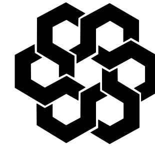

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International
Accounting Standards
Board

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

INFORMATION FOR OBSERVERS

Board Meeting:	**17 April 2008, London**
Project:	**Revenue Recognition**
Subject:	**Accounting for contracts with customers (Agenda paper 11B)**

CHAPTER 2 (DRAFT)

INTRODUCTION

1. From their first childhood visit to the corner shop, people learn that buying chocolate requires handing over cash to a shopkeeper. Most people thereafter consider revenue to be the amount of cash the shopkeeper receives for giving chocolate to the customer, and this simple view serves most transactions well. Indeed, the vast majority of transactions—initiated and completed almost simultaneously—pose few problems for revenue recognition. If these were the only type of transactions between entities and customers, the Boards would not have embarked on a revenue recognition project.

2. However, all transactions are not this simple. For example, customers often pay cash at a different time from when they receive goods or services, and entities often provide multiple goods and services over extended periods of time. To deal with these common complicating factors, accountants have

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 substantially 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*.

Issues in U.S. GAAP

Definition of an Earnings Process

3. As simple as this earnings process and realization model appears, its application has led to more than 200 pieces of guidance on revenue and gain recognition in the U.S. 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 U.S. literature, and people often disagree on what the earnings process is in particular situations.

4. 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, but only to the extent of direct costs incurred by the provider.

5. In contrast to the cable TV provider, consider a telecommunications provider that requires a customer to pay an upfront, nonrefundable "activation fee" plus regular monthly fees for usage. The activation fee ostensibly covers the cost of

transferring a customer's telephone number and connecting a new or existing phone to the entity's network, although this cost is nominal. Does the provider's earnings process involve *only* the provision of the telecommunication network during the contract period? Or, does the process of transferring the customer's existing phone number and connecting the customer's phone to the network 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, *Revenue Recognition in Financial Statements*, that such setup efforts do not constitute a separate earnings process. As a result, nonrefundable activation fees for a telecommunication provider cannot be recognized as revenue upfront.[1]

6. 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 substantially complete once the customer purchases the ticket. In contrast, an airline that provides the same upfront service with its own in-house sales force does not recognize revenue for these services because some argue that 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?

7. As a final example, separately priced extended warranties result in revenue recognition over the warranty period 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 result in revenue recognition at the point of sale instead of during 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. Because revenue is

[1] As if this contradictory guidance was not already perplexing enough, consider the difficulty faced by an entity that provides both telephone and cable services through the same network!

recognized differently for these two economically similar situations, profit is also recognized in different amounts and with different timing.

8. Many more examples like these can be found throughout U.S. GAAP. For many people, the fact that the earnings process model can be applied so inconsistently across economically similar transactions calls into question the usefulness of that model. Moreover, the existence of so many different requirements for what otherwise seem to be economically similar transactions means that identifying correctly the applicable standard for a particular transaction is vital.

Conflicts with Asset and Liability Definitions

9. In addition to the inconsistent guidance it can provide, the earnings process model is also criticized because it sometimes produces outcomes that conflict with the definitions of assets and liabilities in the FASB conceptual framework. That is, the application of an earnings process model sometimes leads to the recognition of deferred debits or credits that do not meet the definitions of assets or liabilities. For example, the decision not to recognize revenue for upfront, nonrefundable gym membership fees in SAB 104, *Revenue Recognition in Financial Statements,* results in deferred credits (presumably a liability) for those fees, even though the future monthly gym usage fees exceed the expected future sacrifice of economic resources by the gym.

10. In effect, the application of an earnings process model often accounts for revenue directly without considering how assets and liabilities arise and change throughout the life of a contract. Because assets and liabilities are often ignored, deferred debits and credits are recognized even though they do not meet the definitions of assets and liabilities. Because assets and liabilities are the cornerstone elements in the FASB conceptual framework—indeed, the current definition of revenue depends on changes in assets and liabilities—some have questioned the conceptual usefulness of the earnings process model.

Issues in IFRS

11. In IFRS, revenue recognition relies less on the notion of a completed earnings process. In fact, IAS 16 *Property, Plant, and Equipment* acknowledges that "income is not necessarily earned only at the culmination of an earning process, and in some cases it is arbitrary to determine when an earning process culminates" (paragraph BC19). Rather than recognize revenue based on an ill-defined earnings process, IFRS recognizes revenue when (among other criteria) "the entity has transferred to the buyer the significant risks and rewards of ownership of the goods" and when "services are rendered" (IAS 18, paragraphs 14 and 21).

12. Although disagreements still arise as to when the significant risks and rewards of ownership transfer to a customer and when services are considered rendered, IFRS arguably provides a more concrete principle for determining when to recognize revenue than the earnings process notion in U.S. GAAP. In fact, some argue that IFRS provides exactly the needed clarification of what an earnings process is. For goods, an earnings process culminates when the risks and rewards of ownership of the goods transfer to the customer. For services, an earnings process culminates when the services are provided.

Conflicts with Asset and Liability Definitions

13. Although the IFRS guidance may provide a more concrete principle by which to recognize revenue, this guidance still suffers from two important deficiencies. First, IFRS is criticized (like U.S. GAAP) because it sometimes produces outcomes that conflict with its conceptual framework's definitions of assets and liabilities. This happens because revenue recognition depends on when the risks and rewards of ownership of the promised goods are transferred to a customer. In contrast, the definition of an asset depends on whether the customer controls the good. As a result, the customer may actually have control of a good, but because some of the risks and rewards of owning that good have not entirely passed to the customer, the entity continues to report the good as its own asset and recognizes no revenue.

14. For example, consider an entity that delivers a good to the customer, but the customer "has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return" (IAS 18, paragraph 16d). In this situation, the customer has control of the good as the result of a past transaction and expects future benefit from that good. As a result, this good is an asset to the customer and is no longer an asset to the entity. However, because the entity bears a significant risk that the customer may return the good, IFRS requires that *no* revenue be recognized and that the good continue to be recognized as an asset by the entity. Such inconsistencies are more than just a conceptual nuisance to standard setters. They are at the heart of why preparers, auditors, and regulators have a difficult time deciding when revenue should be recognized.

No Explicit Measurement Guidance

15. The other significant deficiency in IFRS revenue recognition literature is the lack of explicit measurement guidance. Although such measurement guidance exists in abundance in U.S. GAAP, IFRS suffers from the opposite extreme. What guidance there is pertains directly to measuring the inflows in a way that reflects the time value of money if payment is deferred (see IAS 18) or to measuring the stage of completion or percentage completion (see IAS 11).

16. For transactions that promise a single good or service delivered within a single reporting period, this dearth of measurement guidance poses no problem. However, for transactions in which more than one good or service is provided, or in which the goods or services are provided over multiple reporting periods, there is no explicit guidance on how to measure or remeasure the promised goods or services. This can lead to significant surprises for users when, for example, an ongoing obligation is measured at the originally promised consideration amount until that obligation is judged onerous. At that point, the obligation is remeasured at a current amount (either to settle or transfer) in accordance with IAS 37, which is considerably higher than the original measure of the obligation.

A FOCUS ON ASSETS AND LIABILITIES

17. Given the shortcomings in U.S. GAAP and IFRS, the Boards have decided to pursue a general revenue recognition model that explicitly focuses on the recognition and measurement of assets and liabilities as defined within their conceptual frameworks. In doing so, the Boards do not intend to abandon the earnings process approach prevalent in US GAAP. To the contrary, the Boards think that focusing explicitly on changes in assets and liabilities will provide needed discipline to the notion of an earnings process.

18. The decision to focus on assets and liabilities is actually consistent with the existing definitions of revenue in U.S. GAAP and IFRS, both of which depend on assets and liabilities:[2]

> 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).

19. Both literatures base revenue on increases in assets, settlements of liabilities, or some combination of the two. By explicitly focusing on the recognition and measurement of assets and liabilities, the Boards think a revenue recognition model can be applied more consistently across industries and transactions than an unanchored 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. This does not mean that the judgments will always be easier; however, a focus on assets and liabilities will at least provide a clearer objective for judgment. As a result, the model is more likely to lead to a faithful and consistent depiction of the underlying economics of transactions than the earnings process model has previously done.

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[2] The IFRS definition of revenue does not actually use the terms assets and liabilities, but does depend on their net, which is equity.

20. It is important to note that many so-called deferred costs and deferred revenues that are recognized in existing revenue recognition guidance (in U.S. GAAP and IFRS) would likely meet the definitions of assets and liabilities. Where this is the case, focusing more carefully on assets and liabilities may not change current revenue recognition practice.

Which Assets and Liabilities?

21. If a revenue recognition model is to depend on 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.

22. 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.

23. 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 lead to revenue recognition in a simple model that focuses solely on the asset 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.

24. Another asset in this example is the good 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 lead to revenue recognition in a 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 be recognized strictly based on the enhancement in the value of the good being produced.

25. 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 lead to revenue recognition in a model that focuses solely on the satisfaction of such liabilities. This model would ignore whether assets (such as cash or the good being manufactured) increased. Revenue would be recognized only when liabilities to the customer are satisfied.

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

CONTRACTS WITH CUSTOMERS

27. With the foregoing discussion in mind, the Boards propose that the general standard on revenue recognition should focus on a single asset or liability—the contract with a customer. Given the definitions of revenue in paragraph 18, the principle on which revenue would be recognized is as follows:

> In a contract with a customer to deliver or produce goods, render services, or other activities that constitute the entity's ongoing major or central operations, revenue is recognized when a contract asset *increases* or a contract liability *decreases* (or some combination of the two).

28. This principle highlights that revenue is recognized because of a change in an asset or liability—the contract asset or liability. This principle is consistent with the existing definitions of revenue and highlights that the asset and liability referred to is the contract itself and not any good or service created pursuant to that contract. For example, the good being constructed for ultimate

delivery under a contract is not the asset that determines revenue recognition. Finally, this principle highlights that the contract must be between an entity and a customer—a third party to whom the entity promises to provide goods or services that constitute the entity's ongoing major or central operations.

29. The Boards decided to focus on contracts with customers for two main reasons. First, contracts to provide goods and services are important real world economic phenomena. In fact, they are the lifeblood of most companies. Moreover, given the pervasiveness of contracts with customers, any general revenue recognition standard has to at least consider the contract as a starting point.

30. Second, most of today's revenue recognition literature focuses exclusively on contracts with customers. For instance, SAB 104, *Revenue Recognition in Financial Statements*, provides four criteria for revenue recognition, with the first criterion requiring that persuasive evidence of an arrangement exists. Transactions within the scope of IAS 18 envisage a customer, and any transaction with a customer 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.

31. By focusing on the contract, 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) might argue that their revenue arises long before an exchange with a customer is contemplated and should be recognized accordingly. These constituents might further argue that obtaining a contract in such industries may be trivial because buyers and sellers are readily available at stated prices. But for purposes of a general standard on revenue recognition, the Boards propose to focus strictly on the changes in a contract with a customer. In other words, the *contract* with the customer is the economic phenomenon to be accounted for.[3]

[3] Although the notion of recognizing revenue without a contract may be unfamiliar or even counterintuitive, it is in fact contemplated by the FASB's definition of revenue (Statements of

How is a Contract an Asset or a Liability?

32. When an entity enters into a contract with a customer, the contract conveys *rights* to the entity to receive consideration from the customer and imposes *obligations* on the entity to transfer economic resources (in the form of goods and services). The combination of the rights and obligations can be treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. A contract is treated as an asset if the measure of the remaining rights exceeds the measure of the remaining obligations. Similarly, a contract is treated as a liability if the measure of the remaining obligations exceeds the measure of the remaining rights. This contract asset or liability reflects the entity's net position in the contract with respect to its remaining rights and obligations.[4, 5]

33. 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 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.

Financial Accounting Concepts No. 6, *Elements of Financial Statements*). This issue is explored further in Chapter X as are the implications for the loss of information that might result from accounting only for the contract.

[4] 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.

[5] A contract also conveys rights to and imposes obligations on a customer, the combination of which can be an asset or liability to the customer. However, accounting for the customer's net position in a contract is outside the scope of this project and is not discussed further in this paper.

34. In this same way, a contract between an entity and a customer 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 22, 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.

35. 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 an obligation to deliver the machine in six months and a right to require the customer to accept the machine and pay for it. If the measure of the right to payment exceeds the measure of the obligation to deliver the machine, the entity's net position in the contract would be an asset. In contrast, if the measure of the obligation to deliver the machine exceeds the measure of the right to payment, the entity's net position in the contract would be a liability.

36. It is important to note that the contract takes into account only the rights and obligations that arise from the promises in that contract. It does not take into account future cash flows from other contracts the customer is likely to enter because the entity and the customer have formed a potentially lasting relationship. The focus 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).

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

How Does a Contract Asset or Liability Change?

38. An entity's net position in a contract can change due to its own performance or the performance of the customer. 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, given the recognition principle in paragraph 27, neither a *decrease* in a contract asset nor an *increase* in a contract liability would lead to revenue recognition. Thus, performance by the customer in and of itself does not lead to revenue recognition.

39. 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 lead to revenue recognition because the entity's contract asset would *increase* or its contract liability would *decrease* when that particular obligation to provide goods or services ceases to exist.

40. In a contract-based model of revenue recognition, there are essentially two changes in a contract that can lead to revenue recognition. The first is the point at which an entity enters into a contract with a customer. For revenue to be recognized at this point (contract inception), the measure of the entity's rights must exceed the measure of the entity's obligations. This would lead to revenue recognition because the recognition of such a contract position would result in an increase in a contract asset. (Obviously, this outcome depends on how the rights and obligations in the contract are measured, an issue dealt with in chapter 5 of this paper).

41. The second point at which revenue can be recognized in the life of a contract is when the entity satisfies an obligation in the contract. As described above, this would lead to revenue recognition because satisfying an obligation in the

contract either leads to an increase in a contract asset or a decrease in a contract liability. The satisfaction of contractual obligations to the customer is likely to be the primary determinant of revenue recognition.

What Do the Boards Mean by a Contract?

42. If the contract with the customer is the asset or liability that will determine revenue recognition, it is important to understand what the Boards mean by a contract. This is important not only because changes in the contract asset or liability directly determine revenue recognition, but also because such a contract must exist before the proposed revenue recognition model can be applied. In other words, a contract with a customer is necessary to trigger the proposed accounting model and to determine when revenue is recognized.

43. For many people, the idea of a contract brings to mind a formal, written, legally binding document that requires signatures. Although such a document is often referred to as a contract, the document itself is only meant to evidence the actual contract. According to *Black's Law Dictionary* (8th Edition), a contract is:

> An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law (page 341).

44. This definition suggests that a contract is broader than a written set of agreements with signatures. A contract is the agreement between two or more parties (such as an entity and a customer) that creates obligations that are enforceable or otherwise recognizable at law. Often the agreement is recorded in writing with signatures affixed. (Indeed, some legal jurisdictions require that an agreement be written in order to be enforceable.) But other times, two parties can make a contract with no written documentation at all.

45. The simplest example of a contract is a cash sale—the type of sale that represents the vast majority of transactions. Consider the shopkeeper selling a piece of chocolate to a customer. In this situation, the shopkeeper and the customer agree to terms often with no written or even verbal expression. The terms are simply, "You (the customer) pay me (the shopkeeper) the stated

46. A more complicated example of a contract is a retail sale with a right of return. In this situation, a customer pays for and accepts title to the good before leaving the store, but the customer has a right to return the good within a fixed period of time for a full refund. The agreement between the retailer and the customer is a contract because the agreement creates obligations that are enforceable or otherwise recognizable at law. The retailer promises to transfer to the customer title to the goods and to permit the customer to return the good for a refund for any reason. Because of the retailer's promises, the customer can require delivery of the good before leaving the store. The customer can also require the retailer to accept the good (if returned) and refund the full consideration.

47. In this contract, the customer also makes promises. The customer promises to pay for the good before leaving the store with the good. Because of this promise, the retailer can require the customer to pay for the good before delivering the good. Because the obligations that arise from the promises in the contract are enforceable or otherwise recognized at law, this agreement is a contract.

48. It is this notion of a contract that the Boards have in mind. Whether the agreed upon terms are recorded in a written document, stated verbally, or otherwise evidenced, if that agreement creates obligations that are enforceable or otherwise recognizable at law, it is a contract. Revenue recognition is determined by the recognition and subsequent measurement of such contracts.

49. It is important to note that such a contract is an *agreement* between the entity and the customer. In other words, both the entity and the customer have agreed to the terms of the arrangement. When an entity makes a firm offer, that offer—though binding against the entity in many jurisdictions—is not an agreement between the entity and a customer because a customer has not agreed to accept the terms of the offer. Once a customer has agreed to the terms of the offer, a contract between the entity and the customer exists as long as it also results in obligations that are enforceable or otherwise recognizable at law. Again, it is this notion of a contract that the Boards have in mind.

Contracts with Firmly Committed Customers

50. Some Board members disagree with this notion of a contract. Specifically, these Board members disagree because they do not think it is appropriate to apply the proposed revenue recognition model to contracts in which the customer can withdraw from the contract with little or no consequence.

51. For example, in a retail sale with a right of return, the customer can effectively unwind the contract after receiving the good by returning it for a refund. The retailer has no ability to compel the customer to keep the goods until the return period expires. Although Board members agree that arrangements like this constitute contracts (because the entity and the customer have agreed to terms that create obligations that are enforceable or otherwise recognizable at law), they do not think such contracts should trigger the proposed revenue recognition model. Instead, they would narrow the set of contracts that trigger this model.

52. In this view, the proposed revenue recognition model is triggered only if a customer is firmly committed to purchase the promised goods or services. A customer is firmly committed if the agreement includes a disincentive for nonperformance that is sufficiently large to make the customer's performance probable (or the unwinding of that performance improbable). If the customer has a right of return, the disincentive for nonperformance is not sufficiently large to make the customer's performance probable (or the unwinding of that

performance improbable). Similarly, if a customer can cancel an order before an entity has delivered, the customer is not firmly committed.

53. By focusing on a narrower set of contracts for revenue recognition purposes, supporters of this view are not suggesting that contracts without firmly committed customers have no value. Indeed, in recent standards on business combinations, the Boards acknowledge that such contracts are assets and require that they be measured at fair value. However, because of the difficulty of distinguishing between a customer relationship intangible asset and a contract asset (as discussed in paragraph 36), some Board members support an alternative view that would base *revenue recognition* only on contracts with firmly committed customers.

54. The implication of this alternative view is that contracts for goods with return rights do not trigger the revenue recognition model until the return period expires. As a result, any payment by a customer is treated as a deposit liability until the return period expires. At that point, the proposed revenue recognition model would be applied. This alternative view would be a significant departure from current practice wherein revenue is typically recognized before the expiration of a return period if the selling entity has sufficient historical evidence to suggest how many customers will return goods for a refund.

55. At this point, the Boards appear to favor a broader view of contracts, even though customers in such contracts can sometimes terminate or unwind the contract with little or no consequence. That is, most Board members think the proposed revenue recognition model should account for an agreement between an entity and a customer once the agreement creates any obligations that are enforceable or otherwise recognizable at law. In essence, the Boards favor a contract recognition principle such as the following:

> An entity recognizes a contract with a customer as an asset or liability when it becomes party to an agreement with a customer that creates obligations on the entity, the customer, or both that are enforceable or otherwise recognizable at law.

CONCLUSION

56. This chapter explains why the Boards decided to pursue a general revenue recognition model and why this model will focus on changes in assets and liabilities. This chapter also explains the Boards' decision to focus on a particular asset or liability—the contract between an entity and its customer. The chapter describes how a contract can be an asset or a liability, depending on the measure of the remaining rights and obligations in the contract. The chapter also describes how increases in a contract asset or decreases in a contract liability (or some combination of the two) lead to revenue recognition.

57. This chapter describes what the Boards mean by a contract, making the point that a contract is much broader than just a formal, written, legally binding agreement with signatures affixed. A contract is an agreement between two parties that create obligations that are enforceable or otherwise recognized at law. The revenue recognition model proposed in this paper is triggered when such a contract between an entity and a customer is created.

58. Finally, this chapter points out that revenue is recognized when a contract asset increases or a contract liability decreases. This means that revenue can be recognized at contract inception (if the measure of the rights exceeds the measure of the obligations) and is recognized subsequently as an entity provides the goods and services promised in the contract.

59. The next few chapters examine the key features of the proposed revenue recognition model. Chapter 3 examines more closely the entity's contractual obligations to a customer, which hereafter are referred to as performance obligations to distinguish these obligations from other obligations the entity may hold (such as debt obligations). If satisfaction of these performance obligations is the primary determinant of revenue recognition in this model, the model needs to be clear about what a performance obligation is and how to identify them in a contract.

60. Chapter 4 examines when a performance obligation is considered satisfied. If revenue is recognized when performance obligations are satisfied, the model

needs to be clear about the principle and indications that would suggest when a performance obligation is indeed satisfied. Finally, Chapter 5 examines how to measure the contract with the customer, focusing on how to measure the rights and performance obligations at initial contract recognition and throughout the remaining life of the contract.