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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **20 July 2006, London**

Project: **Revenue Recognition**

Subject: **Application of the Boards' Decision on the Meaning of Performance (Agenda Papers 14A-E)**

Agenda Paper 14A—Introduction: Application of the Boards' Decision on the Meaning of *Performance*

BACKGROUND

1. At their respective meetings in February and March 2006, the IASB and FASB Boards discussed two revenue recognition methods. Under one, the extinguishment-based method (EBM), revenue is recognized when the obligation to provide goods, services, or other rights is extinguished. Under the other, the performance-based method (PBM), revenue is recognized as the entity's production process creates or enhances assets for customers.

2. At their joint meeting in April 2006, the Boards continued to discuss methods for revenue recognition. At that meeting, both Boards agreed that the notion of *customer acceptance* is important in determining when performance has occurred (and, thus, when revenue should be recognized). The Boards 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 Boards 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.

3. Furthermore, the majority of both Boards tentatively agreed that using the notion of customer acceptance to determine when performance has occurred could be viewed as modification of the PBM because customer acceptance would be an external validation of the entity's performance to date. (However, some Board members thought that it could be viewed as a modification of the EBM because customer acceptance would indicate that the entity has been released from part of its obligation.)

CRITERIA FOR REVENUE RECOGNITION

4. As noted in paragraph 2, the Boards agreed that revenue should be recognized when the reporting entity has obtained an unconditional right to at least some consideration for its performance to date. The Boards further noted that an unconditional right might arise under the contract terms or the operation of the relevant contract law. The staff thinks that there are two notions in that decision. First, an unconditional right to consideration could arise from **contractually stated customer acceptance provisions**. Second, an unconditional right to consideration could arise from **relevant contract law**.

5 - 7. [Paragraphs omitted from observer notes]

8. To analyze the affect of contractual customer acceptance provisions and legal remedies on revenue recognition, the staff trifurcated the Boards' decision into three criteria for revenue recognition and considered each separately. 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 which unconditionally obligate the customer to compensate the reporting entity for performance to date. Those criteria are explained further below:

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

9. 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, the contract will be physically settled in full ('full physical settlement').

10. [Paragraph omitted from observer notes]

11. In summary, specific performance is a remedy that requires both parties to precisely fulfil their contractual obligations. It 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

12. At the joint meeting, one aspect of the criterion that the Boards agreed to explore for revenue recognition (reproduced at the end of paragraph 2 of this memorandum) was that revenue should be recognized if, in the event of customer cancellation, the customer is obligated to pay damages reflecting performance to date. However, the staff thinks that the criterion should refer more broadly to the legal concept of customer **breach**, not customer **cancellation**. Some may perceive the notion of customer cancellation as only applying to contracts that include a specific customer cancellation clause. That was not the staff's intent; rather the staff was referring to the legal remedy that the courts would enforce if the customer breached the contract.

13. 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.

14. The staff bifurcated Criterion 2 into two sub-criteria. That is, the customer is required to pay monetary damages reflecting performance to date reflecting either (a) net compensatory damages to the seller, a one-way flow (of cash) from the buyer to the seller or (b) damages that reimburse the seller for its costs for production to date plus a profit margin[1] and, in exchange, the buyer obtains the work in process and title to it, a two-way flow of resources between the parties ('partial physical settlement'). Those sub-criteria are described further below.

Sub-criterion A: The customer is required to pay a net cash settlement amount

15. Sub-criterion 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,[2] less any costs avoided because of the buyer's breach. If the good has not been resold, the seller may recover damages from the buyer measured by the difference between the contract price and the lower market price at the time and place of the tender of the good, plus incidental damages, less costs avoided.

16. If the buyer breaches the contract before the good is finished, the seller may choose between completing manufacture of the good for ultimate resale to another buyer or selling it for its scrap value. In making that decision, the seller is required to use reasonable judgment in an effort to minimize damages.

17. Some sellers will not be satisfied with the difference between the contract price and the resale price of the good (or the market value, if the good has not been resold).

[1] In some cases, the court might order the buyer to reimburse the seller for the costs incurred to date plus a profit margin on those costs or in other cases, the court might order the buyer to reimburse the seller for costs incurred to date plus the estimated profit margin on the entire contract. The courts generally would make that determination on a contract-by-contract basis.

[2] Incidental damages to an aggrieved seller include any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation, care and custody of goods after the buyer's breach, in connection with return or resale of the goods or otherwise resulting from the breach (UCC Section 2-710).

That would be the case if the 'substitute sale' (that is, the resale of the good) does not mitigate the harm caused by the breach because that resale is an **additional** transaction that the seller would have entered into regardless of the buyer's breach. That is, the breach reduced the volume of the seller's business, which resulted in lost profits. If the seller could have sold an additional item, then that seller is considered a 'lost volume seller' and is entitled to recover the entire lost profit of the breached contract.[3]

18. The staff understands that the remedy described in paragraph 15 is the most common form of net cash settlement damages; therefore, the approach taken in the memoranda for this meeting focuses on that remedy.

Sub-criterion B: The parties to the contract physically settle it <u>in part</u>

19. Sub-criterion 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 its 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 title to it. In other words, the parties physically settle the finished portion of the contract.

20. At the joint meeting, one aspect of the criterion that the Boards agreed to explore for revenue recognition (reproduced at the end of paragraph 2 of this memorandum) was that revenue should be recognized if the contract has a legal remedy that '*is like* specific performance.' The Boards did not discuss explicitly the meaning of that phrase, but the staff thinks it is a misnomer. The term *specific performance* is a precise legal term that means that the parties to the contract are required to perform as promised. The phrase '*is like* specific performance' is not a legal concept. In other words, a remedy either **is** specific performance or it **isn't**. If a remedy does not meet the definition of specific performance, then that remedy generally is a form of monetary damages. For that reason, the staff has included remedies that require partial physical settlement in the discussion of monetary damages. Going forward, the staff recommends that the phrase 'is like specific performance' not be used because it is not a legal concept and can result in miscommunication. The staff proposes using the term 'partial physical settlement.'

Criterion 3: The Contract Contains Explicit Customer Acceptance Provisions

21. Based on the staff's interpretation of the Boards' discussion in April, contracts that contain explicit customer acceptance provisions 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.

22. The staff notes that there may be other views on the meaning of *customer acceptanc*e and how the application of that notion would affect revenue recognition. For example, the staff is considering the interaction among customer acceptance provisions, cancellation clauses, and return rights. The staff notes that in some contracts, those terms allow the customer to refuse or return the good for any reason (or no reason) while in other contracts, the goods must be damaged or otherwise not in conformance with the specifications of the contract. The staff further notes that customer acceptance might be delegated to a third party (for example, in a construction contract, the building inspector

[3] *Understanding Contracts* by Jeffrey Ferriell and Michael Navin (LexisNexis, 2004), pages 614 and 634.

might accept performance to date rather than the customer). The staff is continuing to explore the meaning of customer acceptance and issues related to that term.

OBJECTIVE OF THIS MEETING AND ORGANIZATION OF THE MEMORANDA

23. **The objective of this meeting is to further discuss the Boards' decision at their joint meeting in April that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration.** It is not critical that the Boards obtain absolute consensus on the application of that decision; rather, the staff would like to obtain input and preliminary thoughts on the illustrative examples included in the memoranda for this meeting. The staff will use that input to continue to analyze and improve the criterion for revenue recognition.

24. To achieve that objective, the staff has prepared four memoranda. Those memoranda are organized based on the aforementioned trifurcation of the Boards' tentative decision and the resulting criteria for revenue recognition. The staff acknowledges that the memoranda for this meeting contain a lot of information. However, the staff thinks it is important to consider each criterion in the context of the other criteria (rather than consider each criterion piecemeal).

- Agenda Paper 14B explores how revenue would be recognized if, in the event of breach, a contract requires a legal remedy of **specific performance**.

- Agenda Paper 14C explores how revenue would be recognized if, in the event of customer breach, a contract requires a legal remedy of **monetary damages** and those damages would require the customer to pay an amount that reimburses the reporting entity for its costs incurred to date plus a profit margin. In return, the customer would obtain the work in process and title to it. In other words, the contract requires a legal remedy of '**partial physical settlement**.'

- Agenda Paper 14D begins to consider how revenue would be recognized if, in the event of customer breach, a contract requires a legal remedy of **monetary damages** and those damages would require the customer to pay a **net cash settlement amount** to the seller. In this memorandum, the staff presents two possible alternatives of how the Boards' decision could be interpreted and applied to a simple contract. However, the staff has not reached a definitive conclusion and is continuing to explore this criterion.

- Agenda Paper 14E begins to consider how revenue would be recognized if a contract has **contractually stated customer acceptance provisions** that unconditionally obligate the customer to compensate the reporting entity for performance to date. The staff acknowledges that the fact pattern illustrated in this memo is simple and perhaps unrealistic; the staff is continuing to explore the notion of customer acceptance (including its precise meaning) and how it would be applied to more complex contracts.

25. [Paragraph omitted from observer notes]

26. In the aforementioned memoranda, the staff uses an example to illustrate how the Boards' decision would be applied to a simple contract. The staff assumes that the

customer pays for the product upon final delivery; however, the timing of the customer's payment does not affect revenue recognition. The Boards agreed that revenue should be recognized when the reporting entity has an unconditional right to at least some consideration for performance to date, but that unconditional right does not have to be mature; that is, it does not have to be due immediately. Therefore, revenue recognition is the same whether the customer pays at contract inception, at specified milestones during the contract, or upon delivery of the finished product.

27. None of the memoranda address financial statement presentation issues; that is, they do not discuss whether any of the assets and liabilities that arise from a revenue contract should be offset against each other ('netted') in the reporting entity's financial statements. That is a presentation (display) issue and is outside of the scope of these memoranda.

28. [Paragraph omitted from observer notes]

Agenda Paper 14B—Application of the Boards' Decision on the Meaning of Performance to Contracts That, in the Event of Breach, Require a Remedy of *Specific Performance*

OBJECTIVE OF THIS MEMORANDUM

1. As noted in Agenda Paper 14A, the objective of this meeting is to further discuss the Boards' decision at the joint Board meeting in April that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. **Specifically, the objective of this memorandum is to discuss the basic operation and application of that decision to a contract that, in the event of breach, has the legal remedy of specific performance.**

2. [Paragraph omitted from observer notes]

ACCOUNTING AT CONTRACT INCEPTION

3. The Boards previously decided that if the legal remedy in the event of breach was specific performance, the unit of account at contract inception should be the assets and liabilities that arise from the contract (that is, the separate assets and liabilities should be recognized in the reporting entity's balance sheet rather than a single (net) asset or liability). The Boards made that decision because, in all cases (including breach), the parties to the contract are required to physically settle the contract, which results in a two-way flow of resources. Recognizing separate assets and liabilities more faithfully represents the assets and liabilities that underlie that two-way flow.

4. At the inception of the contract, the reporting entity has both an asset and a liability. Specifically, the reporting entity has either an unconditional right to consideration (if the customer is required to perform first) or an unconditional right to the customer's stand-ready performance (if the reporting entity is required to perform first). Correspondingly, the reporting entity has either an unconditional obligation to perform (if it must perform first) or an unconditional obligation to stand ready to perform (if the customer must perform first). The objective of this memorandum is not to explore further the nature of the asset and liability that exist at contract inception. Rather, the key point is that both an asset and a liability exist at contract inception and, based on the Boards' prior decision, those elements will be recognized separately in the reporting entity's balance sheet.

ACCOUNTING FOR PERFORMANCE

5. As noted above, both Boards 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 Boards agreed that the reporting entity obtains such an unconditional right for its performance to date if, in the event of breach, the contract's legal remedy is specific performance. In other words, if a contract has a remedy of specific performance, revenue should be recognized as the reporting entity performs because the customer is required to accept performance to date (and compensate the reporting entity for it).

ILLUSTRATIVE EXAMPLE

6. The following example illustrates how the Boards' decision on the meaning of performance should be applied to a contract that, in the event of breach, has a legal remedy of specific performance.

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.
>
> There are no contractual customer acceptance provisions. 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.

Two scenarios are illustrated for the 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.

7. [Paragraph omitted from observer notes]

<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>Summary of Account Balances—
Contract inception</td><td colspan="2"><u>Balance Sheet</u>
Claim against the customer $100,000

Contract liability $100,000

<u>Income Statement</u>
No activity</td></tr>
<tr><td></td><td colspan="2">Staff note: As noted earlier in this memorandum, the Boards 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.

In this contract, Company is required to perform before Customer is required to pay. Therefore, the asset that arises at contract inception is an unconditional claim against Customer. That claim represents Company’s unconditional right to Customer’s contractual promise to pay. However, the claim <u>is not</u> an unconditional right to receive consideration from Customer (that is, it is not a receivable) because Customer is not yet required to tender cash until Company performs.</td></tr>
<tr><td></td><td colspan="2"></td></tr>
</table>

	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 1 To recognize revenue and costs associated with Company's performance to date; production is 60% complete	Production asset $60,000 Contract revenue $60,000 ($100,000 x 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 x 60%) Contract liability $60,000 Claim against Customer $60,000 Consideration receivable $60,000 Production asset $60,000	Production asset $60,000 Contract revenue $60,000 ($100,000 x 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 x 60%)
	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.	***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.

	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 1**	<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	<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
	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.	***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). Thus, it appears that Company's assets are overstated (or that the assets that arise from the contract are double counted). 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.[4]

[4] Alternatively, at the end of Period 1, Company could make an entry to reduce both the contract liability and the claim against Customer by $60,000 (identical to the entry made in Scenario A). Under this accounting treatment, the liability has been partially extinguished because, in a contract that requires specific performance, the reporting entity will transfer the production asset to Customer. If that entry was made, the remaining balances of the claim against Customer and the liability would be $40,000 each (identical to Scenario A).

	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.
<u>End of period 2</u> 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 x 100% - 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 x 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 x 100% - 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 x 100% - 36,000) Consideration receivable $100,000 Claim against Customer $100,000
Summary of Account Balances— **End of Period 2**	<u>Balance Sheet</u> Consideration receivable $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> Consideration receivable $100,000 Contract liability $100,000 Less: Production asset <u>(100,000</u>) ---- Accounts payable $60,000 Retained earnings $40,000 <u>Income Statement</u> Contract revenue $40,000 Contract expense $24,000

<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>Beginning of Period 3</u>
Customer picks up the completed Product and pays for it.</td><td>Cash $100,000
Consideration receivable $100,000</td><td>Cash $100,000
Consideration receivable $100,000

Contract liability $100,000
Production asset $100,000</td></tr>
<tr><td>Summary of Account Balances—
End of Period 3</td><td colspan="2"><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</td></tr>
</table>

Agenda Paper 14C—Application of the Boards' Decision on the Meaning of Performance to Contracts That, in the Event of Customer Breach, Require a Remedy of *Partial Physical Settlement*

OBJECTIVE OF THIS MEMORANDUM

1. As noted in Agenda Paper 14A, the objective of this meeting is to further discuss the Boards' decision at the joint Board meeting in April that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. **Specifically, the objective of this memorandum is to discuss the basic operation and application of that decision to a contract that, in the event of customer breach, has the legal remedy of monetary damages that require the parties to physically settle the contract in part.** That is, the customer is required to pay an amount that reimburses the reporting entity for its costs incurred for production to date plus a profit margin (either on production to date or on the entire contract) and, in exchange, the reporting entity transfers the work in process and title to it to the customer. The staff has labelled this remedy 'partial physical settlement.'

2. If the customer breaches during the performance period, the outcome of the aforementioned legal remedy has certain similarities to a contract that requires specific performance. That is because there will be a two-way flow of resources between the parties; the reporting entity will be compensated for its performance to date and, in exchange, will transfer the work in process to the customer. However, as noted in Agenda Paper 14A, this remedy is not specific performance because the contract will not be physically settled **in full** (as is required by a legal remedy of specific performance); it will be physically settled **in part**. In other words, only the finished portion of the contract will be physically settled. (Additionally, if the customer cancels the contract before the reporting entity begins performance, no portion of the contract will be physically settled; rather, the legal remedy for the wholly executory contract would be a net cash settlement between the parties).

ACCOUNTING AT CONTRACT INCEPTION

3. The Boards previously agreed that the unit of account for a wholly executory contract in which the legal remedy in the event of customer breach is monetary damages should be the contract as a whole (that is, the assets and liabilities should be recognized 'net'). The Boards made that decision because, in the wholly executory stage, the contract generally can only be settled immediately with a one-way flow of resources. That is, the contract could be settled if (a) the reporting entity legally laid off the contract to a third party, (b) either the buyer or the seller settled directly with the counterparty by making a payment, or (c) either the buyer or the seller breached the contract and paid monetary damages to the counterparty.

4. 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. 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.

ACCOUNTING FOR PERFORMANCE

5. As previously noted, both Boards 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 Boards 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 its performance.

6. If a contract has a remedy of partial physical settlement, revenue should be recognized as performance occurs because, in all cases, the customer will be required to compensate the reporting entity for its work in process. The accounting for performance in a contract that requires partial physical settlement is similar to the accounting illustrated in Memorandum 84 for a contract that requires specific performance. That is because, under both remedies, the reporting entity will be compensated for its performance.

ILLUSTRATIVE EXAMPLE

7. The following example illustrates how the Boards' decision should be applied to a contract that requires a legal remedy of partial physical settlement.

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.

There are no contractual customer acceptance provisions. 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 title to it.

Two scenarios are illustrated for the 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.

8. [Paragraph omitted from observer notes]

	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.
<u>Contract inception</u>	No entry	No entry
	Staff note: As noted earlier in the memorandum, the Boards 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. Therefore, the asset (the claim against Customer) and liability arising from the contract would be recognized 'net' at contract inception and their net value would be zero under the allocated customer consideration approach.	

	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.
<u>End of Period 1</u> To recognize revenue and costs associated with Company's performance to date; production is 60% complete	Production asset $60,000 Contract revenue $60,000 ($100,000 x 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 x 60%) Consideration receivable $60,000 Production asset $60,000	Production asset $60,000 Contract revenue $60,000 ($100,000 x 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 x 60%) Claim against Customer $60,000 Contract liability $60,000 Consideration receivable $60,000 Claim against Customer $60,000[5]
	Staff note: The accounting for performance in this contract generally parallels the accounting illustrated in Agenda Paper 14B for contracts that require 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). As noted in Agenda Paper 14B, 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.	

[5] In practice, this journal entry could be combined with the preceding entry. The staff included both entries to illustrate the parallels between the accounting under this contract and the accounting in Agenda Paper 14B for a contract that requires specific performance.

	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	Balance Sheet			Balance Sheet		
	Consideration receivable	$60,000		Consideration receivable		$60,000
				Contract liability	$60,000	
				Less: Production asset	(60,000)	------
	Accounts payable	$36,000		Accounts payable		$36,000
	Retained earnings ($60,000 - 36,000)	$24,000		Retained earnings ($60,000 - 36,000)		$24,000
	Income Statement			Income Statement		
	Contract revenue	$60,000		Contract revenue		$60,000
	Contract expense	$36,000		Contract expense		$36,000
	Staff note: The account balances for the **performed** portion of the contract are almost identical to the account balances in Agenda Paper 14B. 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, in Agenda Paper 14B, the entire contract would be physically settled; therefore, Company must complete Product before it has a receivable from Customer (until then, Company has a claim against Customer). The accounting for the **unperformed** portion of this contact is different than Agenda Paper 14B. 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).[6]					

[6] Some might think that when the reporting entity begins to perform, the unit of account for both the performed **and** unperformed portions of the contract should be the separate assets and liabilities that arise from the contract (that is, the unperformed portion of the contract should no longer be recognized **net**). In that case, at the end of Period 1, the reporting entity would record an additional entry to recognize a claim against Customer and a contract liability for the unperformed portion of the contract ($40,000). Under that treatment, the accounting for the remainder of the contract would be identical to the accounting in Agenda Paper 14B for a contract that requires specific performance.

	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.
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 x 100% - 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 x 100% - 36,000) Consideration receivable $40,000 Production asset $40,000	Production asset $40,000 Contract revenue $40,000 ($100,000 x 100% - 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 x 100% - 36,000) Claim against Customer $40,000 Contract liability $40,000 Consideration receivable $40,000 Claim against Customer $40,000
Summary of Account Balances— **End of Period 2**	Balance Sheet Consideration receivable $100,000 Accounts payable $60,000 Retained earnings $40,000 ($100,000 – 60,000) 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 ($100,000 – 60,000) 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	Contract liability $100,000 Production asset $100,000 Cash $100,000 Consideration receivable $100,000

	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 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	

Agenda Paper 14D—Preliminary Exploration: Application of the Boards' Decision on Performance to Contracts That, in the Event of Customer Breach, Require a Remedy of *Net Cash Settlement*

OBJECTIVE OF THIS MEMORANDUM

1. As noted in Agenda Paper 14A, the objective of this meeting is to further discuss the Boards' decision at the joint Board meeting in April that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration for its performance to date. **Specifically, the objective of this memorandum is to begin to consider issues related to the basic operation and application of that decision to a contract that, in the event of customer breach, has the legal remedy of monetary damages that requires a net cash settlement between the parties.** That remedy represents a one-way flow (of cash) from the customer to the seller. Generally, its objective is to place the aggrieved party in as good a position as it would have been in if the contract had been performed.

2. Paragraphs 15 through 17 of Agenda Paper 14A presented different ways that a net cash settlement remedy could be computed. This memorandum focuses on a remedy that is computed as the difference between the contract price and the price at which the seller resells (or could resell) the finished good, together with any incidental damages, less costs avoided because of the buyer's breach.

3. The staff thinks it may be difficult to compute that net settlement amount **prior to** the customer's breach because the amount is based on prices that may fluctuate during the contract period (for example, the estimated resale price of the good). Furthermore, the remedy amount could be affected by other contract-specific factors such as customer acceptance provisions or the customer's reason for breaching the contract (for example, perhaps the buyer was unhappy with the seller's performance or, in contrast, perhaps the buyer found a lower cost provider). Given the number of factors that could impact a net cash settlement, the staff thinks that there may be different views on how the Boards' decision would be applied to contracts that require that remedy. Accordingly, the staff has developed two possible views and wishes to solicit Board members' thoughts on those alternatives. Based on the Boards' feedback, the staff will continue to analyze this criterion.

ACCOUNTING AT CONTRACT INCEPTION

4. As noted in Agenda Paper 14C, both Boards previously agreed that the unit of account for a wholly executory contract in which the legal remedy in the event of breach is monetary damages should be the contract as a whole (that is, the assets and liabilities should be recognized 'net'). Moreover, under the allocated customer consideration approach, at contract inception, the sum of the amounts allocated to the liabilities would equal the consideration (the asset). Therefore, 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.

ACCOUNTING FOR PERFORMANCE

5. The Boards 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 Boards 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.

6. As noted above, the staff thinks that Board members may have different views on how to apply that decision to contracts that require a legal remedy of net cash settlement. Two possible views are described below and an illustrative example follows those descriptions.

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

7. 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.

8. The reporting entity will receive the same amount of cash under a contract that requires net cash settlement as it would under a contract that requires specific performance (that is, in both cases, the reporting entity will receive the entire contract amount). Therefore, revenue recognition should be the same under both of those remedies.

9. A counter-argument is that if the customer breaches, the contract amount ultimately will be collected from **two** customers—the original counterparty and the substitute customer. Thus, the reporting entity does not necessarily have a right to consideration for its performance to date under its original contract with the original counterparty. Rather, its rights to the remainder of the consideration would arise from the second contract with a substitute customer. Therefore, it may be inappropriate to consider the consideration that will be received from a subsequent (substitute) contract for the purposes of computing revenue on the original contract; the rights and obligations under the two contracts should be accounted for separately.

10. Another argument is that the reporting entity's position **is different** than if the contract requires physical settlement. That is because in a contract that requires physical settlement, the customer might be viewed as implicitly accepting performance continuously and, as a result, is required to pay for that performance. Hence, the reporting entity is obtaining an unconditional right to consideration as it performs. In contrast, in a contract that requires net cash settlement, the customer is **not** implicitly accepting performance continuously. Hence, the entity does not obtain an unconditional right to consideration as it performs.

11. A third argument is that the court's objective in awarding net cash damages is **not** to compensate the reporting entity for its performance to date or to estimate the value to the customer (or to the reporting entity) of the work in process. Rather, the objective of that remedy is to place the reporting entity in as good a position as it would have been in had the contract been completed. Therefore, the legal remedy of net cash settlement does not meet the criterion for revenue recognition (as articulated in Memorandum 83, paragraph 2).

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

12. 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 these events occurs, the entity has not obtained any right to consideration; therefore, revenue should not be recognized until either one of those events occur.

13. A counter-argument is that the reporting entity generally does have an unconditional right to consideration during the performance period, although that unconditional right is not mature because it is not yet due from the customer. The reporting entity obtains an unconditional right to some consideration as it performs because in all cases (including customer breach), the reporting entity will be compensated for its performance.

14. Furthermore, Alternative B is not consistent with the view of the majority of Board members that production gives rise to revenue and that customer acceptance is a validation of that production.

ILLUSTRATIVE EXAMPLE

15. The following example illustrates how the Boards' decision could be applied to a contract that requires a remedy of net cash settlement.

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. The Customer picks up the Product and pays for it at the beginning of Period 3.

There are no contractual customer acceptance provisions. 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.

16. [Paragraph omitted from observer notes]

	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
	Staff note: As noted earlier in the memorandum, the Boards 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. Therefore, the asset (the claim against the customer) and liability arising from the contract would be recognized 'net' at contract inception and their net value would be zero under the allocated customer consideration approach.	
<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 x 60%) Contract expense $36,000 Accounts payable $36,000 ($60,000 x 60%)	Production asset $36,000 Accounts payable $36,000 ($60,000 x 60%)
	Staff note: Under this alternative, production gives rise to revenue because in all cases (including breach) Company will ultimately receive the contract amount. The staff is still analyzing the nature of the asset in this example. The staff's preliminary thinking is that it is a combination of the Product and Company's right to collect damages from Customer if Customer breaches. In total, the staff thinks that the combined asset has a value of $60,000. The staff will continue to explore this issue.	*Staff note:* Under this alternative, production does not give rise to revenue because Company does not obtain an unconditional right to consideration until it delivers Product.

	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 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 x 100% - 60,000) Contract expense $24,000 Accounts payable $24,000 ($60,000 x 100% - 36,000)	Production asset $24,000 Accounts payable $24,000 ($60,000 x 100% - 36,000)
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

<table>
<tr><th></th><th>Alternative A: The Reporting Entity Should Recognize Revenue Over the Contract Period Based on Its Performance to Date</th><th>Alternative B: Company Should Recognize Revenue When Its Performance Is Complete or When the Customer Breaches the Contract</th></tr>
<tr><td><u>Beginning of Period 3</u>
Customer picks up the completed Product and pays for it.</td><td>Cash $100,000
Production asset/Claim against Customer $100,000</td><td>Cash $100,000
Contract revenue $100,000

Contract expense $60,000
Production asset $60,000</td></tr>
<tr><td>Summary of Account Balances—
End of Period 3</td><td><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</td><td><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</td></tr>
</table>

Agenda Paper 14E— Preliminary Exploration: Application of the Boards' Decision on Performance to Contracts that have *Contractually Stated Customer Acceptance Provisions*

OBJECTIVE OF THIS MEMORANDUM

1. As noted in Agenda Paper 14A, the objective of this meeting is to further discuss the Boards' decision at the joint Board meeting in April that revenue should be recognized when the reporting entity obtains an unconditional right to at least some consideration. **Specifically, the objective of this memorandum is to begin to consider issues related to the basic operation and application of that decision to a contract that contains explicit customer acceptance provisions.** That is, under the staff's interpretation of the meaning of customer acceptance, the customer would only be unconditionally obligated to pay the reporting entity at a contractually agreed point at which the customer accepts performance to date.

2. To simplify the analysis in this memorandum, the staff assumed that there are no other legal remedies for customer breach (other than what is included in the customer acceptance provision). That is, if the customer were to breach the contract before the contractually stated acceptance point, the reporting entity will receive no consideration for its performance (that is, the customer is not obligated to pay anything). The staff acknowledges that this may be an unrealistic assumption. As noted in Agenda Paper 14A, the staff's analysis in this memorandum reflects our preliminary thinking; the staff is continuing to analyze customer acceptance provisions and how they would be applied to more complex contracts.

ACCOUNTING AT CONTRACT INCEPTION

3. Both Boards previously agreed that the unit of account for a wholly executory contract should be the contract as a whole unless the legal remedy in the event of breach is specific performance. Moreover, under the allocated customer consideration approach, at contract inception, the sum of the amounts allocated to the liabilities would equal the consideration (the asset). Therefore, 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.

ACCOUNTING FOR PERFORMANCE

4. As previously noted, both Boards 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.

5. 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. Hence, revenue will be recognized only at those points. In other words, the entity's production will result in revenue recognition **only** when the entity obtains an unconditional right to consideration for that productive effort. Some might view this accounting as inconsistent with the view of the majority of Board members that revenue arises from the reporting entity's production process. This is discussed further below.

ILLUSTRATIVE EXAMPLE

6. The following example illustrates how the Boards' decision should be applied to a contract that has contractually stated customer acceptance provisions.

Example Facts

In Period 1, Company and Customer enter into a contract for a 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.

Product is fungible. Production is 60 percent complete at end of Period 1 and 100 percent complete at the end of Period 2. The Customer picks up the Product and pays for it at the beginning of Period 3.

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.[7] 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 in the case of customer breach, no additional legal remedies are available to Company.

7. [Paragraph omitted from observer notes]

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[7] Under some contracts, the customer may be unconditionally obligated to compensate the reporting entity for an amount <u>less than</u> its performance to date. For example, at the first acceptance point (production is 75 percent complete), Customer might only be unconditionally obligated to pay 65 percent of the contract amount. The remainder of the contract amount would be conditional upon the successful completion of Product.

	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
	Staff note: As noted earlier in the memorandum, the Boards previously decided that the unit of account for a wholly executory contract should be the contract as a whole, unless the legal remedy in the event of breach was specific performance. Therefore, the asset (the claim against Customer) and liability arising from the contract would be recognized 'net' at contract inception and their net value would be zero under the allocated customer consideration approach.
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 x 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 x 75% - 36,000) Consideration receivable $75,000 Contract revenue $75,000 ($100,000 x 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 x 100% - 45,000)

<table>
<tr><td></td><td>Title of Product transfers to Customer on acceptance of each phase. That is, Customer has legal ownership of the work in process.</td></tr>
<tr><td>Summary of Account Balances—
End of Period 2</td><td><u>Balance Sheet</u>
Production asset $15,000
Consideration receivable $75,000

Accounts payable $60,000

Retained earnings $30,000

<u>Income Statement</u>
Contract revenue $75,000
Contract expense $45,000</td></tr>
<tr><td><u>Beginning of Period 3</u>
Customer accepts and picks up Product and pays for it.</td><td>Consideration receivable $25,000
Contract revenue $25,000
($100,000 x 100% - 75,000)

Contract expense $15,000
Production asset $15,000

Cash $100,000
Consideration receivable $100,000</td></tr>
<tr><td>Summary of Account Balances—
End of Period 3</td><td><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 $25,000
Contract expense $15,000</td></tr>
</table>

SOME OBSERVATIONS ON THE ACCOUNTING IN THE ABOVE EXAMPLE

8. The staff notes that at the joint meeting, supporters of the PBM and supporters of the EBM coalesced around a single revenue recognition criterion (reproduced at the end of paragraph 2 in Agenda Paper 14A). However, the rationale for revenue recognition under those two methods was different. Under the PBM, revenue arises as the entity's production process creates or enhances assets for customers. Under the EBM, revenue arises when the entity extinguishes its performance obligation. As noted in Memorandum 83, the majority of both Boards tentatively agreed that the revenue recognition criterion should be viewed as modification of the PBM because customer acceptance would be an external validation of the entity's performance to date.

9. The example in this memorandum highlights that a consequence of the Boards' revenue recognition criterion developed at the joint meeting is that, in some cases, it is not the entity's production process that results in revenue recognition. For example, in Period 1, the entity is producing an asset for its customer under a contract; however, no revenue is recognized because the entity has not established an unconditional right to consideration from its customer until the first acceptance point. Instead, revenue is recognized when the customer accepts production to date and the entity has obtained an unconditional right to consideration as a result of its performance. This means that the reporting entity's production process will give rise to revenue recognition only if the entity's production process is simultaneously establishing an unconditional right to consideration (as illustrated in Agenda Papers 14B and 14C).

10. The staff therefore thinks that when revenue recognition is precluded, but the entity is creating an asset for a customer under a contract, that asset will be accounted for as inventory (as in Period 1 in the example) and generally would be measured at cost.

11. Accordingly, the staff thinks that the Boards' revenue recognition criterion developed at the joint meeting is a perhaps a more significant change to the PBM in some cases than might have been apparent from the papers for that meeting. This is because it is difficult to reconcile a revenue recognition criterion that might result in revenue being recognized only at discrete points (when an unconditional right to consideration arises) with a recognition model (PBM) that envisaged revenue arising continuously as the entity performs. The staff acknowledges that the majority of both Boards supported, in principle, a PBM model. But the revenue recognition criterion may point to a model that is closer to EBM in some cases.

12. For instance, in the above example assume that the entity prepaid $100,000 under the contract. In this case, the reporting entity would recognize its performance obligation at contract inception. At the first acceptance point (when production is 75 percent complete) the entity would remeasure that performance obligation from $100,000 to $25,000 with the corresponding credit of $75,000 recognized as revenue. Although the entity has not fully extinguished its performance obligation at the first acceptance point, it might be regarded as having *partly* extinguished that performance obligation. This is because the customer has accepted the entity's performance and is obligated to pay for that performance, and has therefore released the entity from part of the performance obligation. Some staff think that this rationale would be consistent with the underlying premise of the allocated customer consideration approach of looking at the transaction from the perspective of the customer. In other words, the liability is partly extinguished because the customer has accepted that portion.