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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting:	**12 December 2007, London**
Project:	**Revenue Recognition**
Subject:	**Measurement model - Part 4: accounting for a broader set of assets and liabilities (Agenda paper 7C)**

PLEASE NOTE THAT THIS PAPER WAS ORIGINALLY POSTED AS AGENDA PAPER 4F FOR NOVEMBER'S IASB MEETING, BUT WAS NOT DISCUSSED AT THAT MEETING.

PURPOSE OF THIS MEMO

1. This memo considers whether a revenue model focused solely on the contract asset or liability would be too narrow.

INTRODUCTION

2. The revenue recognition model discussed in November (ie Appendix B) and Agenda Paper 7B accounts for a narrow and precisely defined set of assets and liabilities—those arising from the remaining unperformed rights and obligations in the contract. Revenue (and profit or loss) would arise when an entity obtains a contract (except in the unusual circumstances in which the underlying obligations exceeded the underlying rights) and as the entity satisfies its obligations in the contract by providing goods and services to the customer. The source of an entity's revenues would be its contracts with

customers, and profit or loss would depict changes in the entity's net position in the contract.

3. Given that revenue has been defined thus far only in relation to an entity's net position in a contract with a customer, this memo considers how appropriate such a narrow focus would be, particularly if the contract is measured at current exit price. It asks the question 'would a focus on the contract asset or liability be too narrow to represent faithfully an entity's economic circumstances'?

CONSEQUENCES OF FOCUSSING ON THE CONTRACT WITH CUSTOMER

4. In considering this question, there are two important consequences to highlight about the measurement model discussed in the previous sections:

   1 Measuring only the contract asset and liability at current exit price could result in accounting mismatches arising in profit or loss that may not faithfully depict economic mismatches (paragraphs 5 and 6).

   2 Profit or loss would depict changes in a narrow set of assets and liabilities that may give an incomplete depiction of the changes in the entity's assets and liabilities throughout the contract (paragraphs 7–9).

Accounting mismatches arising in profit or loss that may not faithfully depict economic mismatches

5. After contract inception, but before fulfilment of the contract, the exit price of a contractual obligation to provide a good to a customer may increase. This will decrease (increase) the measurement of the contract asset (liability) and result in the recognition of a contract loss. However, suppose that the entity has already acquired or manufactured the good that is to be transferred to the customer to satisfy the obligation. If the entity does not remeasure this good to reflect its current value, then it recognises only the decrease (increase) in the contract asset (liability). This would result in an incomplete and potentially misleading depiction of how the price change has affected all the entity's assets and liabilities.

Suppose Oil Co enters a fixed-price contract on 1 January with a customer to deliver 1000 gallons of oil in four equal quarterly instalments starting on 31 March. Suppose also that the customer pays in full in advance and, therefore, Oil Co recognises a contract liability of CU3,000. Oil Co purchased all of the oil required to fulfil this contract on 1 January and measures its oil inventory at cost.

On 1 March 2007, the price of oil increases by 10 per cent. Suppose that this increase in the price of oil results in the exit price of the contract liability increasing to CU3,300 and, therefore, that Oil Co recognises a contract loss of CU300.

6. The point to note in this example is that if Oil Co does not reflect any increase in the carrying amount of its oil inventory in March when it remeasures its contract liability, profit or loss depicts Oil Co as if it was economically identical to an entity that had not obtained any oil to fulfil the contract. In other words, it depicts Oil Co as if it was fully exposed in its contract to changes in market prices of oil, whereas it has effectively hedged its position in the contract.

Incomplete depiction of the changes in the entity's assets and liabilities throughout the contract

7. An entity may create an asset (eg an item of inventory) under an enforceable contract for eventual transfer to the customer. However, until the asset is transferred, the entity's contractual obligation to the customer will not change and no revenue will arise. Furthermore, if the asset is measured at accumulated cost, any value added from creating the asset will not be reflected in profit or loss until the asset is transferred to the customer. Hence, the income statement may give an incomplete depiction of the changes in the entity's assets and liabilities *throughout* the contract.

Homebuilder is developing an estate of 10 houses. Suppose on 31 March 2007, it enters into a contract with a customer for the sale of House 2 of the development for the fixed price of CU250,000. Assume that it incurs expenses of CU8,000 in obtaining the contract. At the time the contract is entered into, Homebuilder has not commenced work on House 2 (ie the house is sold to the customer 'off plan').

On entering into the contract the customer pays Homebuilder a non-refundable deposit of CU25,000. The remaining amount of the consideration (CU225,000) is due when the Homebuilder transfers the completed house to the customer. Assume that this occurs on 31 January 2008. Assume that the exit price of the obligations on 31 March is CU240,000 and, therefore, that the initial measurement of the contract liability is CU15,000 (ie remaining rights of CU225,000 less remaining obligation of CU240,000).

Following the principles in Appendix B, revenue of CU10,000 is recognised on 31 March (ie cash obtained of CU25,000 less contract liability incurred of CU15,000) and revenue of CU240,000 recognised on 31 January 2008 when the contract liability becomes a contract asset of CU225,000.

Between 31 March 2007 and 31 January 2008, Homebuilder builds the house. Suppose that this house is treated as an item of inventory and is measured at the lower of cost and net realisable value. Suppose that the cost of the partly completed house together with its land is CU105,000 and CU165,000 at 30 June and 31 December 2007, respectively, and that the cost of the completed house and land is CU175,000. Accordingly, on 31 January 2008, Seller would derecognise House 2 from inventory and recognise an expense.

8. Assuming that Homebuilder reports half-yearly, the income statements and statement of financial position for 2007 and 2008 with respect to the contract for the sale of House 2 would be as follows:

	June 2007	Dec 2007	June 2008	Total
Income Statement extracts				
Revenue	10,000	-	240,000	250,000
Expenses	(8,000)	-	(175,000)	(183,000)
Margin	2,000		65,000	67,000
Statement of Financial Position extracts				
Cash	(88,000)	(148,000)	67,000	
Inventory asset	105,000	165,000	-	
Contract liability	(15,000)	(15,000)	-	
Retained earnings	2,000	2,000	67,000	

9. The point to note in this example is that CU65,000 of the margin in the contract is not recognised until Homebuilder transfers the house to the customer on 31 January. However, that margin can be viewed as being attributable to the activity of building the house rather than transferring it to the customer.

10. In that regard, note that Homebuilder's margin would have been the same in 2007 if it had entered into that contract on 31 December rather than 31 March (all other things being the same). In other words, profit or loss does not distinguish between a homebuilder that has nearly completed the construction of a house and one that has only just started, even though the economic circumstances of the two entities would clearly be different.

BROADENING THE SET OF ASSETS AND LIABILITIES

11. Suppose that the set of assets and liabilities in the model was broadened beyond those that arise directly from the rights and obligations in the contract. For instance suppose that they also included inventory assets (when they are the subject of a contract).

12. In the case of Oil Co, profit or loss would provide a more faithful depiction of the effect of the prices changes on Oil Co's assets and liabilities at 31 March if Oil Co also measured its oil at current exit price. This is because it would reflect the effect of the price change on both its contract liability and its inventory asset, thereby giving a more complete and faithful depiction of the effects of the price changes on Oil Co.

13. In the case of Homebuilder, if House 2 was also measured at current exit price, profit or loss would provide a more faithful depiction of the changes in the entity's assets and liabilities that occur *throughout* the contract. This is because the effects of the entity's production activities (in this case, building a house) on its assets and liabilities would be reported as they occur, rather than being delayed until the output from those activities is transferred to the customer.

14. To illustrate this, suppose that the exit prices of House 2—the price that Homebuilder could sell it to another homebuilder—are CU120,000 and CU220,000 at 30 June and 31 December, respectively. Homebuilder's assets and liabilities at each reporting date would therefore be as follows:

	June 2007	Dec 2007	June 2008
Cash	(88,000)	(148,000)	67,000
Inventory asset	120,000	220,000	-
Contract liability	(15,000)	(15,000)	-
Retained earnings	17,000	57,000	67,000

15. The margin resulting from the changes in these assets and liabilities could be analysed as follows:

	June 2007	Dec 2007	June 2008	Total
Sources of *margin*				
Obtaining contract	2,000	-	-	2,000
Building House 2	15,000	40,000	10,000	65,000
Margin	17,000	40,000	10,000	67,000

16. The margin reported for 2007 in this table may be more relevant to users than that in the table in paragraph 8. This is because it provides a more complete and timely depiction of the entity's activities in the period and therefore provides greater feedback information. In the table in paragraph 8, only the contract was measured at current exit price. Therefore, after contract inception margin is reported only when obligations are satisfied (which in this example is judged to be when Homebuilder cedes control of House 2 by transferring it to the customer). Hence, margin from production is not reported until the output from that production is actually transferred to the customer, ie on 31 January 2008. In contrast, in the table in paragraph 15, margin is reported over the period 31 March 2007 to 31 January 2008 as the production results in an increase in net assets, regardless of whether the output from that production transfers to the customer.

17. There are two main ways in which the set of assets and liabilities could be broadened:

- the definition of revenue could be broadened (paragraphs 18–24)
- another component of income could be introduced (paragraphs 25–32).

Broaden the definition of revenue

18. One way to focus the model onto a broader set of assets and liabilities would be to broaden the definition of revenue. That is to say, to link the definition to the changes in a broader set of assets and liabilities rather than just those arising from the rights and obligations in the contract.

19. For instance, revenue could be defined in terms of the changes in assets and liabilities that arise from the activities that are integral to the provision of the entity's goods and services. The assets from which revenue could arise would then also include the assets that the entity buys or creates for the purpose of eventually transferring to the customer.

20. A possible definition of revenue to capture this view could be as follows:

> Revenues are increase in the entity's assets (including inflows of assets or enhancements of assets) or decreases in its liabilities resulting from activities that are integral to the provision of goods and services that are ultimately destined for customers.

21. This broader definition of revenue would depict different economic phenomena than the customer contract definition of revenue discussed in Appendix B.[1] This is because the customer contract definition of revenue depicts only the changes in the entity's net position in its contract with the customer, specifically the increase in the contract asset or decrease in the contract liability. The economic phenomena being accounted for are the underlying rights and obligations in the contract with the customer. In contrast, the definition of revenue in paragraph 20 depicts the changes in the assets (including inflows of assets and enhancements of assets) and liabilities from the entire process of producing goods and services, selling them and delivering them to customers. This is because, in addition to the contract, the economic phenomena being accounted for are the goods and services that will *ultimately* be transferred to customers. Hence, rather than only the contract with the customer, the source of the entity's revenues is its productive activities in its broadest sense—the whole process of buying and converting

[1] The customer contract definition of revenue in Appendix B (paragraph 5) is: Revenue is an increase in a contract asset or a decrease in a contract liability (or a combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to a customer.

assets to add utility and value to them, the process of obtaining customers and selling the goods and services, and collecting the sales price.

22. The definition of revenue in paragraph 20 might appear to be a new concept, because it predominantly views revenues in terms of asset creation or enhancement of assets. It is, however, similar to the definition of revenue in FASB Concepts Statement No. 6 *Elements of Financial Statements*. Therefore, to distinguish it from the customer contract definition of revenue discussed in Appendix B, it will be described as the ‘refined Con 6 definition of revenue’. (Attached to this paper is an appendix that explains in more detail the definition of revenue in Concepts Statement 6.)

23. For instance, if Homebuilder’s contract liability and inventory asset were measured at current exit price as in the table in paragraph 14, and the refined Con 6 definition of revenue was adopted rather than the customer contract view, one way of presenting Homebuilder’s income statement and the statement of financial position would be as follows:

	June 2007	Dec 2007	June 2008	Total
Income Statement extracts				
Revenue				
contracting	10,000	-	-	10,000
production	120,000	100,000	20,000	240,000
	130,000	100,000	20,000	250,000
Expenses				
contracting	(8,000)			(8,000)
production	(105,000)	(60,000)	(10,000)	(175,000)
	(113,000)	(60,000)	(10,000)	(183,000)
Margin	17,000	40,000	10,000	67,000
Statement of financial position extracts				
Cash	(88,000)	(148,000)	67,000	
Inventory asset	120,000	220,000	-	
Contract liability	(15,000)	(15,000)	-	
Retained earnings	17,000	57,000	67,000	

24. The point to note in this table is that the gross increase in the value of House 2 is recognised as revenue from production as it arises.

Introduce another component of income

25. Another significant difference between the customer contract and refined Con 6 definitions of revenue is that the customer contract definition of revenue limits revenues to situations in which the entity has a contract with a customer. The refined Con 6 definition would not. This is because productive activities can be undertaken in the absence of a contract or knowledge of who the customer might be. For instance, an entity that is growing crops or producing other readily marketable commodities could have revenue under the refined Con 6 definition, even though it has no contracts in place for those products. Conceptually, therefore, that notion could also extend to an entity producing, say, houses, boats or furniture for inventory, because the production process similarly enhances assets (although that concept might not be able to be implemented in those cases due to measurement uncertainty or similar concerns).

26. However, although revenue is *arising* from the creation or enhancement of assets, it does not necessarily follow that it has to be *recognised* at that time. The focus of this project has always been revenues arising under contract. Hence, in developing a revenue recognition model the Boards are not considering whether production outside a contract should result in the *recognition* of revenue. For instance, in the case of the Homebuilder in paragraph 7, the Boards are not considering whether revenue or some other component of comprehensive income should be recognised if the Homebuilder starts to build, say, House 3, with no customer contract yet in place.

27. Nonetheless, the notion that revenue can *arise* outside a contract (even if it is not recognised) is troubling for some. For them, revenue is inextricably linked with contracts with customers and they cannot contemplate revenue arising in the absence of a contract.

28. One of the main reasons for considering broadening the set of assets and liabilities is to report the *margin* in the contract in a more representationally faithful way than if the margin is reported only when obligations are satisfied. In essence, this is an asset and liability recognition and measurement issue. Whether that margin should be described as revenue or as some other component of comprehensive income can be viewed as a display issue and is, therefore, a secondary issue. This is because the purpose of giving labels such as revenue or gains to the components of comprehensive income is essentially to assist users in understanding how the entity obtains its comprehensive income. Said another way, definitions of revenue and other forms of comprehensive income are not required to determine whether, and how much, comprehensive income has arisen. Such determinations are made by considering the recognition and measurement of assets and liabilities. So in that regard, revenue, gains or other forms of comprehensive income can be viewed as display elements.

29. Therefore, instead of broadening the definition of revenue, the model could be extended by describing the increase in inventory asset as it is created or enhanced as being a different component of comprehensive income, such as ‘production income’ or ‘production margin’. In other words, in a contract in

which an entity is creating or enhancing an asset to fulfil contractual obligations, after contract inception the entity could recognise:

- production income or production margin as it creates or enhances the asset
- revenue when it transfers the asset to the customer.

30. For instance, the changes in Homebuilder's assets and liabilities in the example in paragraph 7, could be displayed as follows:

	June 2007	Dec 2007	June 2008	Total
Revenue[2]	10,000		240,000	250,000
Production margin[3]	15,000	40,000	10,000	65,000
Expenses	(8,000)		(240,000)	(248,000)
Total margin[4]	17,000	40,000	10,000	67,000
Cash	(88,000)	(148,000)	67,000	
Inventory asset	120,000	220,000	-	
Contract liability	(15,000)	(15,000)	-	
Retained earnings	17,000	57,000	67,000	

31. The above display limits *revenue* to the credits that arise from the increase in the entity's net assets arising from its rights and obligations in the contract, consistent with the customer contract definition of revenue. That display also reports the increase in the entity's asset that is being created to fulfil a contractual obligation as another component of comprehensive income—production margin—as it arises. In this way, the margin attributable to creating or enhancing the asset that will be transferred to the customer is reported as those activities occur. The margin that would be reported when revenue is recognised on transferring the asset to the customer would relate only to contract completion activities.

[2] The revenue line is the same as in the table in paragraph 8.
[3] The production margin is the same as the line 'Building House 2' in the table in paragraph 15.
[4] The total margin is the same as the margin line in the tables in paragraphs 15 and 23.

32. Some argue that the above display is more complicated than that in the table in paragraph 23. Others also argue that the components of income are ‘double counted’. This is because the entity recognises revenue of CU250,000 and production income of CU65,000. In response they note the following:

- Analysing the changes in assets and liabilities between revenue and another component of comprehensive income arguably provides additional information content in the income statement.

- The *margin* in the contract is not ‘double counted’. This is because the inventory asset is measured at its current exit price until the date it is derecognised. Hence, the revenue recognised at that date (which in effect represents the market price of the asset transferred to the customer) will equal the carrying amount of the asset derecognised. It would also be possible to introduce reclassification adjustments to mitigate the effects of ‘double counting’ the components of comprehensive income.

ADVANTAGES AND DISADVANTAGES OF BROADENING THE SET OF ASSETS AND LIABILITIES

33. The discussion in paragraphs 5–10 has highlighted some of the consequences of a revenue recognition model that accounts only for the assets and liabilities arising from the customer contract. It has also illustrated how by broadening the set of assets and liabilities beyond the contract, the income statement can provide a more complete and timely depiction of the changes in the entity’s assets and liabilities from providing goods and services In addition, the effects of accounting mismatches in profit or loss can be reduced.

34. Some Board members would restrict the measurement model to the customer contract alone and adopt the customer contract definition of revenue. They note the following points.

- A model based around the contract with the customer simplifies the scope of the project because it targets a precisely defined set of assets and liabilities for which the accounting would need to be specified. Furthermore, defining revenue in terms of changes in specific assets and liabilities should assist in sharpening the distinction between revenue and other components of comprehensive income.

- Once the set of assets and liabilities that is included in the model is broadened beyond the contract, it would be difficult to draw the boundary. For example, suppose all of the bricks required for House 2 were acquired and delivered to the building site at the start of the contract. Should acquiring and delivering the bricks give rise to some production margin?

- Accounting for the customer contract is consistent with the scope of the project that was initially designed to consider revenues associated with contracts.

- Revenues under the customer contract definition can arise only in the context of a contract with a customer. In contrast, the refined Con 6 definition of revenue contemplates revenues arising outside a contract with a customer. As noted, there is anecdotal evidence to suggest that any definition of revenue that could contemplate revenue arising outside a contract (even if that revenue was not recognised) would conflict with how many view revenue. Said another way, even if an inventory asset was readily marketable (as would be the case with a commodity) and was measured at current exit price, some would not describe the resulting credit in profit or loss as revenue. Indeed, IAS 41 *Agriculture* describes the increase in the fair value of a biological asset—including the change from physical changes—as a *gain* rather than *revenue*.[5]

- The accounting for inventory assets could be addressed separately in a later project. Such a project could also consider when it is appropriate to recognise income from production even when there is no contract with a customer yet in place.

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[5] Although in the context of the definitions of revenue and gains in Concepts Statements 6, that suggests that the activities resulting in those changes were not the entity's 'ongoing major or central operations', which generally would not be the case.

- Accounting mismatches are an inherent feature of the current mixed measurement accounting model. Even if the inventory asset is also measured at current exit price, other accounting mismatches would still arise in the subsequent accounting.

35. Other Board members would not restrict the measurement model to accounting for the customer contracts alone. They note the following points.

    - As discussed in paragraphs 7–10, focussing on a narrow set of asset and liabilities can result in an incomplete depiction of the changes in the entity’s assets and liabilities while the entity is making progress towards fulfilling its obligations in the contract. This could make it difficult for users to evaluate an entity’s performance in a period, particularly when production spans several accounting periods.

    - Under a customer contract definition of revenue, revenue will be recognised, and margin reported, when goods and services are transferred to customers. In some contracts, this happens continuously. For instance, the service of risk protection is being provided to the customer continuously in the case of a warranty. Hence, revenue and margin are reported continuously over the term of the contract. Similarly, in the case of a contract in which a customer engages an entity to construct a building on its own land, (construction) services and building materials are being provided continuously. However, in other cases, goods or services are not transferred to the customer continuously even though the entity performs under the contract continuously. For instance, in the homebuilder example above in paragraph 7, Homebuilder performs continuously under the contract, but the house is transferred to the customer at a discrete point. Therefore, a customer contract definition of revenue creates sharp distinctions between entities in the reporting of margin arising from customer contracts. Whilst it is true that such contracts are different, in that in the former examples obligations are satisfied continuously, and in the latter at discrete points, some think that profit or loss should reflect an entity’s performance under a contract rather than only when goods and services are transferred to customers, thereby satisfying contractual obligations.

- A revenue recognition model that focuses only on the customer contract would place significant stress on determining the points at which obligations are satisfied. This could result in pressure to determine that obligations are being satisfied, when this is not the case. For instance, in the case of the construction of a machine under contract that spans multiple accounting periods and in which the customer takes ownership of the machine on completion, there could be a pressure to conclude that the substance of the arrangement is that the entity is providing construction services. In other words, to conclude that the machine under construction is in substance an asset of the customer rather than the supplier. As a result, the usual principles of asset and liability recognition and derecognition may be circumvented in order to achieve the desired outcome for revenue recognition.

- The accounting mismatches that could arise as described in paragraphs 5 and 6 could make it difficult for users to evaluate an entity's performance and for entities to explain their performance. Furthermore, those mismatches could be so large as to prevent acceptance of the idea of a revenue recognition model that is based on explicit current measurements of assets and liabilities.

- In some cases, an entity could not transfer only its remaining contractual rights and obligations to a market participant and would also need to transfer the inventory asset. For instance, in the example in paragraph 7 (the contractual obligation to provide House 2), a third party taking over Homebuilder's obligation at, say, 31 December, would also need to take over the partially completed asset. In that regard, the reference transaction for measuring the contract asset or liability (the price that the entity would expect to pay or receive from a market participant for the remaining rights and obligations in the contract) is somewhat artificial. In those instances, a more appropriate reference transaction would be the price that the entity would expect to pay or receive from the market participant for the rights and obligations together with the price it would expect for the inventory asset.

CONCLUSIONS

36. Appendix B and Agenda Paper 7B developed a revenue recognition model that was focussed on the rights and obligations in an enforceable contract with a customer. This paper has highlighted some of the consequences of such a model, and in particular has highlighted how such a narrow focus on the contract might not represent the economic circumstances of an entity as faithfully as it otherwise might.

37. As highlighted, the focus of the revenue recognition project is contracts with customers to provide goods and services. Nonetheless, the overall objective of any model addressing the accounting for such contracts should be to depict as completely as possible the changes in an entity's assets and liabilities *throughout* the contract. In some contracts, this necessarily entails considering more than just the assets and liabilities arising from the contract.

38. Therefore, the leaning of proponents of the measurement model is that the contract-based model described in Appendix B and Agenda Paper 7B would need to be extended. They also think that the approach that would be met with the most acceptance would be that described in paragraphs 25–32. This is because it retains a definition of revenue that is focuses on the contract with the customer whilst simultaneously accommodating recognising profit or loss from assets other than the contract.

Appendix: Definition of Revenue in Concepts Statement 6.

A1. The definition of revenue in Concepts Statement 6 is as follows:

> Revenues are *inflows* or other enhancements *of assets* of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.[6]

A2. This definition refers to revenues as inflows of assets. Similarly, the definition of revenue in IAS 18 refers to revenue as the gross inflow of economic benefits. Such inflows are commonly understood to mean the consideration obtained in exchange for providing goods and services. However, the discussion in Concepts Statement 6 of the above definition suggests that the meaning may be different conceptually. The particular passage to note in Concepts Statement 6 is as follows:

> 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, which may be recognized . . .when product is delivered, when cash is received, or when production is completed rather than as production takes place. *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*.[7]

A3. In essence, Concepts Statement 6 is making the point that delivering goods and services to the customer itself does not create value. That results only in the entity sacrificing goods and services to customers for (generally) cash or promises of cash. The revenue itself arises from the entity's output of assets in the form of its goods and services that it ultimately transfers to customers.

A4. To illustrate the point that Concepts Statement 6 is making in the above extract, consider the case of an entity that manufactures a widget and then sells that widget. Concepts

[6] Concepts Statement 6, paragraph 78, emphasis added.
[7] Concepts Statement 6, footnote 40, emphasis added.

Statement 6 contemplates that with respect to the good (ie ignoring the selling activity), revenue arises from *manufacturing* the good, rather than the exchange of the good with the customer that satisfies the contract. Suppose for instance that the customer pays CU1,000 in advance for a good that will cost the entity CU600 to manufacture. The entity has therefore recognised a liability of CU1,000 for the advance.

A5. The accounting entries that are usually made to reflect the manufacture and delivery of the goods are as follows:

Dr inventory	600	
Cr raw materials, payables, etc		600

To record manufacture of goods and costs incurred

Dr advance from customer	1,000	
Cr revenue		1,000

Dr cost of goods sold	600	
Cr inventory		600

To record delivery of goods to customer in satisfying the obligation to customer and to record related revenue and expenses

A6. In contrast, Concepts Statement 6, contemplates two conceptual events:

Dr inventory	600	
Cr raw materials, payables, etc		600

To record manufacture of goods and costs incurred

Dr inventory	400	
Dr expense	600	
Cr revenue		1,000

To record completion of manufacture and revenue value of goods

Dr advance from customer	1,000	
Cr inventory		1,000

To record transfer of goods to customer in exchange for satisfying the liability

A7. Note that the above journals were not meant to explain whether and how revenue should be recognised over the production process, nor whether revenue should be CU1,000 or some other amount, such as CU400. Rather, they are designed to illustrate the source of an entity's revenues under Concepts Statement 6.

A8. Thus, the asset inflows that occur in conjunction with the generation of revenue relate to the goods being manufactured, not the consideration that is received in exchange for those goods. In essence, the asset inflows relate to the creation of new assets or the enhancement of existing assets as a result of the production process from which revenues arise.