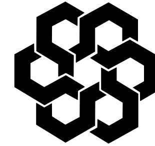

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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting: **14 November 2007, London**

Project: **Revenue Recognition**

Subject: **An asset and liability approach (Agenda paper 4B)**

PURPOSE OF THIS MEMO

1. This memo describes why the Boards decided not to pursue a revenue recognition model based on notions of realization and an earnings process. It also describes why the Boards have instead pursued a model based on changes in assets and liabilities. Finally, this memo explains the Boards' initial effort to define revenue in terms of one specific asset or liability—an entity's contract with a customer.[1]

INTRODUCTION

2. From their first childhood visit to the corner shop, people learn that buying chocolate requires handing over cash to a shop keeper. Most people thereafter consider revenue to be the amount of cash the shopkeeper receives for giving chocolate to the customer, and this child-like view serves most transactions well. Indeed, any model of revenue recognition that altered this outcome for such simple transactions would be suspect.

3. Unfortunately, this child-like view is easily confused by situations in which a customer pays cash at a time different from when goods or services are

[1] Throughout this memo, the word contract is used to represent an enforceable arrangement between two parties. Although the definition of contract, the mechanisms of enforcement, and the operation of law will vary across jurisdictions, the word contract is simply meant to capture the enforceable terms to which the two parties have agreed (implicitly or explicitly).

received or in which an entity provides multiple goods or services over extended periods of time. To deal with these common complicating factors, the accounting profession has employed a model in which revenue is recognized when payment or promise of payment is received from a customer *and* the goods or services promised by the entity have been provided. That is, revenue is recognized when payment is realized or realizable and the earnings process is complete, as described in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* and, to a lesser extent, in the IASB *Framework for the Preparation and Presentation of Financial Statements*.

What Is Wrong with the Earnings Process Model?

4. As simple as this model appears, its application has led to more than 200 pieces of guidance on revenue and gain recognition in the United States alone, much of which is industry-specific and often conflicting. This is largely because the notion of an earnings process is not defined precisely anywhere in the literature, and people often disagree on what the earnings process is in particular situations.

5. For example, consider a cable TV provider. Does its earnings process involve *only* the provision of a cable signal to the customer over the subscription period? Or does the process of hooking the customer up to the cable TV network represent its own separate earnings process? Some argue that the earnings process cannot begin until the customer starts to receive the service for which it contracted—the actual cable signal. Others argue that in contracting for the cable service, the customer implicitly contracts for the hookup, which represents a separate earnings process. With no clear definition of what an earnings process is, the FASB decided in Statement No. 51, *Financial Reporting by Cable Television Companies*, to treat cable TV hookup services as a separate earnings process and to recognize revenue to the extent of direct selling costs incurred by the provider.

6. In contrast to the cable TV provider, consider an exercise gym that gives its members access to hundreds of sites across the country in exchange for an upfront, non-refundable membership fee plus regular monthly fees for usage. Does the gym's earnings process involve *only* the provision of working gym facilities over the membership period? Or does the process of creating gym membership cards and entering member information into the country-wide database represent its own separate earnings process? Although this scenario is economically similar to that of a cable TV provider, the U.S. Securities and Exchange Commission (SEC) concluded in Staff Accounting Bulletin (SAB) 104 that such setup efforts do not constitute a separate earnings process, and thus, upfront non-refundable membership fees cannot be recognized as revenue upfront.

7. As another example, consider the earnings process of a travel agent and an airline company. A travel agent helps a customer purchase an airline ticket and recognizes revenue for its commission at the point the customer purchases the ticket. Some argue that revenue recognition is appropriate because the earnings process of the travel agent—helping the customer make travel plans and arrangements—is largely completed once the customer purchases the

ticket. In contrast, an airline that provides the same upfront service with its own in-house sales force cannot recognize revenue for these services because the airline's earnings process is incomplete until the flight itself is provided. Why do similar services provided by companies with different overall business models constitute an earnings process for one company and not for the other?

8. As one final example, separately priced extended warranties result in revenue recognition over the warranty period under both U.S. GAAP and IFRS because the earnings process of warranty providers is said to span the warranty period. In contrast, warranties that are not priced separately from the warranted good do not result in revenue recognition over the warranty period, even though the efforts undertaken to service such warranties (that is, the earnings process associated with those warranties) clearly span the warranty period.

9. Many more examples like these can be found throughout today's revenue recognition literature, both in U.S. GAAP and IFRS. The fact that the earnings process model is applied inconsistently across similar transactions calls into question the usefulness of that model. Although some argue that the IASB literature does not contain as many such inconsistencies as U.S. GAAP, anecdotal evidence suggests that preparers who report under IFRS often look to U.S. GAAP when IFRS does not provide sufficient guidance, which is frequently the case for revenue recognition situations. Thus, the inconsistencies resulting from the application of an earnings process model are often just as pervasive under IFRS as they are under U.S. GAAP.

Conflicts with Definitions of Assets and Liabilities

10. In addition to these inconsistencies, the earnings process model also creates conflicts with the definitions of assets and liabilities in the FASB and IASB frameworks. This is because, in some instances, the application of an earnings process model leads to the recognition of deferred debits and deferred credits that do not meet the definitions of assets and liabilities. For example, the decision not to recognize revenue for upfront, non-refundable gym membership fees results in deferred revenue for those fees, even though the expected future sacrifice of economic resources by the gym is less than future monthly gym usage fees.

11. In effect, the earnings process model attempts to account for revenue directly without considering how assets and liabilities arise and change throughout the exchange with the customer. Because assets and liabilities are ignored, deferred debits and credits sometimes arise that do not meet the definitions of assets and liabilities. Because assets and liabilities are the cornerstone elements in the FASB and IASB frameworks—indeed, the current definitions of revenue depend on assets and liabilities—the Boards have questioned the conceptual usefulness of the earnings process model.

What Is Wrong with IAS 18 *Revenue*?

12. Given the shortcomings of the earnings process model, which is largely a product of U.S. GAAP, some have questioned why the Boards do not simply

adopt a general standard akin to IAS 18 *Revenue*. The Boards decided not to take such an approach for two reasons. First, as already alluded to in paragraph 9, the guidance in IAS 18 is inconclusive on matters such as multiple-element arrangements. Because almost all revenue transactions can be thought of in terms of a multiple element arrangement, this is a fundamental weakness of IAS 18. Second, and much more importantly, the underlying principles in IAS 18 are too inconsistent or vaguely described to provide a conceptual basis on which to develop a revenue recognition standard. (Indeed the risk and reward principles in IAS 18 sometimes seem to conflict with the definitions of assets and liabilities.) The Boards thought that if a general standard was to be coherent and capable of subsequent interpretation, they would need to describe the underlying principles more clearly than IAS 18 did. Hence, they decided to start this project from first principles.

AN ASSET AND LIABILITY MODEL

13. Given the shortcomings of the earnings process model and the flaws in IAS 18, the Boards decided to pursue a revenue recognition model founded on the recognition and measurement of assets and liabilities. Although this so-called asset and liability model would be a departure from the current standards-level guidance, which is dominated by an earnings process model, it is consistent with the existing definitions of revenue in both the FASB and IASB literature:

> 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 (SFAC 6, paragraph 78)
>
> Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants (IAS 18, paragraph 7).

14. Both definitions base revenue on increases in assets, settlements of liabilities, or some combination of the two. Thus, revenue is a residual from recognizing and measuring increases in assets and decreases in liabilities. Instead of an independent evaluation of how much revenue has been "earned" and can therefore be recognized, an asset and liability model focuses on the changes in assets and liabilities themselves to determine how much revenue to recognize. Revenue itself is not measured directly.

15. Because the asset and liability model relies on the recognition and measurement of assets and liabilities, the Boards think it can be applied more consistently across industries and transactions than an earnings process model. That is, the Boards think there will be more agreement on whether an asset has increased or a liability has decreased than there is currently on what an earnings process is and whether it is complete. Moreover, an asset and liability model does not recognize deferred debits and credits that do not meet the definitions of an asset and liability. As a result, this model is more likely to

lead to a faithful and consistent depiction of the underlying economics of transactions than the earnings process model has done.

16. The Boards acknowledge that some so-called deferred debits and credits that arise from applying existing revenue recognition guidance may turn out to meet the definitions of assets and liabilities. Where this is the case, adopting an asset and liability model would not change practice with respect to whether they should be recognized. However, the asset and liability model may lead to changes in how the recognized assets and liabilities are described, which in turn may lead to changes in how the assets and liabilities are measured. For example, changing from recognizing a liability for "deferred revenue" to recognizing a liability to provide services may lead to changing from a measure based on the proceeds received to a measure of the services to be provided (that is, an explicit measure of the contractual liability). The Boards think such an analysis of measurement attributes under an asset and liability model is likely to improve the consistency and representational faithfulness with which revenue is depicted across industries and transactions.

Which Assets and Liabilities?

17. If revenue is to be defined in terms of increases in assets and decreases in liabilities, the model needs to be clear about the assets and liabilities to which it refers. The existing definitions of revenue provide few clues in this regard, except to focus on the assets and liabilities that arise in connection with the provision of goods or services that constitute an entity's ordinary, ongoing, or central activities. However, many assets and liabilities arise in connection with such activities.

18. Consider the following example:

A customer enters into a contract with a manufacturing entity in which the entity promises to deliver a standard good in six months. The entity manufactures its own goods, usually over a six month period. The customer pays for the good in advance.

19. In this example, there are a number of assets and liabilities that arise in connection with making and delivering the standard good. Perhaps the most obvious of these is the cash received from the customer. An increase in this asset (when the customer pays) would give rise to revenue in a simple asset and liability model that focuses solely on cash. Such a model would ignore whether the entity had actually transferred the good and thus settled any liability with the customer because the model's focus would be strictly on one asset—the cash received from the customer.

20. Another asset in this example is the good itself that the entity is manufacturing. An increase in this asset (as the entity acquires materials and applies labor to those materials throughout the manufacturing process) would give rise to revenue in an asset and liability model that focuses solely on the good being manufactured. Such a model would ignore whether any liability had decreased or whether any other asset (such as cash) had increased.

Revenue would arise strictly from the enhancement in the value of the good being produced.

21. In this example, there is also a liability (after the customer prepays) because the entity must sacrifice economic resources to manufacture and deliver the good in six months. A decrease in this liability (when the entity delivers the good to the customer) would give rise to revenue in an asset and liability model that focused solely on the satisfaction of such liabilities. Such a model would ignore whether assets (such as cash or the good being manufactured) increased. Revenue would arise only upon the satisfaction of liabilities to the customer.

22. Any of the assets or liabilities identified in this example could feasibly be the focus of an asset and liability revenue recognition model. Indeed, there is no conceptually right or wrong answer about which assets or liabilities should affect revenue. At best, the Boards can only select the set of assets and liabilities that they think are most likely to result in recognized revenue that is decision-useful to financial statement users.

Decision Usefulness of One General Definition of Revenue

23. It should be noted here that by defining revenue in terms of only one particular set of assets and liabilities, the Boards assume that the decision usefulness to financial statement users across all industries can be achieved by defining revenue in terms of the same assets and liabilities. In other words, by aiming for one general standard on revenue recognition in which revenue arises from changes in a defined set of assets and liabilities, the Boards assume financial statement users across all industries will consider the resulting recognized revenue to be decision useful. If this is not the case, then some users of financial statements will be adversely affected by this effort to create one general revenue recognition standard.

24. For example, in the timber industry (and other agricultural industries), users may think the most useful definition of revenue is one that captures the changes in the value of the growing timber itself. That is, financial statement users in this industry might prefer an asset and liability model of revenue that focuses on the good being produced (an asset). As the timber grows, revenue is recognized. Although sales to customers—which occur many years after trees begin to grow—would also be important to users in this industry, they may in fact prefer a top-line revenue number that reflects the changing value of the timber as it grows. This is because the timber (or the land with the timber that is growing on it) could be sold to others in the timber industry. A general standard that defines revenue in terms of an asset (such as cash) and/or the satisfaction of a liability (such as on delivery of timber to the customer) would preclude labeling the increases in the value of timber as it is growing as revenue.

25. There are likely to be other industries with differences in what users think revenue should capture, and a general standard on revenue recognition that attempts to define the assets and/or liabilities that give rise to revenue will preclude these differences from being reported. While this would make the resulting standard more consistently applicable across industries and

transactions, the decision usefulness of the reported revenue for a particular industry or for a particular transaction may be diminished.

CONTRACTS WITH CUSTOMERS

26. With the foregoing discussion in mind, the Boards decided to focus the revenue recognition model on the asset or liability that arises directly from a contract with a customer. The Boards decided to focus on the contract itself for two main reasons. First, contracts to provide goods and services are important real world economic phenomena. In fact, they are the lifeblood of companies. They represent an exchange of promises between an entity and a customer which gives rise to assets and liabilities. Moreover, given the pervasiveness of contracts with customers, any revenue recognition model has to at least consider the contract as a starting point.

27. Second, most of today's revenue recognition literature focuses exclusively on contracts with customers. For instance, SAB 104 provides four criteria for revenue recognition and the first criterion requires that persuasive evidence of an arrangement exists. Transactions within the scope of IAS 18 envisage a customer, and any customer transaction either explicitly or implicitly involves a contract. Because the objective is to develop a model that can supplant much of the existing literature, that model needs to encompass at least as broad a scope as the existing literature.

28. By initially focusing on the contract itself, the Boards do not intend to preclude the possibility that revenue might also be recognized outside contracts with customers. Indeed, the Boards recognize that some constituents (for example, constituents in the agricultural industry as noted above) might argue that their revenue arises long before an exchange with a customer is contemplated. But for initial purposes in this paper, the Boards decided to focus strictly on the asset or liability that arises directly from the contract with a customer. In other words, the *contract* with the customer is the economic phenomenon to be accounted for. Hence, the changes in the assets and liabilities giving rise to revenue would be the changes arising *directly* from the contract between the entity and its customer.

A Tentative Definition of Revenue

29. A tentative definition of revenue based on an asset and liability model that focuses specifically on the contract with a customer could be as follows:

> Revenue is an *increase* in a contract asset or a *decrease* in a contract liability (or a combination of the two) that results from providing goods and services to a customer.

30. First and foremost, this definition highlights that revenue arises from a change in assets and liabilities—the contract asset or liability. This definition also highlights that the assets and liabilities referred to arise *from* the contract between the entity and its customer. This limits which assets and liabilities are considered in the model to just the contract itself. For example, the good being constructed for ultimate delivery under the contract is not an asset that arises

from that contract. Finally, this definition highlights that the change is related to providing goods or services to customers. This acts as a filter to distinguish revenue-generating contracts from other contracts.

31. Note that there are some important issues that this definition does not address. For instance, it does not explain whether changes in the contract asset or liability that result from performance by third parties (for example work undertaken by a subcontractor) should be revenue. The reference to goods and services could also benefit from clarification so as to address questions such as whether a sale of an item of property, plant, or equipment previously used to generate revenue should be treated as a revenue-generating contract. This is important because many users assign different valuation multiples to components of income that are persistent (that is, recur from period to period) from those that are not. However, these issues can be considered later.

32. This, of course, is just a tentative definition. It is simply a first attempt to explain what revenue is by defining it in terms of a particular set of assets and liabilities—those that arise from the contract itself. It does not explain *when* an increase in an asset or a decrease in a liability from providing goods or services occurs. But to explore this issue first requires an explanation of how and why contracts with customers give rise to assets and liabilities and how those assets and liabilities change as both the entity and customer perform under the contract.

How an Asset or Liability Arises from a Contract

33. When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises impose *obligations* on the entity to transfer economic resources (in the form of goods and services) and convey *rights* to receive consideration from the customer in exchange.

34. The rights and obligations in the contract are inextricably linked because neither would be enforced without the other also being enforced. As a result, the combination of the rights and obligations is treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. Thus, at any given point in time, a contract is treated as an asset if the remaining rights exceed the remaining obligations. Similarly, a contract is treated as a liability if the remaining obligations exceed the remaining rights. This asset or liability reflects the entity's net position in the contract with respect to the remaining rights and obligations.[2]

35. The notion of a net position in a contract is not new. Forward contracts for financial instruments are already treated as assets or liabilities in existing accounting literature. In a forward contract, two parties agree to exchange a fixed amount of consideration for a financial instrument at some future date. The parties report their respective positions in the contract based on the

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[2] The Boards have decided that in contracts with the legal remedy of specific performance, which requires both parties to fulfill the promises made in the contract, the entity's rights should be presented gross as assets and its obligations should be presented gross as liabilities. For purposes of this paper, revenue would arise from the same circumstances, regardless of whether the rights and obligations are recognized gross or net in the balance sheet. For simplicity, the discussion in this paper assumes contracts do not require the remedy of specific performance.

relationship between the promised consideration and the current price of the financial instrument. If the promised consideration exceeds the current price of the financial instrument, the party that promised the consideration treats the contract as a liability because the settling of the contract would result in a net outflow of economic resources. At the same time, the party that promised the financial instrument treats the contract as an asset because the settling of the contract would result in a net inflow of economic resources.

36. In this same way, a revenue contract can be treated as an asset or liability depending on the relationship between the remaining rights and obligations in the contract. Consider again the example in paragraph 18, in which a manufacturing entity contracts to deliver a machine in six months and the customer pays in advance. Immediately *after* the customer makes payment, the manufacturing entity has no remaining rights in the contract. Instead, all that is left is an unfulfilled obligation. As a result, the entity's net position in the contract is a liability. To release itself from the remaining obligations in the contract, it would have to satisfy the obligation by delivering the machine, refund the customer's original payment plus any required penalty, or pay another party to legally assume the obligation to deliver the machine.

37. That a prepaid contract would be treated as a liability is perhaps not surprising, but now consider the same example immediately *before* the customer makes payment. At this point, the manufacturing entity has a right to the customer's payment and an obligation to deliver the machine in six months. If the right to payment exceeds the obligation to deliver the machine, the entity's net position in the contract would be an asset. Such an asset position might be evidenced by a third party's willingness to pay the entity for that remaining set of rights and obligations. In contrast, if the obligation to deliver the machine exceeds the right to payment, the entity's net position in the contract would be a liability. This liability position might be evidenced by a third party that would require payment from the entity to take on the remaining rights and obligations.

38. It is important to note that the focus on the contract takes in only the rights and obligations in that contract. This focus would not include any future cash flows from the customer that are likely to occur simply because the entity and the customer have formed a potentially lasting relationship. The focus on the contract is solely on the rights and obligations in that particular contract, and the unit of account is the entity's net position in the remaining rights and obligations in that contract only (or some collection of contracts, if they are deemed to be related—an issue not discussed in this paper).

39. In summary, a contract to deliver goods and services to a customer can be either an asset or a liability, depending on the remaining rights and obligations in the contract. Consider now how a contract changes as both parties fulfill their promises.

How a Contract Asset or Liability Changes

40. An entity's net position in a contract can change due to its own performance or the performance of the customer (among other things). For example (as noted above), when a customer performs by paying its promised consideration in

advance, the entity's net position in the contract (whether an asset or liability before that time) decreases because the entity no longer has any remaining rights in the contract. An entity's contract asset would decrease or its contract liability would increase because the rights to the customer's payment no longer exist. Importantly, neither a *decrease* in a contract asset nor an *increase* in a contract liability would meet the tentative definition of revenue, which requires instead an *increase* in a contract asset or a *decrease* in a contract liability. Thus, performance by the customer in and of itself does not lead to revenue recognition.

41. An entity's net position in a contract also changes when the entity provides its promised goods or services. Once these goods or services are provided, the entity no longer has this particular obligation in the contract. As a result, its net position in the contract (whether an asset or liability before that time) increases. Note that this change would meet the tentative definition of revenue because the entity's contract asset would *increase* or its contract liability would *decrease* when its obligation to provide goods or services ceases to exist.

The Importance of Asset Transfer

42. According to the tentative definition of revenue, revenue arises because goods and services are provided, which ultimately leads to an increase in a contract asset or a decrease in a contract liability. Given the pivotal role that the provision of goods or services plays in this definition of revenue, it is important to understand *when* a good or service is actually provided or transferred to a customer. That is, in an asset and liability model in which revenue arises from the provision of goods or services, there must be some principle or criterion to suggest *when* a good or service has actually been transferred to the customer. Additionally, this principle must be applied consistently across the model.

43. Essentially, this is a question of asset transfer—whether an entity has transferred or provided an economic resource to the customer. For example, once a good is transferred to a customer (that is, the customer has the ability to direct the use and benefit of the good), there can be no remaining obligation for the entity to transfer that good to the customer. The entity may have a different obligation associated with a potential return of that good, but that is not the same as an obligation to deliver that good. Thus, upon transferring a good to the customer (and derecognizing the asset if it was previously recognized), a contractual obligation is satisfied, leading to either an increase in a contract asset or a decrease in a contract liability—in other words, revenue.

44. In contrast to a good, determining when a service has been provided to a customer is often simpler. For example, when a cleaning company provides one day of office cleaning in a 30-day cleaning contract, the cleaning service is clearly provided to the customer on that day. There is no asset for the entity to derecognize because the benefit created by the entity's activities immediately transfers to the customer. That the cleaning service provides a

benefit to the customer each day indicates that an obligation under the contract is satisfied each day, and thus revenue arises each day.

45. Unfortunately, determining when a service provides a benefit to the customer is not always so simple. Consider a contract in which a consulting company promises to deliver a final report to the customer, and delivers nothing to the customer except that final report. The consulting work done prior to the delivery of the report has the appearance of being a service, but the work itself does not provide any benefit or asset to the customer until the final report is compiled and delivered. In effect, the entity is creating an intangible product that it plans to transfer to the customer once all knowledge is gathered together into the final report. In this situation, what appears to be a service effort turns out to be the production of an intangible asset. The customer receives no benefit from the consulting work until the report is actually delivered.

46. These simple situations highlight the importance of identifying when a resource or benefit transfers to a customer and thus satisfies an obligation in a contract-based definition of revenue. In fact, focusing on the time at which a benefit or resource transfers to the customer may provide a workable solution for identifying separate promises to deliver goods and services within a multi-element arrangement. In other words, if the criteria for determining when a benefit or resource transfers to the customer can be clearly articulated, those same criteria can be used to identify separate obligations in multi-element arrangements.

47. Although a satisfactory analysis of the asset transfer issue is beyond the scope of this paper, it is important to note the primary role asset transfer plays in a contract-based revenue recognition model. Both revenue recognition models developed by the Boards must deal with the question of when a good or service is transferred or provided. In fact, the Boards decided in October 2007 that both models must utilize a similar set of criteria for determining when an asset has transferred to a customer and thus satisfied an obligation. In essence, the Boards decided that there is no reason the two models should differ in their conclusions of when an asset or resource has been provided to the customer and thus gives rise to revenue by satisfying a contractual obligation.

48. Of course, this is easier said than done. Board members differ strongly in their views on when an asset or resource actually transfers to a customer, and this project cannot hope to resolve that issue within the next few months before publishing a due process document. Therefore, this paper simply highlights the importance of asset transfer, and will highlight in later chapters any instance in which this question surfaces and how it is dealt with in that moment. The paper cannot completely ignore this issue because constituents who want to understand how the two models would affect their current practice will need to know *when* revenue would be recognized under those models. And, as pointed out above, asset transfer primarily determines when obligations are satisfied and revenue is recognized.

49. In summary, the notion of asset transfer is pivotal in a contract-based focus of revenue recognition because it is the transfer of assets or resources to customers that satisfies the obligations in a contract. This is perhaps the most difficult aspect of an asset and liability revenue recognition model that focuses

solely on the contract with the customer. Such a focus places tremendous pressure on determining whether an asset or resource has actually been provided to the customer. Both revenue recognition models developed by the Boards have to deal with this issue.

EXAMPLES OF REVENUE ARISING FROM CHANGES IN CONTRACTS

50. The previous section explains how the remaining rights and obligations in an enforceable contract with a customer give rise to a contractual asset or liability. That section also explains at a high level how changes in this contract asset or liability can lead to revenue recognition according to the tentative definition of revenue. This section uses a few simple examples to illustrate more concretely the relationship between changes in contracts and revenue recognition.

51. The examples illustrate how a contract asset or liability changes over the duration of the contract. Because measurement has not yet been discussed, the examples are intended to illustrate only when changes in the contract occur as a result of the entity providing goods or services. By illustrating how revenue would result from such changes, this section is meant to illustrate more generally how revenue would arise under a contract-based definition of revenue.

A contract to deliver a single good

52. Consider the following facts in which an entity promises to deliver a single good in the future:

> A customer enters into a contract with a retailer in which the retailer promises to deliver a standard good in six months in exchange for CU10. The customer pays for the good in advance. The retailer acquires the good at a cost of CU6.

53. In this scenario, a contract asset or liability would arise at contract inception, depending on the relationship between the underlying rights and obligations in the contract. Immediately before the customer pays, the retailer would have a contract asset if the rights to the customer payment exceeded the obligation to deliver the good in six months time. In contrast, the retailer would have a contract liability if the obligation to deliver the good in six months exceeded the rights to the customer payment. Finally, the retailer would have neither an asset nor a liability if the right to the customer's payment were judged to be equal to the obligation to deliver the good. For purposes of this example, assume that the measure of the obligation is equated to the measure of the rights, so no asset or liability arises at inception.

54. Immediately after the customer makes payment, the retailer would have a contract liability because it would have no remaining rights in the contract. Given that no contract asset or liability was recorded at inception, the customer's payment of CU10 would be recorded as follows:

Dr cash	10	
Cr contract liability		10

55. Six months later, when retailer delivers the promised good, there are no remaining rights or obligations in this contract. As a result, the contract liability would decrease and thus give rise to revenue. As a result, the retailer would make the following entry:

Dr contract liability	10	
Cr revenue		10
Dr cost of goods sold	6	
Cr inventory		6

A Contract to Deliver Multiple Goods at Different Times

56. Consider the following facts in which an entity promises to deliver two goods in the future:

> A customer enters into a contract with a retailer in which the retailer promises to deliver two standard goods, one in three months and another in six months in exchange for CU10 each. The retailer acquires each good at a cost of CU6. The customer makes payment for both goods upon the second delivery.

57. In this scenario, a contract asset or liability would arise at contract inception, depending on the relationship between the underlying rights and obligations in the contract. The retailer would have a contract asset if the rights to the customer payment exceeded the obligation to deliver the goods over the next six months. In contrast, the retailer would have a contract liability if the obligation to deliver the goods exceeded the rights to the customer's payment. Finally, the retailer would have neither an asset nor a liability if the right to the customer's payment were judged to be equal to the obligation to deliver the goods. For purposes of this example, assume that the measure of the obligations is equated to the measure of the rights, so no asset or liability arises at inception.

58. Three months later, when retailer delivers the first promised good and derecognizes that asset, this obligation is satisfied. There is now only one remaining obligation and a remaining right to the customer's payment. As a result, a contract asset would be created and give rise to revenue. The retailer would make the following entry:

Dr contract asset	10	
Cr revenue		10
Dr cost of goods sold	6	
Cr inventory		6

59. After another three months, when retailer delivers the second promised good and derecognizes that asset, there are no remaining obligations, only the remaining right to the customer's payment. This decrease in obligations would lead to another increase in contract assets, recorded as follows:

Dr contract asset	10	
Cr revenue		10
Dr cost of goods sold	6	
Cr inventory		6

60. Finally, after receiving the second good, the customer makes payment to the retailer, which satisfies the only remaining right in the contract. The retailer would thus reduce its contract asset to CU0 and record the receipt of cash, as follows:

Dr cash	20	
Cr contract asset		20

CONCLUSIONS

61. This memo explains why the Boards favor an asset and liability model over an earnings process model, and describes a contract-based definition of revenue that is consistent with an asset and liability model. This memo also explains how a contract gives rise to an asset or a liability that represents an entity's net position in the contract, depending on the remaining rights and obligations in the contract. Finally, this memo describes how the entity's net position in the contract changes as the entity and the customer fulfill their contractual promises, and which of these changes would lead to the recognition of revenue.

62. At this point, there are two primary questions that still need to be addressed—how to measure the rights and obligations in the contract and how to determine that a good or service has actually been provided. The two revenue models described in the following chapters both deal specifically with these questions, and in the process propose a more refined definition of revenue that is consistent with their respective views on these two questions.