30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org   Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Revenue Recognition (Agenda Paper 12)**

Extinguishment-Based Method versus Performance-Based Method: Additional Examples and Other Issues

OBJECTIVE OF THE MEMO

1 During the IASB's February 2006 Board meeting and the FASB's March 1, 2006 Board meeting, the Boards discussed two methods for recognizing revenue: the extinguishment-based method (EBM) and the performance-based method (PBM). Those discussions gave rise to certain requests:

> **Request No. 1:** Board members requested additional examples illustrating circumstances under which the EBM and PBM would result in different revenue recognition.
>
> **Request No. 2:** Board members requested examples of multiple-element contracts illustrating how the EBM and PBM would interact with the Boards' prior decisions on separate units of account.

2 Those discussions also highlighted various concerns:

> **Concern No. 1:** Some Board members do not agree with the staff's proxy for extinguishment under the EBM. Those Board members argue that another proxy for extinguishment would permit an entity to recognize revenue before delivery of a good constructed under a long-term contract.
>
> **Concern No. 2:** One Board member (and there may be others) does not think that one has to choose between the EBM and the PBM, rather that Board member thinks one must establish scope criteria for when to use one or the other method.

> **Concern No. 3:** Some Board members argue that the PBM is inconsistent with the customer perspective. Those Board members assert that the allocated customer consideration approach must be consistent with the customer perspective.

3 Section I of this memo deals with both requests identified above. Section II of this memo covers Concern No. 1. Concern No. 2 assumes that it is not necessary to identify one method as a conceptual basis for all revenue recognition. Concern No. 3 assumes that a revenue recognition approach must be internally consistent with whatever the underlying perspective is (that is, customer versus reporting entity). The staff expects that additional Board discussions on the EBM and PBM will provide clarification on whether Concern Nos. 2 and 3 must be addressed in future memos.

SUMMARY OF EBM AND PBM

5 Before presenting the additional examples, the staff thinks it would be helpful to review the two methods of revenue recognition proposed by the staff in [February 2006].

EBM

6 The EBM is based on the following proposition:

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

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 because the staff does not think that a literal interpretation of that proposition is a viable alternative for a revenue recognition method. That is because the complexity associated with multiple legal jurisdictions and multiple laws (common law versus statutory law) results in inconsistent legal outcomes for similar economic transactions. Furthermore, that complexity creates uncertainty about when particular performance obligations would be regarded as *legally* extinguished. 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. Thus, revenue recognition is based on an accounting proxy for legal extinguishment.

7 The staff thinks that the best accounting 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.** The customer generally obtains goods when they are physically transferred to it because that is when the customer obtains the right to use or benefit from the goods. The customer generally obtains services when they are rendered because that is when the customer obtains the right to use or benefit from them. Section II of this memo will discuss other potential accounting proxies.

PBM

8 The PBM is a proportionate-performance method. 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. (The term *production process* is used with the same meaning described in Concepts Statement No. 6, *Elements of*

Financial Statements; that is, it includes "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.*") 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. Hence, the PBM is based on the following proposition:

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

9 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 contractual obligation to provide goods, services, or other rights to the customer.** A reporting entity using the PBM would determine when acts have occurred that faithfully reflect performance in the production process. Those acts of performance may be reflected by outputs from the production process, inputs to the production process, the passage of time, or the reduction of risk.

SECTION I—ADDITIONAL EXAMPLES

10 This memo presents four examples that illustrate the circumstances under which the EBM and PBM give rise to different revenue recognition. Two of those examples also illustrate how the EBM and PBM interact with prior Board decisions on separating units of account using the notion of customer utility.

Example A—Tangible Asset

11 Example A is based on the following facts:

> Seller contracts with the customer to construct a tangible asset for €5,000,000. Construction takes place in two annual periods. At completion, the customer will pick up the completed asset. This is not a multiple-element contract.
>
> There are two progress payments of 30 percent of the contract price that are each due at stage completion points (conditional upon customer acceptance of progress to date). One final payment of 40 percent of the contract price is due when construction is complete (also conditional upon customer acceptance of the final product).

Revenue Recognition for Example A

13 Under the EBM proposed above, … revenue is recognized only upon customer acceptance of the completed asset.

14 Under the PBM, the seller must choose a performance measure that faithfully represents its production process and use it consistently. It may decide to use an output- or input-based method. For this example, the staff assumes that the seller uses an input method based on costs incurred. Thus, the production process creates or enhances assets for customers, and thus revenue is recognized, based on the input method.

Example B—Audit Service

16 Example B is based on the following facts:

Seller contracts with the customer to provide an annual financial statement audit for $40,000. Audit procedures will occur throughout the year subject to audit and the audit opinion must be available by the end of February of the subsequent year.

In the event of customer cancellation, the customer will pay all out-of-pocket costs incurred by the seller plus a normal profit margin thereon. This is not a multiple-element contract.

17 There are two major types of services: continuous and discrete. Continuous services provide utility to the customer over time as they are performed (e.g., a loan, lease, insurance policy), and discrete services provide utility to the customer only when they are completed. An audit service is a discrete service. The customer only has utility for the output of the audit service; that is, the audit opinion.

Revenue Recognition for Example B

18 Under the EBM, the customer does not obtain benefit from the audit until the audit opinion is submitted to the customer. Therefore, the performance obligation is extinguished and, thus, revenue is recognized, only when the audit opinion is submitted to the customer.

19 Under the PBM, the seller's production process may be measured using an input method based on costs incurred or labor hours expended. Thus, the production process creates or enhances assets for customers and, thus, revenue is recognized based on the input method.

ADDITIONAL EXAMPLES—MULTIPLE ELEMENTS

20 Before presenting multiple-element examples, the staff will summarize the Boards' decisions on disaggregating revenue contracts into separate units of account. The Boards decided that revenue contracts should be disaggregated (that is, performance obligations should be identified as separate units of account) from the customer's perspective, based on whether the good, service, or other right has *utility to the customer*. Utility to a customer means that the product underlying the performance obligation is, in and of itself, fit for some purpose or serviceable for some end as determined by the customer. A good, service, or other right has utility to a customer if either:

a. It is sold separately or as an optional extra by any vendor in the customer's reference market or it could be resold separately by the customer. (This criterion assumes that the customer would be able to resell the item at an amount that would substantially recover the original selling price.)

b. It gives the customer an unconditional right that obligates the reporting entity to stand ready to provide goods, services, rights, or other consideration if specified events occur. (The phrase *if specified events occur* also applies to situations in which the specified event is the nonoccurrence of an event (for example, the specified event in a loan guarantee arrangement is the debtor's nonpayment of a scheduled loan payment)).

Those disaggregation criteria would be applicable to all revenue contracts, both short-term and long-term.

Example C—Tangible Asset

21 Example C is based on the following facts:
Seller contracts with the customer to construct a tangible asset for €5,000,000. Construction takes place over two annual periods. At completion, the customer will pick up the completed asset. This asset also is sold without the added items below.

The seller agrees to provide a three-year warranty contract for an additional €500,000. Such contracts are sold as optional extras.

Two progress payments for 30 percent of the contract price are due at certain stages of completion. The final payment will cover the remaining 40 percent of the contract price and the price of the warranty contract. Progress and final payments are due only after the customer inspects and accepts construction to date.

The customer borrows 40 percent of the contract price (the amount of the final payment) from a third-party bank to finance the purchase. The bank loan is payable in monthly installments over five years from the date of construction completion. Seller agreed at no additional charge to provide the third-party bank with a loan guarantee.

In the event of customer cancellation, the customer will pay all the seller's out-of-pocket costs incurred to date plus a normal profit margin thereon. Under this clause, the customer also obtains all legal rights to the partially completed asset.

Application of Disaggregation Criteria to Example C

22 The disaggregation criteria are designed to work independently of the method used for revenue recognition. Therefore, whether the EBM or PBM is used, the same units of account should be identified. In this example, the following units of account are identified:

Tangible Asset: The tangible asset is sold separately.

Warranty Service: The warranty service is sold as an optional extra. (The warranty also requires the seller to transfer goods and services in the event of product failure or malfunction.)

Loan Guarantee: The Bank can require the seller to transfer cash (or other assets) on behalf of the customer to the Bank if the customer defaults on its loan.[1]

Revenue Recognition for Example C

23 Under the EBM (and identical to Example A), no revenue is recognized for the completed tangible asset until the customer's acceptance. The warranty service is a continuous service and revenue is recognized when a customer receives benefits in the form of risk protection as that service is provided (after completion of the asset). That benefit may be provided on a straight-line basis. Similar to the warranty, the loan guarantee service also is a continuous service and revenue is recognized when the bank (and customer) receives benefits in the form of risk protection as that service is provided.

[1] Because the Bank is not technically a customer, the staff thinks that disaggregation criteria (b) (paragraph 20) might need to be modified to include any entity, not just the customer. …

24 Under the PBM (and identical to Example A), revenue is recognized over the construction period for the tangible asset. Revenue recognition under the PBM for the warranty and loan guarantee services is identical to the EBM.

Example D—Retail Transaction

25 Example D is based on the following facts:

> Retailer sells high-quality power tools and offers a lifetime warranty and 60-day return right. Historically, returns have been less than three percent of sales. Retailer has its own delivery truck and makes its own deliveries.
>
> On the same day, three customers each purchase a large drill press out of inventory. Each drill press sells for ₤1,000.
>
> The first customer pays for the drill press and takes it home.
>
> The second customer pays for the drill press and asks the retailer to hold it in storage until Saturday (when she will pick it up). Retailer's insurance covers any property loss that might occur to the drill press prior to customer pick-up.
>
> The third customer pays for the drill press and pays ₤50 extra for delivery. Delivery of the drill press is scheduled for the same Saturday on which the second customer will pick up her drill press. Retailer's insurance covers any property losses that might occur to the drill press prior to delivery to the customer's location.

Application of Disaggregation Criteria to Example D

26 As noted earlier, the same units of account should be identified regardless of whether the EBM or PBM is used. In this example, the following units of account are identified:

> **Drill Press:** No retailers sell drill presses without return rights. However, drill presses could be resold without return rights by the customers.
>
> **Warranty:** The customers have the right to require the retailer to repair or replace the drill presses at any time.
>
> **Return Right:** The customers have the right to require the retailer to refund the original purchase price back to them at any time during the 60-day return period.
>
> **Delivery:** Delivery services are sold as an optional extra.

Revenue Recognition for Example D

27 Under the EBM, the key issue is when the customer obtains the right to use or benefit from the drill press because that is the point at which the performance obligation is deemed to be extinguished. Thus, extinguishment occurs when the asset, which is the thing being sold, is transferred from the reporting entity to the customer. That is, the asset is derecognized by the reporting entity and simultaneously recognized by the customer. Determining the point at which derecognition/recognition occurs, which is often referred to as determining when delivery has occurred, has been a significant source of practice problems for accountants.

32 The preceding analysis … seems to indicate that the customers obtain assets at the point of sale. Therefore, under the EBM, revenue would be recognized for the drill presses at the time of sale. However, that is a point of debate among staff members and is related to the weight that staff members place on particular indicators. For example, some staff members place greater weight on the right to use the asset to generate economic benefits and, therefore, conclude that Customers 2 and 3 do not have assets until the drill presses have been picked-up/delivered. As noted above, this is an issue that will be addressed in greater detail in the future.

33 Under the PBM, the retailer would measure performance based on units sold to customers. … [Thus], revenue for the drill presses would be recognized at the point of sale.

34 The warranty and return right are both continuous services that provide the customer with benefits over time. Under the EBM and PBM, revenue recognition would be the same.

35 The delivery is a discrete service. Under the EBM, revenue for the delivery would be recognized when the drill press is delivered to the third customer's location. Under the PBM, given that deliveries in this example would be local and completed on the same day, revenue for the delivery would be recognized in practice when the drill press is delivered to the third customer's location.

Variant of Example D

36 One IASB Board member at the February 2006 Board meeting asked what would happen if an item sold was not in inventory. Assume that the retailer in Example D only had two drill presses in inventory. Thus, Customers 1 and 2 are allocated a drill press; however, Customer 3 must wait for another drill press to arrive at the retailer's location. It will take the retailer four weeks to receive another drill press from the manufacturer. As in Example D, the third customer pays for the drill press and delivery on the same day that Customers 1 and 2 make their purchases.

Discussion Question No. 1: What concerns do Board members have with the examples presented?

Discussion Question No. 2: What additional examples, if any, would Board members like the staff to analyze?

SECTION II—BRIDGING THE GAP BETWEEN EBM AND PBM

38 … [T]he staff understands that some Board members do not agree with the staff's proxy for extinguishment under the EBM. Those Board members argue that another proxy for extinguishment would permit an entity to recognize revenue before delivery of a good constructed under a long-term contract. That proxy might effectively bridge the gap between the EBM and PBM. This section addresses that argument by using a modified version of Example A in Section I of this memo (paragraphs 11–15) to explore other possible proxies.

Modified Example A

39 The modified version of Example A is based on the following fact:

> Seller contracts with the customer to construct a tangible asset for €5,000,000. Construction takes place in two annual periods. At completion, the customer will pick up the completed asset. This is not a multiple-element contract.

40 Modified Example A uses three sets of variables to alter the contract and create eight separate scenarios for the Boards' consideration. Under the EBM and PBM, the three sets of variables do not change the revenue recognition outcome described in paragraphs 13–15.

41 The first set of variables involves the timing of customer payments under the contract: the scenarios consider when there are progress payments and when there are none. Specifically, the scenarios consider the following types of payment arrangements.

> **Progress Payments:** There are two progress payments of 30 percent of the contract price that are each due at stage completion points. One final payment of 40 percent of the contract price due when construction is complete.

> **Final Payment Only:** One payment for 100 percent of the contract price is due when construction is complete.

42 The second set of variables involves the timing of customer acceptance: the scenarios consider when customer acceptance occurs at stage completion points and when it occurs only at delivery.

> **Final Customer Acceptance Only:** The customer is required to inspect and accept construction only when it is complete.

> **Customer Acceptance in Stages:** The customer is required to inspect and accept construction to date at two stage completion points as well as when construction is complete.

43 The third set of variables is the nature of an explicit customer cancellation provision that is enforceable by the jurisdiction's legal authority. The scenarios consider two types of customer cancellation provisions:

> **Variable Cancellation Amount:** In the event of customer cancellation, the customer will pay all out-of-pocket costs incurred to date plus a normal profit margin thereon. Under this clause, the customer also obtains all legal rights to the partially completed asset.

> **Predetermined Cancellation Amount:** In the event of customer cancellation during the first or second year of construction, the customer will pay 40 percent or 80 percent, respectively, of the contract price. Under this clause, the customer obtains <u>no</u> legal rights to the partially completed asset.

44 The following table summarizes the eight scenarios considered. The staff has considered all possible variable combinations for the sake of completeness.

Scenario No.	Cust. Pymt (Var. 1)	Cust. Acceptance (Var. 2)	Cust. Cancellation Amt (Var. 3)
1	Progress	Final	Variable
2	Progress	Stages	Variable
3	Progress	Final	Predetermined
4	Progress	Stages	Predetermined
5	Final	Final	Variable
6	Final	Stages	Variable
7	Final	Final	Predetermined
8	Final	Stages	Predetermined

Analyzing the Three Variables

49 The notion of utility to a customer and its underlying justification (the customer perspective) precludes the idea of partial utility—either the customer has rights to the good and can use the good for its benefit or the customer does/can not. Said differently, customer utility is like an on-off switch, with no in-between state. Therefore, partial customer acceptance is inconsistent with the notion of utility and the customer perspective.

57 [T]he staff does not think that the use of any of the three variables for revenue recognition is consistent with the notion of customer utility, which is based on the customer perspective.

Discussion Question No. 3: Do Board members agree with the staff's interpretation of the notion of customer utility and the customer perspective? If not, why not?

Discussion Question No. 4: Are there other variables or sets of variables that seem to comport with the notion of customer utility?