



**International
Accounting Standards
Board**

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: February 2006, London

Project: Revenue Recognition (Agenda Papers 7A, 7B & 7C)

Agenda Paper 7A: Wholly Executory Revenue Contracts

BACKGROUND AND OBJECTIVE OF THIS MEMORANDUM

2. **The objective of this memorandum is to discuss and illustrate how the allocated customer consideration approach would be applied to wholly executory (or wholly unperformed) revenue contracts.** *[Remainder of paragraph omitted]*
4. The staff made certain simplifying assumptions in this memorandum to focus the Boards' discussion on the stated objective.
 - a. The subject of the revenue contract is fungible and the legal remedy in the case of breach would be monetary damages.
 - b. Neither the contract nor any of the units of account in the contract are onerous.
 - c. Liabilities are not remeasured for non-performance-related events (such as changes in prices).
 - d. Customer relationship intangible assets are ignored.

WHAT IS THE NATURE OF THE RIGHTS AND OBLIGATIONS THAT ARISE FROM WHOLLY EXECUTORY CONTRACTS?

5. The Boards previously agreed that revenue contracts give rise to 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.

6. The Boards 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 Boards 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 Boards previously 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. Unconditional rights and obligations that arise from wholly executory contracts can meet the definitions of assets and liabilities.

10. The required sequence of performance affects the conditionality of the parties' rights and obligations in the wholly executory stage of a revenue contract. The party that is either explicitly or constructively 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 (or its obligation may be mature if it is due immediately). The counterparty's performance is conditional because that party is not required to perform until the first party has performed. However, the counterparty has an unconditional obligation to stand ready to perform.

11. 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.

12. 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. In addition, unconditional rights and obligations include unconditional **stand-ready** rights and obligations.

DO THE MATURE AND UNCONDITIONAL RIGHTS AND OBLIGATIONS THAT ARISE FROM WHOLLY EXECUTORY CONTRACTS MEET THE DEFINITIONS OF ASSETS AND LIABILITIES?

13. In the Revenue Recognition project, revenues are defined in terms of changes in assets and liabilities. Thus, the relationship of contractual rights and obligations to assets and liabilities is fundamental to accounting for revenues.

14. The Boards previously decided that conditional rights and obligations are not assets and liabilities, but unconditional and mature rights and obligations can be assets and liabilities. However, the Boards did not specify *which* mature and unconditional contractual rights and obligations meet those definitions.

15. FASB Concepts Statement No. 6, *Elements of Financial Statements*, provides the following definitions for assets and liabilities (footnotes omitted):

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

16. The IASB's *Framework for the Preparation and Presentation of Financial Statements* provides similar definitions:

An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Mature and Unconditional Obligations

17. To meet the definition of a liability, a mature or unconditional obligation must satisfy three criteria: (a) the obligation must relate to a probable (or expected) economic sacrifice (or outflow), (b) that economic sacrifice is a present obligation to transfer resources to other entities, and (c) that economic sacrifice is the result of a past transaction or event.

18. **Mature and unconditional contractual obligations to provide or to stand ready to provide goods, services, or other rights that arise from wholly executory contracts meet the definition of a liability.** *[Remainder of paragraph omitted]*

Mature and Unconditional Contractual Rights

19. To meet the definition of an asset, a mature or unconditional contractual right must satisfy three criteria: (a) the right must relate to a probable (or expected) economic benefit to the reporting entity, (b) that economic benefit is controlled by the reporting entity, (c) that economic benefit is the result of a past transaction or event.

20. **Mature and unconditional contractual rights to receive consideration or to stand ready to receive consideration from the customer that arise from wholly executory contracts meet the definition of an asset.** *[Remainder of paragraph omitted]*

HOW WOULD THE ASSETS AND LIABILITIES THAT ARISE FROM WHOLLY EXECUTORY CONTRACTS BE ACCOUNTED FOR UNDER THE ALLOCATED CUSTOMER CONSIDERATION APPROACH?

21. Having determined that the unconditional (and mature) rights and obligations that arise from wholly executory contracts meet the definition of assets and liabilities, it is necessary to consider how those assets and liabilities would be recognized and measured under the allocated customer consideration approach. This section reviews the Boards' decision about the appropriate unit of account in a wholly executory contract and then addresses how that unit of account would be measured under the Boards' allocated customer consideration approach.

22. In a previous memorandum, the staff suggested that different legal remedies have implications for the question of what the unit of account should be for the assets and

liabilities that arise from wholly executory revenue contracts. Both Boards 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 rights and obligations should be reported “net”). The Boards made that decision because, in the wholly executory stage, the only way the reporting entity generally can settle the contract immediately is with a one-way flow of resources. That is because the reporting entity generally would have to either (a) legally lay off the contract to a third party or (b) breach the contract and pay monetary damages to the counterparty. Conversely, 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 rights and obligations are reported “gross”). The Boards made that decision because, in all cases (including breach), the parties to the contract are required to physically settle the contract (a two-way flow of resources).

23. Moreover, both Boards 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 the liabilities would equal the consideration (the asset) and hence, revenue would not be recognized.

24. Based on those prior Boards’ decisions, for wholly executory contracts in which the unit of account is the contract as a whole, a reporting entity will not record any assets or liabilities in its financial statements at contract inception because the net measurement of those assets and liabilities initially will be zero. For wholly executory contracts in which the unit of account is the individual assets and liabilities arising from the contract, the measurement of the liabilities recognized would equal the measurement of the assets recognized. Those assets and liabilities would be recognized gross on the balance sheet.

ILLUSTRATIVE EXAMPLE

25. 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 visits Furniture Company (Furn Co) to purchase a new dining room table. She looks through the showroom but doesn’t find a table that she wants. However, Furn Co does have a table in its catalog that Annie likes, so she orders it.

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

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, 2006.¹

26. 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 1-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**.

27. 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.
- 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**.

¹ 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.

28. 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 (which measures 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 ON THE NATURE OF CONTRACTUAL RIGHTS AND OBLIGATIONS THAT ARISE FROM WHOLLY EXECUTORY CONTRACTS

29. The staff considered an alternative view on the nature of the contractual rights and obligations that arise from wholly executory revenue contracts and how those rights and obligations would be recognized under the allocated customer consideration approach.

30. This alternative view is that 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 staff observes that this view relies on different definitions of *conditional* and *unconditional* from those in paragraph 5 of this memorandum (which are based on contract law and have been used throughout the project to date). The combined right and obligation is not regarded as being conditioned on counterparty performance if the counterparty has a contractual obligation (as opposed to option) to perform.

31. Additionally, the combined right and obligation to make the exchange does not give rise to a separate asset and liability. This is 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. *[Remainder of paragraph omitted]*

33. Applying the alternative view, it could be argued that the combined right and obligation of a wholly executory contract should always be recognized as a single asset or liability, regardless of the remedy for breach of contract. *[Remainder of paragraph omitted]*

Discussion Question 1—Which view do Board members think best reflects the nature of the contractual rights and obligations that arise from wholly executory revenue contracts?

Discussion Question 2—If Board members prefer the majority view, do Board members agree with the staff's application of the allocated customer consideration approach to wholly executory revenue contracts (presented in paragraphs 25–28)? If not, how would Board members apply the approach differently?

APPENDIX A to agenda paper 7A

MEASURING UNCONDITIONAL STAND-READY OBLIGATIONS AT FAIR VALUE

34. In September 2005, the IASB Board tentatively decided to measure all unconditional stand-ready obligations at fair value (rather than at an allocated customer consideration amount). In October 2005, the IASB Board clarified that an unconditional stand-ready obligation should be measured at fair value even if that obligation is the only unconditional obligation in the arrangement. Thus, a reporting entity might recognize revenue at the inception of a contract if the unconditional stand-ready obligation is the only unconditional obligation in the contract.

35. The Boards deliberated that issue in the context of prepaid contracts. The staff thinks that the IASB Board's decision was context-specific and only applied to unconditional stand-ready obligations that arise in the post-performance period (that is, the period after one of the parties to the contract has performed). To extend that decision to unconditional stand-ready obligations that arise in the pre-performance period (that is, the period of time between when a contract is first signed and when the goods, services, or other rights are provided or paid for) has unusual consequences.

36. Consider, for example, the contractual obligations that arise in Scenario 2 of the illustrative example presented earlier in this memorandum—(a) a conditional obligation to provide a table to Annie and an associated unconditional stand-ready obligation to provide the table if Annie pays the initial payment of \$300 and (b) a conditional obligation to provide warranty coverage and an associated unconditional obligation to stand ready to provide that warranty. In that scenario, the only unconditional obligations that exist at contract inception are two stand-ready obligations. If the IASB Board extends its decision to the pre-performance period, both of those unconditional obligations would be measured at fair value—that is, those obligations would be measured based on the amount that Furn Co would have to pay to legally lay off those obligations to a third party. Revenue (or contra-revenue/loss) might be recognized at contract inception because the sum of the fair values of the stand-ready obligations generally would not equal the fair value of the unconditional (or mature) rights.

37. However, when Annie performs (that is, when Annie pays the initial payment of \$300), Furn Co's unconditional stand-ready obligation to perform would be replaced by an unconditional obligation to perform. Based on the Boards' tentative decisions to date, that unconditional obligation to perform would be measured at an allocated customer consideration amount (not at fair value). Due to the change in measurement attribute, the revenue that had been recognized at contract inception would be reversed.

Discussion Question 3—Do IASB Board members agree that the unconditional stand-ready obligations that arise in the pre-performance period should be measured at an allocated customer consideration amount, not at fair value?

Agenda Paper 7B: Accounting for Performance

OBJECTIVE OF THE MEMORANDUM

1 This memo presents two revenue recognition methods: the extinguishment-based method (EBM) and the performance-based method (PBM). This memo (a) compares and contrasts those two methods and (b) evaluates each method against the conceptual criteria in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, and the IASB *Framework for the Preparation and Presentation of Financial Statements*. This memo then asks Board members which method they want the staff to more fully develop.

SECTION I: PRESENTATION OF THE METHODS BACKGROUND

3 The EBM and PBM can be related to two of several categories of revenue recognition methods that were described in the FASB staff's "bottom-up" report, which was presented to the FASB at its August 13, 2003 Board meeting. That report contained the results of the FASB staff's survey of existing revenue recognition practices in U.S. GAAP. That report analyzed those practices and organized them into four general categories:

- a. Mark to market – Revenues (or gains/losses) are recognized based on changes in the fair value of an asset or a liability.
- b. Proportionate performance – Recognition occurs as performance occurs or as time passes.
- c. Sales – Recognition is delayed until performance is complete or substantially complete (also includes the completed contract method).
- d. Collection – Profit is recognized upon collection of the consideration after performance has occurred.

6 The PBM is a proportionate-performance-type method, and the EBM is a hybrid of a proportionate-performance-type and a sales-type method. The remainder of this memo analyzes those two methods in detail.

The Meaning of *Performance*

7 Before presenting the two methods, the staff will discuss the meaning of the term *performance*. The noun *performance* is defined as follows:

The carrying out of a command, duty, purpose, promise, etc.; execution, discharge, fulfilment.²

8 That definition is particularly apt given that what is being carried out is a legally enforceable promise. To more fully express the meaning in those definitions, the staff has included the definitions of *action* and *act* below:

² The Compact Oxford English Dictionary (2nd Edition, 1998).

The process or condition of acting or doing (in the widest sense), the exertion of energy or influence; working, agency, operation.

A thing done; a deed, a performance³

9 Thus, 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:⁴

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

10 The two methods presented in this memo interpret that description in two very different ways. 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. 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 the goods, services, or other rights). The following sections describe why those two methods result in such different interpretations of performance.

The Extinguishment-Based Method

11 Under the EBM, revenue is generally recognized only when the goods, services, or other rights have been delivered to the customer. 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.

12 Thus, the objective is to recognize revenue when the obligation to provide goods, services, or other rights is legally extinguished. However, that objective must be modified. *[Remainder of paragraph omitted]*

13 Consequently, 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. For this reason, the staff has used the phrase *extinguishment-based*. *[Remainder of paragraph omitted]*

14 The staff thinks that 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 obtains the goods, services, or other rights when the customer obtains the right to use or benefit from the goods, services, or other rights.** 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.

³ The Compact Oxford English Dictionary (2nd Edition, 1998).

⁴ A performance obligation is a legally enforceable obligation of a reporting entity to its customer, under which the entity is obligated to provide goods, services, or other rights.

The Performance-Based Method

16 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. Concepts Statement No. 6, *Elements of Financial Statements*, describes the production process:

An enterprise increases the values of goods or services it holds or acquires by adding time, place, or form utility. Thus, *productive efforts* and *producing* and *distributing* activities include not only manufacturing and other conversion processes but also other productive activities such as storing, transporting, lending, insuring, and providing professional services that might be overlooked if *producing* were narrowly equated with *manufacturing*. [Paragraph 74, footnote 38; emphasis in original.]

17 In principle, all acts in the production process are carried out to fulfill a contractual obligation and are economic events that give rise to revenue. Revenue arises because each act in the production process gives rise to an asset or enhances an existing asset. This rationale is supported by Concepts Statement 6, which states the following:

In concept, revenues increase assets rather than decrease liabilities, but a convenient shortcut is often to directly record reduction of liabilities. Production is essentially an asset conversion process to create future economic benefit It adds utility and value to assets and is the primary source of revenue Production does not directly incur or settle liabilities but is often closely related to exchange transactions in which liabilities are incurred or settled. . . . The assets produced by operations may be used to settle liabilities (for example, by delivering product that has been paid for in advance). However, again, to record a liability as being directly reduced by recording revenue is a useful shortcut that combines two conceptually separate events: (a) an internal event (production) that resulted in an asset and revenue and (b) an exchange transaction in which the asset was transferred to another entity to satisfy a liability. [Paragraph 79, footnote 40.]

As noted in the excerpt, production is an asset conversion process; that process creates or enhances an asset by adding utility and value. That asset represents the asset that will be ultimately 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.

18 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. . . . In a revenue contract involving more than one good, service, or other right (a multiple-element contract), a reporting entity would apply the PBM to each item meeting the separate-unit-of-account criteria.

SECTION II: COMPARING AND CONTRASTING THE METHODS

19 This section compares and contrasts the EBM and PBM by using a series of examples that illustrate how those methods would operate for different revenue contracts.

20 **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. *[Remainder of paragraph omitted]*

21 **Example B: Equipment lease.** A lessor provides a customer with a two-year equipment lease that is classified as operating under IFRS and U.S. GAAP. 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. *[Remainder of paragraph omitted]*

22 **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 it 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.

23 **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. *[Remainder of paragraph omitted]*

24 **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.

25 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. *[Remainder of paragraph omitted]*

26 **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. *[Remainder of paragraph omitted]*

27 **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 LBM and PBM also would provide similar revenue recognition; that is, 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 is recognized over the life of the return right). *[Remainder of paragraph omitted]*

28 **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.

SECTION III: EVALUATION OF METHODS AGAINST CONCEPTUAL CRITERIA

30 This section evaluates the methods using the conceptual criteria in Concepts Statement 2 and the Framework. Those criteria are understandability, relevance, reliability, and comparability. Those criteria are constrained by the balance between benefit and cost.

SECTION IV: CONCLUSION AND RECOMMENDATION

47 Throughout this memo, the staff has alluded to the fact that the EBM is similar to various types of revenue recognition methods used internationally and in the U.S. EBM-type methods have been in existence for a long time. Those methods have contributed to the problems that the Boards wanted to address in deciding to add this project to their agendas. It is not clear to a majority of the staff that the EBM is capable of providing a sufficiently strong conceptual basis that would provide for a robust principles-based standard on revenue recognition. However, a majority of the staff would argue that the PBM is capable of providing that strong conceptual basis. The PBM provides information that is more decision useful because it is more relevant and representationally faithful. The PBM can be generally applied to all contracts for goods, services, and other rights (be they short term or long term). Therefore, the majority of the staff recommends that the PBM be used as the conceptual basis for a standard on revenue recognition. *[Remainder of paragraph omitted]*

Agenda Paper 7C: Illustrative Examples

INTRODUCTION AND OBJECTIVE

1. Agenda Paper 7B, *Accounting for Performance*, discusses two revenue recognition methods—(a) the extinguishment-based method (EBM) and (b) the performance-based method (PBM). That memorandum compares and contrasts those two methods, evaluates each method against conceptual criteria, and asks the Boards which method they want the staff to more fully develop.
2. This memorandum presents an illustrative example that demonstrates the application of those two methods. The objective of this memorandum is to illustrate how the two methods would operate when they are applied to a simplified, single-element transaction. In the example, the staff assumed that the subject of the revenue contract is fungible and the legal remedy in the case of breach would be monetary damages. *[Remainder of paragraph omitted]*
3. The staff made several additional simplifying assumptions in this memorandum:
 - e. The contract is not onerous. Furthermore, over the course of the contract, the costs incurred to produce the product are assumed to be consistent with the reporting entity's expectations.
 - f. Liabilities are not remeasured for non-performance-related events (such as changes in sales prices).
 - g. The time value of money is ignored.
 - h. Customer relationship intangible assets are ignored.
4. Furthermore, this memorandum does not address certain financial statement presentation issues; that is, it does not discuss whether the contract asset and the contract liability that can arise from a revenue contract under the performance-based method should be offset against each other ("netted") in the reporting entity's financial statements.

ILLUSTRATIVE EXAMPLE

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% complete at end of Period 1; 90% complete at the end of Period 2; and 100% 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
<u>Contract inception</u> To recognize full up-front payment from Customer	Cash \$1,000 Contract liability \$1,000	Cash \$1,000 Contract liability \$1,000
<u>End of period 1</u> To recognize revenue and costs associated with Company's performance to date; production is 30% complete	Contract asset \$300 Revenue \$300 ($\$1,000 \times 30\%$) Costs of goods sold \$180 Accounts payable \$180 ($\$600 \times 30\%$)	(No entry for revenue) Inventory \$180 Accounts payable \$180
Summary of Account Balances--End of Period 1	<u>Balance Sheet</u> Cash \$1,000 Contract asset 300 Accounts payable 180 Contract liability 1,000 Retained earnings 120 ($\$300 - 180$) <u>Income Statement</u> Revenue \$300 Costs of goods sold 180	<u>Balance Sheet</u> Cash \$1,000 Inventory 180 Accounts payable 180 Contract liability 1,000
<u>End of period 2</u> To recognize revenue and costs associated with Company's performance to date; production is 90% complete	Contract asset \$600 Revenue \$600 ($\$1,000 \times 90\% - \300) Costs of goods sold \$360 Accounts payable \$360 ($\$600 \times 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	<u>Balance Sheet</u> Cash \$1,000 Contract asset 900 Accounts payable 540 Contract liability 1,000 Retained earnings 360 (\$900 – 540) <u>Income Statement</u> Revenue \$600 Costs of goods sold 360	<u>Balance Sheet</u> Cash \$1,000 Inventory 540 Accounts payable 540 Contract liability 1,000
<u>During period 3</u> 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
<u>Pick up</u> 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	<u>Balance Sheet</u> Cash \$1,000 Accounts payable 600 Retained earnings 400 (\$1,000 – 600) <u>Income Statement</u> Revenue \$100 Costs of goods sold 60	<u>Balance Sheet</u> Cash \$1,000 Accounts payable 600 Retained earnings 400 (\$1,000 – 600) <u>Income Statement</u> Revenue \$1,000 Costs of goods sold 600

Scenario 2: Customer pays in full upon delivery

	Performance-Based Method	Extinguishment-Based Method
	(No entry)	
<u>Contract inception</u>	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. (Refer to Revenue Recognition Memo No. 78—Wholly Executory Revenue Contracts.)	
<u>End of period 1</u> 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	<u>Balance Sheet</u> Contract asset \$300 Accounts payable 180 Retained earnings 120 (\$300-180) <u>Income Statement</u> Revenue \$300 Costs of goods sold 180	<u>Balance Sheet</u> Inventory \$180 Accounts payable 180
<u>End of period 2</u> 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
Summary of Account Balances--End of Period 2	<u>Balance Sheet</u> Contract asset \$900 Accounts payable 540 Retained earnings 360 (\$900 - 540) <u>Income Statement</u> Revenue \$600 Costs of goods sold 360	<u>Balance Sheet</u> Inventory \$540 Accounts payable 540

	Performance-Based Method	Extinguishment-Based Method
<u>During period 3</u> 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
<u>Pick up</u> 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	<u>Balance Sheet</u> Cash \$1,000 Accounts payable 600 Retained earnings 400 (\$1,000 – 600) <u>Income Statement</u> Revenue \$100 Costs of goods sold 60	<u>Balance Sheet</u> Cash \$1,000 Accounts payable 600 Retained earnings 400 (\$1,000 – 600) <u>Income Statement</u> Revenue \$1,000 Costs of goods sold 600