under the EBM. Mr. Tovey agreed.

15. Mr. Trott noted that perhaps both the EBM and the PBM are appropriate methods for revenue recognition but that they should be used in different circumstances. He stated that the different legal remedies discussed in Revenue Recognition Memo No. 78 may be a helpful tool to determine which of the performance methods is appropriate for a particular transaction. That is, if the legal remedy for the revenue contract is specific performance, the reporting entity would recognize revenue using the PBM. That is because the customer is receiving utility as the contract progresses because the contract will be fulfilled under all circumstances. The asset conversion process is occurring as the contract progresses. However, if the legal remedy is monetary damages, the reporting entity would use the EBM because the subject of the contract does not have utility to the customer until it is completed. In the event of breach, the contract would be net settled and the customer would not receive the item.

16. Ms. Seidman noted that she agreed with some comments made by IASB Board members at their meeting on February 22, 2006. That is, Ms. Seidman asked whether differences between the two methods could be “bridged” by determining if things like progress payments, cancellation penalties, and customer acceptance of deliverables could be considered evidence of the reporting entity’s fulfillment of its contractual obligations under the EBM.

17. Ms. Schipper noted that the Board previously tentatively decided to use the customer’s perspective to identify which contractual rights and obligations meet the criteria to be accounted for as separate units of account and to measure

those units of account. Based on those tentative decisions, Ms. Schipper stated she agreed with the extinguishment-based method. Ms. Schipper asserted the allocated customer consideration amount required that revenue for goods, services, and rights be recorded upon delivery, regardless of the number of accounting periods required to deliver goods, services, or rights or the legal remedy required by the contract. Ms. Schipper noted that in the case of a construction contract, the Board did not make any decisions related to monetary versus specific performance legal remedies; the Board only decided that recognition would be based on what the customer agreed (or would have agreed) to purchase separately. Thus, revenue from a construction contract that does not specify elements that the customer would purchase separately would be recognized only upon completion of the contract (delivery to the customer).

18. Mr. Herz noted that based on the analysis in Memorandum No. 79, the *customer's* perspective would be used to identify separate units of account and to allocate the customer consideration amount to those units; however, the *reporting entity's* perspective would be used to determine when revenue should be recognized. He questioned whether the perspective used to initially identify and measure units of account necessarily needed to be linked to the perspective used to recognize revenue. Ms. Schipper responded that if those activities did not use the same perspective, revenue recognition accounting would have a "shifting perspective." It would be neither the customer's perspective nor the reporting entity's perspective.

19. Ms. Seidman agreed that the EBM appears consistent with the Board's decision to use the customer's perspective. However, she noted that a strict notion of legal extinguishment in the EBM does not appear reasonable. Ms. Seidman suggested exploring whether there are other indicators that the customer has received and accepted something of value before the reporting entity completely extinguishes the obligation. Ms. Seidman questioned whether there is there a broader notion of extinguishment or delivery.

20. Mr. Herz summarized that Board members appeared to generally prefer EBM but that they would like to explore how to apply that method to long-term contracts.

Follow-up Items:

The Board asked the staff to further analyze both methods of revenue recognition and apply them to a variety of different fact patterns.

General Announcements:

None

APPENDIX

Financial Accounting Standards Board

Board Meeting Handout
March 1, 2006

Joint Revenue Recognition Project

The Board will discuss two topics related to accounting for revenue contracts under the assets and liabilities approach—(a) accounting for wholly executory (or wholly unexecuted) revenue contracts and (b) assessing when *performan*ce has occurred and, thus, when revenue should be recognized.

WHOLLY EXECUTORY REVENUE CONTRACTS (Memo No. 78)

The Board will discuss the nature of the rights and obligations that arise from wholly executory (or wholly unperformed) contracts and how the allocated customer consideration approach would be applied to wholly executory revenue contracts.

The Board previously agreed that revenue contracts consist of contractual rights and obligations. A contractual right or obligation can be classified as one of three types:

a. **Conditional—**Its performance is subject to the occurrence of an event that is not certain to occur (including performance by the counterparty).
b. **Unconditional—**Its performance is subject to nothing other than the passage of time.
c. **Mature—**Its performance is not subject to any event, including the passage of time.

The Board also decided that conditional rights and obligations are not assets and liabilities but that unconditional and mature rights and obligations may be assets and liabilities. The Board further observed that conditional rights and obligations give rise to unconditional rights or obligations to stand ready, the latter of which may meet the definition of an asset or a liability. The Board acknowledged that those decisions apply to wholly executory (or wholly unperformed) contracts. That is, wholly executory contracts give rise to conditional and unconditional rights and obligations and such rights and obligations can meet the definitions of assets and liabilities.

In a revenue contract, the seller performs by providing a good, service, or other right and the buyer performs by paying for that item. At the inception of a revenue contract in which the parties will perform simultaneously, the seller's promise to provide the item and the customer's promise to pay for it may be conditioned on one another and give rise to a conditional right and obligation for both parties. However, those conditional contractual rights and obligations both give rise to unconditional rights and obligations to stand ready, the latter of which can meet the definition of an asset or a liability.

In other cases, the parties are not required to perform simultaneously. One party to a contract must perform first and that required sequence of performance affects the conditionality of the parties' rights and obligations. That is, at contract inception, one party's performance is conditioned upon the other party's performance. The party that is required to perform first has an unconditional obligation to do so (or to pay damages if it breaches) because nothing other than the passage of time is required to make its performance due. The counterparty's performance is conditional because it is not required to perform until the first party has performed. However, the counterparty has an unconditional obligation to stand ready to perform.

For example, consider a contract between an automobile mechanic and a customer. The mechanic promises to repair the customer's automobile and the customer promises to pay the mechanic for those services. The mechanic must repair the customer's automobile before the customer is required to pay; if the mechanic does not repair the automobile, the customer is not required to pay. Thus, at contract inception, the automobile mechanic has an unconditional obligation to repair the customer's automobile. The customer has a conditional obligation to pay the mechanic; however, that conditional obligation gives rise to an unconditional stand-ready obligation because the customer must stand ready to pay the mechanic if he performs the repair.

In summary, all revenue contracts can be understood in terms of the contractual rights and obligations that arise from them. Each contractual right or obligation can be classified as one of three types: (a) conditional, (b) unconditional, or (c) mature. Unconditional rights and obligations include unconditional **stand-ready** rights and obligations. Conditional rights and obligations are not assets and liabilities but unconditional and mature rights and obligations may be assets and liabilities.

The Board agreed that the unit of account for a wholly executory contract in which the subject is fungible (and the legal remedy in the event of breach is monetary damages) should be the contract as a whole (that is, the contractual assets and liabilities should be reported "net"). However, the Board agreed that the unit of account for a wholly executory contract in which the subject is unique (and the legal remedy in the event of breach is specific performance) should be the individual assets and liabilities arising from the unconditional contractual rights and obligations in that contract (that is, the contractual assets and liabilities are reported "gross").

Moreover, the Board agreed to explore an approach for revenue recognition under which performance obligations would be measured by allocating the customer consideration amount. Under that approach, at contract inception, the sum of the amounts allocated to performance obligations would equal the consideration amount (the asset) and, hence, no revenue would be recognized. That position would apply to all contracts, whether the subject is fungible or unique.[1]

Illustrative Example

The following example illustrates the contractual rights and obligations that arise from a wholly executory contract and discusses how they would be recognized under the allocated customer consideration approach. The staff uses two scenarios to demonstrate how different contract terms could affect the nature of the contractual rights and obligations that arise from a revenue contract.

Example Facts

On December 1, 2005, Annie and Furn Co enter into a contract for a table for $1,000. Included in the price of the table is a one-year warranty under which Furn Co promises to repair the table if there is a manufacturer's defect. The table is scheduled to be ready for Annie to pick up on January 2, 2006.

Scenario 1

Annie does not have to pay any amount until the table is ready for her to pick up on January 2, 2006. At that time, the full amount of $1,000 is due.

Scenario 2

---

[1] Both the FASB and IASB Boards decided to make an exception for those obligations that are required by other accounting guidance to be measured at fair value; those obligations should continue to be measured at fair value. Additionally, the IASB Board decided that all unconditional stand-ready obligations initially should be measured at fair value (rather than at an allocated customer consideration amount). Under that decision, revenue could be recognized at contract inception in some cases.

Annie has to pay 30 percent of the contract amount ($300) within 5 days of entering into the contract with Furn Co. Furn Co will begin manufacturing the table only after it receives that initial payment. The remaining amount ($700) is due when the table is ready for Annie to pick up on January 2, 2006.[2]

In the first scenario, Furn Co has the following contractual rights and obligations at contract inception:

a. An **unconditional obligation** to provide to Annie a table. Furn Co must perform first; nothing other than the passage of time is required to make Furn Co's performance due.

b. A **conditional obligation** to provide a one-year warranty. Furn Co is not required to provide the warranty until it provides the table to Annie and she pays the $1,000. However, if Furn Co provides the table to Annie and she pays, Furn Co must provide the one-year warranty. Therefore, associated with the conditional obligation to provide a warranty is an **unconditional stand-ready obligation** to do so.

c. A **conditional right** to Annie's payment. Annie's payment is conditioned upon Furn Co's providing her the table. However, Annie must stand ready to pay if Furn Co performs (Annie must pay for the table if Furn Co provides it to her). Therefore, associated with Furn Co's conditional right to Annie's payment is an **unconditional right to her stand-ready performance**.

In the second scenario, Furn Co has the following contractual rights and obligations at contract inception:

a. A **conditional obligation** to provide Annie a table. Furn Co's obligation is conditional upon Annie's initial payment of $300. However, Furn Co must stand ready to perform (Furn Co must provide the table if Annie pays $300). Therefore, associated with that conditional obligation is an **unconditional stand-ready obligation** to provide the table if Annie pays the initial amount.

b. A **conditional obligation** to provide a one-year warranty. Furn Co is not required to provide the warranty until it provides the table to Annie and she pays for it. However, if Furn Co provides the table and Annie pays for it, Furn Co must provide the one-year warranty. Therefore, associated with the conditional obligation to provide a warranty is an **unconditional stand-ready obligation** to do so.

c. An **unconditional right** to Annie's initial payment ($300). Her performance is due within five days; nothing other than the passage of time is required to make her performance due.

[2] Furn Co would be required to refund Annie's initial payment of $300 if it does not provide the table to her. This illustrative example assumes that the contract is executed successfully.

d. A **conditional right** to Annie's second payment ($700). Annie's payment is conditioned upon Furn Co's providing the table to her. However, Annie must stand ready to pay if Furn Co performs (Annie must make the second payment if Furn Co provides the table to her). Therefore, associated with Furn Co's conditional right to Annie's second payment is an **unconditional right to her stand-ready performance**.

Based on the Boards' decisions made to date, presuming that the legal remedy in the event of breach is monetary damages, the assets and liabilities arising from the unconditional rights and obligations in both scenarios would be recognized "net" at contract inception. The net value of the assets and liabilities in both scenarios initially would be zero because under the allocated customer consideration approach, the sum of the liabilities would be measured based on the consideration amount (that is, the inflowing asset). Therefore, in both scenarios, no assets or liabilities would be recognized in Furn Co's financial statements at contract inception.

Alternative View

The staff also considered an alternative view on the nature of the rights and obligations that arise from wholly executory contracts. Under that view, a sales contract gives the seller a **combined** right and obligation to exchange economic benefits (goods, services, or rights to use) for consideration from the customer. Both parties have agreed unconditionally to this exchange; only breach of contractual obligation would prevent the exchange from happening and only the passage of time is required to make the exchange due. Thus, regardless of the sequence in which the two parties are required to perform, the entity's combined right and obligation is unconditional.

The combined right and obligation to make the exchange does not give rise to a separate asset and liability because the entity's right and obligation are inextricably linked; neither one would be enforced without the other also being enforced. The combined obligation and right therefore give rise to a single "contract" asset or liability, separate and distinct from the underlying assets to be received and sacrificed when performance occurs. Under the allocated customer consideration approach, no asset or liability would be recognized at the inception of the contract because the combined right and obligation that make up the single asset or liability would be measured at zero.

<u>Discussion Question 1 of Memo No. 78</u>—Which view do Board members think best reflects the nature of the contractual rights and obligations that arise from wholly executory revenue contracts?

<u>Discussion Question 2 of Memo No. 78</u>—Do Board members agree with the staff's application of the allocated customer consideration approach to wholly executory revenue contracts? If not, how would Board members apply the approach differently?

ACCOUNTING FOR PERFORMANCE (Memo No. 79)

The Board will discuss two revenue recognition methods for accounting for performance: (a) the extinguishment-based method (EBM) and (b) the performance-based method (PBM).

In a revenue contract, performance is a thing done (or act) by an entity to carry out a contractual (or legally enforceable) promise. That promise is an obligation and, therefore, the preceding sentence can be described as follows:

> **Performance is an act (or acts) of an entity to fulfill an obligation.**

The two methods interpret that description of performance in two very different ways.

Extinguishment-Based Method

Under the EBM, the only act of the reporting entity that fulfills an obligation is the one in which goods, services, or other rights are delivered or transferred to the customer and, therefore, revenue is recognized only when the customer obtains those goods, services, or other rights.

The EBM is based on the following proposition:

> **An obligation to provide goods, services, or other rights is extinguished (and, therefore, revenue arises) only when it is legally extinguished.**

However, given the difficulties associated with a "strict" legal extinguishment method, the objective of the EBM is to recognize revenue *at the approximate time* when the obligation to provide goods, services, or other rights is legally extinguished. The best proxy for legal extinguishment is the point in time at which the customer obtains the goods, services, or other rights (because, assuming the items meet the customer's specifications, the reporting entity has no further obligation with respect to the items). The customer generally obtains goods when they are physically transferred to it because that is the point when the customer obtains the right to use or benefit from the goods.

The customer generally obtains services when they are rendered because that is the point when the customer obtains the right to use or benefit from them. In arrangements involving more than one good, service, or other right (multiple-element contracts), revenue would be recognized when the right to use or benefit is obtained for each item (not all items) meeting the separate-unit-of-account criteria (that is, for each item having utility to the customer). Under the EBM, changes in assets and liabilities from a contract that give rise to revenues are deemed to occur for accounting purposes only when the customer obtains the right to use or benefit from the goods, services, or other rights.

Performance-Based Method

Under the PBM, any act of the reporting entity in the production process creates an asset that can be used to satisfy performance obligations under a contract and, therefore, revenue may be recognized as performance occurs (that is, before the customer obtains goods, services, or other rights). The PBM is a proportionate-performance method. That means that revenue is generally recognized as performance occurs over the period of performance. As opposed to the EBM, in which performance is deemed to occur in a single act (when goods or services are obtained), under the PBM, performance includes all acts in the production process.

Production is an asset conversion process; that process creates or enhances an asset by adding utility and value. That asset represents the asset that ultimately will be delivered to the customer. Hence, the PBM is based on the following proposition:

> **The production process creates or enhances assets (and, therefore, gives rise to revenue).**

Consequently, the objective of the PBM is to recognize revenue as the production process occurs. In revenue contracts, the production process occurs when the reporting entity carries out acts to fulfill its obligation to provide goods, services, or other rights. A reporting entity using the PBM would determine when acts have occurred that faithfully represent the production process. Those acts of the production process may be reflected by outputs from the production process, inputs to the production process, the passage of time, or the reduction of risk.

Examples of the Methods

This section provides a series of examples to illustrate how the EBM and PBM would operate for different revenue contracts.

Example A: Car loan. A bank provides a customer with a three-year fixed-rate loan to purchase a new car. The bank extinguishes part of its obligation to the customer each day the customer has use of the money because the customer has the right to use that money each day; therefore, the bank would recognize interest revenue over the life of the loan under the EBM. Under the PBM, the production process would reflect the provision of the right to use the bank's capital over the life of the loan; thus, the bank would recognize interest revenue over the life of the loan. In this case, the two methods would provide the same revenue recognition.

Example B: Equipment lease. A lessor provides a customer with a two-year equipment lease that is classified as an operating lease. The lessor extinguishes part of its obligation to the customer each day the customer has use of the equipment because the customer obtains the right to use the equipment each day; therefore, the lessor would recognize lease revenue over the life of the lease under the EBM. Under the PBM, the production process would reflect the provision of the right to use the leased asset over the life of the lease; thus, the lessor would recognize rental revenue over the life of the lease. In this case, the two methods would provide the same revenue recognition.

Example C: Car insurance. An insurer provides a customer with a one-year car insurance policy covering collisions and other accidental losses. The customer obtains a benefit each day because it benefits from risk protection each day the insurance contract is outstanding. Under the EBM method, an entity may recognize revenue on a straight-line basis (or a time-unit basis) because the customer receives a similar benefit on a daily basis. However, that benefit should reflect when protection is provided against the risk exposure that is insured. To illustrate, consider a hurricane insurance contract in the U.S. Because the U.S. hurricane season runs from June 1 through November 30, the vast majority of risk protection occurs during that time period rather than in the period from December 1 through May 31. In that scenario, recognizing revenue on a straight-line basis would not faithfully reflect when the customer benefits from risk protection. Under the PBM, the production process reflects the process of providing risk protection rights over the life of the insurance contract; therefore, revenue would be recognized when risk is reduced, which may be on a straight-line basis (for example, the car insurance) or some other pattern (for example, the hurricane insurance). Therefore, the EBM and PBM would provide the same revenue recognition.

Example D: Standard manufacturer's warranty. A car manufacturer provides a customer with a one-year standard warranty; the warranty is included in the price of the car (that is, it is not separately priced). A warranty is like other forms of insurance because it provides a customer with risk protection rights. Therefore, the discussion for this example is consistent with Example C in the preceding paragraph. Hence, the EBM and PBM would provide similar revenue recognition.

Example E: Outsourcing contract. An outsourcing service provider administers a customer's human resources function for five years in exchange for a fixed fee. Because the customer obtains benefits from those services as they are provided, the service provider would recognize revenue over the life of the outsourcing contract under the EBM. Additionally, since the nature of the services is constant over the contract term, revenue may be recognized on a straight-line basis. However, if services are provided to the customer in some other pattern, a straight-line basis would not be appropriate. Under the PBM, the production process might be reflected on an input basis, such as the number of labor hours incurred. However, it may be reflected on a straight-line basis under the assumption that the production process's nature is constant throughout the life of the contract. Therefore, the EBM and PBM may yield similar accounting.

However, if the service provider incurred significant set-up costs (such as converting the customer's system to the service provider's system), the EBM and PBM might yield different patterns of revenue recognition. Under the PBM, more revenue would be recognized during the set-up period than under the EBM because more labor hours may be incurred in performing the set-up activities.

Example F: Specialized Equipment. An equipment manufacturer designs and constructs a piece of specialized equipment for the customer in exchange for a fixed fee. Design and construction is expected to be completed in two years. Under the EBM, no revenue is recognized until the customer obtains the right to use or benefit from the specialized equipment. Under the PBM, the production process might be reflected by using milestones (outputs) or inputs such as labor hours or costs; therefore, revenue would be reflected over the production period. Thus, the EBM and the PBM will result in different revenue recognition.

Example G: Television Reseller: television and return right. A television reseller provides a television and a 30-day return right to the customer in exchange for a fee. Under the EBM, the customer obtains the good when it is delivered and, thus, revenue for the television is recognized at that point. Under the PBM, resellers generally would measure performance based on an output measure, in this case, the television delivered. Consequently, the EBM and PBM provide the same revenue recognition for the television. For the right of return, the EBM and PBM also would provide similar revenue recognition: revenue would be recognized as the customer benefits from the ability to return the television over the life of the return right (that is, revenue would be recognized over the life of the return right).

Example H: Bolt supply contract. A bolt manufacturer agrees to provide a machine manufacturer with 100,000 bolts at a fixed price per bolt to be delivered in four equal installments over the following 12 months. Under the EBM, revenue would be recognized when the customer obtains each installment of bolts because that is when the customer has the right to use or benefit from them. Under PBM, the production process for such a manufacturer may be reflected by an output measure, namely, each bolt manufactured (not delivered). An interesting question is whether the bolt manufacturer should recognize revenue if it produces 100,000 bolts on the first day of the annual contract. If the machine manufacturer is unconditionally obligated to buy 100,000 bolts from the bolt manufacturer, then it would seem that performance has occurred because the bolt manufacturer has performed (except for the delivery of the bolts). However, if the machine manufacturer has no such obligation or the bolt manufacturer would not enforce its unconditional right, then recognizing revenue for each bolt manufactured would be inappropriate. Furthermore, if the bolt manufacturer could sell those bolts to other customers and manufacture others to satisfy the contract, then revenue should not be recognized because the 100,000 bolts represent inventory not specifically set aside to satisfy the contractual obligation.

<u>Discussion Question 1 of Memo No. 79</u>: Which method does the Board want the staff to more fully develop?

The appendix to this handout provides a detailed example of the accounting for a simplified transaction under the EBM and PBM.

APPENDIX—ILLUSTRATIVE EXAMPLES OF THE TWO REVENUE RECOGNITION METHODS

This appendix presents an illustrative example that demonstrates the application of the two revenue recognition methods to a simplified, single-element revenue transaction.

Example Facts

> In Period 1, Company and Customer enter into a contract for a single Product that Company is to produce for $1,000. Company's expected and actual cost to produce the Product will be $600. Delivery cost will be zero because Customer will pick up Product at Company's production facility.
>
> Production is 30 percent complete at end of Period 1; 90 percent complete at the end of Period 2; and 100 percent complete in Period 3, at which time Customer picks up the Product.

The following two scenarios demonstrate how different payment terms affect the assets and liabilities that arise from the revenue contract:

Scenario 1: Customer pays in full at contract inception.

Scenario 2: Customer pays in full upon delivery.

Scenario 1: Customer pays in full at contract inception

	Performance-Based Method	**Extinguishment-Based Method**
Contract inception To recognize full up-front payment from Customer	Cash $1,000 Contract liability $1,000	Cash $1,000 Contract liability $1,000
End of period 1 To recognize revenue and costs associated with Company's performance to date; production is 30% complete	Contract asset $300 Revenue $300 ($1,000 x 30%) Costs of goods sold $180 Accounts payable $180 ($600 x 30%)	(No entry for revenue) Inventory $180 Accounts payable $180
Summary of Account Balances--End of Period 1	Balance Sheet Cash $1,000 Contract asset 300 Accounts payable 180 Contract liability 1,000 Retained earnings 120 ($300-180) Income Statement Revenue $300 Costs of goods sold 180	Balance Sheet Cash $1,000 Inventory 180 Accounts payable 180 Contract liability 1,000
End of period 2 To recognize revenue and costs associated with Company's performance to date; production is 90% complete	Contract asset $600 Revenue $600 ($1,000 x 90% - $300) Costs of goods sold $360 Accounts payable $360 ($600 x 90% - $180)	(No entry for revenue) Inventory $360 Accounts payable $360

	Performance-Based Method	**Extinguishment-Based Method**
Summary of Account Balances--End of Period 2	Balance Sheet Cash $1,000 Contract asset 900 Accounts payable 540 Contract liability 1,000 Retained earnings 360 ($900 – 540) Income Statement Revenue $600 Costs of goods sold 360	Balance Sheet Cash $1,000 Inventory 540 Accounts payable 540 Contract liability 1,000
During period 3 To recognize revenue and costs associated with Company's performance to date; production is complete	Contract asset $100 Revenue $100 ($1,000 x 100% - 900) Costs of goods sold $60 Accounts payable $60 ($600 x 100% - $540)	(No entry for revenue) Inventory $60 Accounts payable $60
Pick up Customer picks up the completed Product.	Contract liability $1,000 Contract asset $1,000	Contract liability $1,000 Revenue $1,000 Cost of goods sold $600 Inventory $600
Summary of Account Balances--End of Period 3	Balance Sheet Cash $1,000 Accounts payable 600 Retained earnings 400 ($1,000 – 600) Income Statement Revenue $100 Costs of goods sold 60	Balance Sheet Cash $1,000 Accounts payable 600 Retained earnings 400 ($1,000 – 600) Income Statement Revenue $1,000 Costs of goods sold 600

Scenario 2: Customer pays in full upon delivery

	Performance-Based Method	Extinguishment-Based Method
Contract inception	(No entry) Company would not record any assets or liabilities in its financial statements at contract inception because the net measurement of the assets and liabilities that arise from the wholly executory contract initially will be zero.	
End of period 1 To recognize revenue and costs associated with Company's performance to date; production is 30% complete	Contract asset $300 Revenue $300 ($1,000 x 30%) Costs of goods sold $180 Accounts payable $180 ($600 x 30%)	(No entry for revenue) Inventory $180 Accounts payable $180
Summary of Account Balances--End of Period 1	Balance Sheet Contract asset $300 Accounts payable 180 Retained earnings 120 ($300-180) Income Statement Revenue $300 Costs of goods sold 180	Balance Sheet Inventory $180 Accounts payable 180
End of period 2 To recognize revenue and costs associated with Company's performance to date; production is 90% complete	Contract asset $600 Revenue $600 ($1,000 x 90% - $300) Costs of goods sold $360 Accounts payable $360 ($600 x 90% - $180)	(No entry for revenue) Inventory $360 Accounts payable $360

	Performance-Based Method	**Extinguishment-Based Method**
Summary of Account Balances--End of Period 2	Balance Sheet Contract asset $900 Accounts payable 540 Retained earnings 360 ($900 – 540) Income Statement Revenue $600 Costs of goods sold 360	Balance Sheet Inventory $540 Accounts payable 540
During period 3 To recognize revenue and costs associated with Company's performance to date; production is complete	Contract asset $100 Revenue $100 ($1,000 x 100% - $900) Costs of goods sold $60 Accounts payable $60 ($600 x 100% - $540)	(No entry for revenue) Inventory $60 Accounts payable $60
Pick up Customer picks up the completed Product.	Cash $1,000 Contract asset $1,000	Cash $1,000 Revenue $1,000 Cost of goods sold $600 Inventory $600
Summary of Account Balances--End of Period 3	Balance Sheet Cash $1,000 Accounts payable 600 Retained earnings 400 ($1,000 – 600) Income Statement Revenue $100 Costs of goods sold 60	Balance Sheet Cash $1,000 Accounts payable 600 Retained earnings 400 ($1,000 – 600) Income Statement Revenue $1,000 Costs of goods sold 600