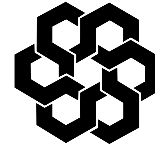

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International Accounting Standards Board

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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:	**January 2008, London**
Project:	**Revenue Recognition**
Subject:	**Examples - Customer Consideration model compared with existing practice (Agenda paper 2D)**

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1. This paper illustrates the Customer Consideration model compared with current practice using the following four examples:
   - A television sold with an extended warranty
   - A house painting arrangement
   - The purchase of a boat
   - A widget sold with a right of return.
2. The fact sets for these examples are identical to those presented at the November and December Boards as illustration of the Measurement model.

TELEVISION WITH AN EXTENDED WARRANTY

3. Consider the following facts and assumptions:

> On December 31, 2007, 20 customers purchase the same model of television from an electronics retailing entity (Retailer) for CU2,300 cash each. Retailer includes a one-year warranty with the sale of all its televisions, as required by consumer protection laws in the country in which Retailer operates. However, each of the customers also chooses to buy an extended two-year warranty (i.e. to increase the warranty period to a total of three years).

Retailer normally sells the television (inclusive of the statutory one-year warranty) for CU2,000 and the extended two-year warranty for CU400. As part of a year-end sale, however, it offers its customers the option of buying the television and extended warranty at the reduced price of CU2,300.

When a warranty claim arises, Retailer processes the claims and repairs or replaces the television itself. Its prior experience with this type of television suggests a 20 percent likelihood that a claim will be filed during the three years of warranty coverage. Hence, Retailer expects four claims to arise from these 20 contracts, with one of these claims being filed in Year 1, another in Year 2, and two of them in Year 3. Actual claims filed during 2008, 2009, and 2010 were one, two, and two, respectively. The total cost of servicing and administering each claim was CU400. All claims were serviced in the same year they were filed and processed.

Retailer incurs various costs for activities to obtain the contracts, including a direct sales commission of CU30 per extended warranty. Retailer also incurs costs in administering the warranties; however, these are not directly attributable to the contracts and are excluded from the illustration. The carrying amount of each television in Retailer's inventory immediately prior to sale was CU1,600.

To simplify the example, assume that the customers do not have the right to return the televisions and cannot cancel the warranties. The time value of money is ignored for simplicity. Retailer reports annually.

4. The staff chose this example for the following reasons:

- A warranty is a common feature of many contracts and accounting for warranties is often cited as an example of inconsistency in current revenue recognition guidance.

- A warranty contract is analogous to many other service contracts in that it features a continuous satisfaction of a performance obligation through continuous transfer of economic resources to the customer.

- Warranties are often long-term contracts and the circumstances surrounding the warranties can change substantially over the contract term. It is important to explore how the Customer Consideration model addresses these changes in circumstance.

Customer Consideration model

Period ended December 31, 2007

5. Under the Customer Consideration model, no contract asset or liability is recognised at inception because the measurement of the rights is equal to the amount allocated to the performance obligations. The amount of rights changes throughout the contract according to the contractual billing terms, but it is the satisfaction of the performance obligations that gives rise to revenue.

6. The television and both warranties represent potential performance obligations because they are goods and services capable of separate delivery or benefit to the customer. The total customer consideration amount is allocated among these performance obligations based on their relative selling prices at contract inception.

7. The observable standard prices at contract inception are CU2,000 for the television (inclusive of the statutory warranty) and CU400 for the extended warranty. Because the statutory warranty is not priced separately, Retailer uses its own estimate to determine that CU25 of the television's CU2,000 selling price was for the statutory warranty. That is, CU25 is the entity's best estimate of a standalone selling price for the statutory warranty. This estimate would be built up by projecting future cash flows and adjusting them for the margins required by the entity. The CU100 discount is then allocated to each performance obligation according to their relative prices as follows (rounded to the nearest whole dollar):

	Base Price	Weighted Average Discount	Allocated Consideration
Television	1,975	(82)	1,893
Statutory warranty coverage	25	(1)	24
Extended warranty coverage	400	(17)	383
Total	2,400	(100)	2,300

8. Once the performance obligations are identified and the total customer consideration is allocated to them, revenue is then recognised as each obligation is satisfied. For the television, the obligation is satisfied upon delivery to the customer when the rights and benefits associated with the television transfer. The statutory warranty obligation is satisfied over the first year and the extended warranty obligation is satisfied over the following two years.

9. Revenue is not necessarily recognised on a straight-line basis for the warranties, however, because the customer consideration may be allocated differently to each increment of time to better approximate the selling price of each increment based on its relative risk and cost. In other words, the standalone selling price (whether observed or estimated) of each economic resource transferred to the customer in each reporting period is used to allocate the customer consideration to that reporting period. The stand alone selling price underlying this allocation is likely to be estimated by Retailer using the expected pattern of performance expenses based on the entity's warranty coverage history.

Period ended December 31, 2007

10. During the year ended December 31, 2007, Retailer recognises the cash consideration received from the customers (CU46,000). This total amount is allocated to each performance obligation. Based on this allocation, CU37,860 (CU1,893 per television × 20 televisions) is allocated to the obligation to deliver the television, CU480 (CU24 × 20) to the statutory warranty, and CU7,660 (CU383 × 20) to the extended warranty.

	Dr	Cr
Dr Cash	46,000	
Cr Contract liability – televisions		37,860
Cr Contract liability – statutory warranty		480
Cr Contract liability – extended warranty		7,660

11. At December 31, 2007, Retailer has fulfilled its obligation to deliver the television and recognises revenue in the amount of consideration originally allocated to that obligation.

	Dr	Cr
Dr Contract liability – televisions	37,860	
Cr Revenue		37,860

12. In practice, the entries shown in paragraphs 10 and 11 are likely to be combined into a single entry. The entries are shown separately here to illustrate the process of identifying the relevant rights and obligations in an arrangement and allocating the customer consideration to the performance obligations.

13. Retailer also derecognises the television inventory when the televisions are delivered to its customers.

	Dr	Cr
Dr Cost of sales (expense)	32,000	
Cr Inventory		32,000

14. Finally, Retailer recognises the direct selling costs incurred of CU30 per warranty.

	Dr	Cr
Dr Selling expenses	600	
Cr Cash		600

Period ended December 31, 2008

15. In the period ended December 31, 2008, Retailer satisfies the statutory warranty obligation which gives rise to revenue in the amount of customer consideration allocated to that obligation at contract inception.

	Dr	Cr
Dr Contract liability – statutory warranty	480	
Cr Revenue		480

16. During the period ended December 31, 2008, Retailer incurs direct and indirect costs of CU400 for servicing and administering one television under the statutory warranty. These costs are charged to warranty expenses as incurred.

	Dr	Cr
Dr Statutory warranties expense	400	
Cr Cash		400

Periods ended December 31, 2009 and 2010

17. In these periods, Retailer recognises extended warranty services revenue of CU2,553 and CU5,107 based on the satisfaction of the performance obligation to provide warranty coverage during these years. Retailer also incurs actual warranty expenses each year of CU800. The revenue amounts represent the satisfaction of the performance obligation as determined at contract inception by the allocation of customer consideration to each time period. In other words, the consideration allocated to the extended warranty was CU7,660, of which one third was recognised in Year 2 and two thirds in Year 3 (due to the original expectation of servicing one of the three additional warranty claims in Year 2 and the remaining two claims in Year 3).

18. Summarising the above journal entries results in the following:

	Inception	Year 1	Year 2	Year 3	Total
Revenue	37,860	480	2,553	5,107	46,000
Cost of sales	(32,000)	-	-	-	(32,000)
Warranty costs	-	(400)	(800)	(800)	(2,000)
Selling expenses	(600)	-	-	-	(600)
Margin	5,260	80	1,753	4,307	11,400
Cash	45,400	45,000	44,200	43,400	
Inventory	(32,000)	(32,000)	(32,000)	(32,000)	
Contract liability – Statutory warranties	480	-	-	-	
Contract liability – Extended warranties	7,660	7,660	5,107	-	
Retained earnings	5,260	5,340	7,093	11,400	

Current practice (U.S. GAAP and IFRS)

19. The principles of revenue recognition under IFRS are similar to revenue recognition principles of U.S. GAAP and therefore often results in the same accounting treatment. However, significant differences in practice may arise for various reasons such as the fact that IFRS is generally not as prescriptive as U.S. GAAP. Differences may also arise in terms of the means by which the same outcome is achieved. The objective of this paper is not to explore these differences between U.S. GAAP and IFRS but rather to illustrate the Customer Consideration model relative to the underlying principles of current practice. For this reason, these examples assume that the results are the same under U.S. GAAP and IFRS. All paragraphs in this paper under the *Current practice (U.S. GAAP and IFRS)* section should be read with this objective in mind.

20. Under current practice, revenue recognition is based largely on the criteria that revenue must be realised or realisable and earned (that is, the earnings process must be complete or substantially complete). Because the customer pays in advance for the television and warranty, the realisation criterion has been met. Revenue is then recognised as the earnings process is completed. Assessing completion of the earnings process, however, is complicated by the existence of multiple deliverables in the same arrangement.

21. Multiple deliverables in a single arrangement require an analysis to identify the unit (or units) of account. In this case, Retailer allocates the CU100 contract discount between the television (including the statutory warranty) and

the additional warranty. Current practice would likely use a relative fair value method to do this allocation.

22. When identifying the separable units of account, current practice looks for objective and reliable evidence of a standalone selling price in order to recognise revenue for each deliverable independently of the others.[1] In this case, the statutory warranty does not have an observable selling price on a standalone basis because it is never sold separately from the television. In other words, the statutory warranty is considered to be an integral part of the television and is not therefore accounted for separately. But the television and the additional warranty are priced and sold separately and are therefore treated as separate units of account. The standard selling prices of the television (CU2,000) and warranty (CU400) serve as the basis to determine revenue associated with each deliverable. Hence, the CU100 discount is applied to the deliverables of each contract as follows:

	Base Price	Weighted Average Discount	Allocated Consideration
Television (and statutory warranty)	2,000	(83.33)	1,917
Extended warranty coverage	400	(17.67)	383
Total	2,400	(100)	2,300

23. Based on the above allocation and the relevant guidance for each deliverable, revenue for the television and statutory warranty is recognised once the television is delivered to the customer while revenue for the warranty is recognised over the period in which the warranty coverage is provided. Warranty coverage revenue is recognised on a straight-line basis over the contract period except when sufficient historical evidence indicates that the costs of performing services under the contract are incurred on another basis. At the commencement of the warranty, Retailer expects to service one television under statutory warranty, one television in the first year of the extended warranty, and two televisions in the last year of the extended warranty. This expectation is based on previous experience with similar warranties on similar products. Revenue for the extended warranty would follow this expected pattern of claims servicing over only the last two years of the total warranty coverage period (i.e. one third of the *extended warranty* revenue in Year 2 and two thirds in Year 3).

Period ended December 31, 2007

24. During the period ended December 31, 2007, Retailer receives full payment of CU46,000 and delivers the televisions. Based on the allocation of contract consideration, television revenue of CU38,340 (CU1,917 × 20) is recognised along with deferred revenue of CU7,660 (CU383 × 20). This deferred revenue represents the realisation of customer consideration in excess of the revenue Retailer has earned.

	Dr	Cr
Dr Cash	46,000	
Cr Revenue		38,340
Cr Deferred revenue		7,660

[1] EITF Issue No. 00-21 addresses this topic under U.S. GAAP. IFRS does not have comparable literature dealing with revenue arrangements with multiple deliverables but does often follow similar principles when determining the unit of account.

25. At inception of the contract, Retailer recognises a liability for the statutory one-year warranty obligation. Suppose this amount is CU400.

	Dr	Cr
Dr Warranty expenses	400	
Cr Warranty liability - statutory		400

26. Retailer recognises cost of sales for the televisions delivered to the customers.

	Dr	Cr
Dr Cost of sales	32,000	
Cr Inventory		32,000

27. Retailer recognises the direct selling expenses incurred of CU30 per warranty. Assume these expenses are not eligible for deferral.

	Dr	Cr
Dr Selling expenses	600	
Cr Cash		600

Period ended December 31, 2008

28. In the period ended December 31, 2008, Retailer does not recognise any revenue because no revenue has been deemed to be earned. Retailer does, however, service one television under the statutory warranty and thereby extinguishes its liability that was set up at contract inception.

	Dr	Cr
Dr Warranty liability - statutory	400	
Cr Cash		400

Periods ended December 31, 2009 and 2010

29. During Years 2 and 3, Retailer recognises extended warranty services revenue of CU2,553 (one third of CU7,660) and CU5,107 (two thirds of CU7,660) and incurs warranty expenses of CU800 (CU400 × 2) and CU800 (CU400 × 2), respectively. The revenue amounts represent the amortisation (based on expected claims servicing) of the deferred revenue balance at inception. In other words, Retailer allocated consideration of CU7,660 to the extended warranties and had an expectation of servicing one television in Year 2 and two televisions in Year 3. One third of the revenue is therefore recognised in Year 2 with two thirds being recognised in Year 3.

30. Summarising the above journal entries results in the following:

	Inception	Year 1	Year 2	Year 3	Total
Revenue	38,340	-	2,553	5,107	46,000
Cost of sales	(32,000)	-	-	-	(32,000)
Warranty expenses	(400)	-	(800)	800)	(2,000)
Selling expenses	(600)	-	-	-	(600)
Margin	5,340	-	1,753	4,307	11,400
Cash	45,400	45,000	44,200	43,400	
Inventory	(32,000)	(32,000)	(32,000)	(32,000)	
Warranty liability – statutory	400	-	-	-	
Deferred revenue	7,660	7,660	5,107	-	
Retained earnings	5,340	5,340	7,093	11,400	

31. Comparing the table above in paragraph 30 to the table in paragraph 18 reveals a key difference between current practice and the Customer Consideration model. The Customer Consideration model treats the statutory warranty as a separate unit of accounting for revenue recognition whereas current practice

does not. This means that under current practise if only the expected costs of that warranty are accrued, then the entire margin from selling the television with the statutory warranty is recognised when the television is delivered to the customer although Retailer has not performed any of its warranty servicing obligations under the statutory warranty. The customer consideration model defers some of the revenue and margin, relating to the statutory warranty, into year one. In addition, the CU100 discount given to each customer for buying the television and the extended warranty together is therefore allocated across three performance obligations under the Customer Consideration model rather than two for current practice.

HOUSE PAINTING

32. Consider the following facts and assumptions:

> PainterCo is a contractor that provides painting services for commercial and private residences. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3,000. The price is inclusive of all paint, which PainterCo obtains at a cost of CU800. PainterCo's cost for labor and other painting materials is CU1,600. The customer is given the right to obtain its own paint, although the customer does not opt to do so in this example and instead purchases the paint and painting services jointly.
>
> All paint necessary to complete the contract is delivered to the customer's house on June 30. PainterCo renders the painting services continuously from July 1 through July 3. In accordance with the contract terms, the customer pays in full upon completion of the house painting.
>
> The time value of money is ignored for simplicity. PainterCo reports monthly.

33. The staff chose this example for the following reasons:

- Although it is a simple illustration, it is similar to construction-type contracts in that the entity provides materials and utilises those materials in the satisfaction of a subsequent obligation.
- This example highlights the relationship between satisfying obligations in a contract and the derecognition of assets that are transferred to a customer to satisfy those obligations.

Customer Consideration model

34. The Customer Consideration model recognises revenue when a performance obligation is satisfied by transferring goods or services to a customer. The contract contains two potential performance obligations—the promise to provide paint and to provide painting services. Both are capable of separate delivery to the customer. However, it is uncertain in this case whether the paint itself is delivered separately from the painting services. Although PainterCo physically delivers the paint to the customer, PainterCo will utilise the paint in the subsequent service and therefore substantially retains the risks

and rewards of ownership of the paint. For these reasons, paint is not treated as a performance obligation separate from painting services.

35. Note that the Customer Consideration model would not always preclude the recognition of revenue for the delivery of paint. If the contract (or operation of law) made it clear that the risks and rewards of paint ownership passed to the customer upon physical delivery of the paint, the Customer Consideration model would treat the delivery of paint as a separate performance obligation, the satisfaction of which would give rise to revenue.

Period ended June 30

36. At contract inception, PainterCo has the right to the customer's performance (measured at CU3000) and allocates this entire measurement to a single performance obligation. As discussed above, the paint is not considered a separate performance obligation, which is why the total consideration is assigned to the combined painting services obligation. PainterCo's net position in the contract is zero because the rights and obligations are equal.

37. PainterCo pays CU800 to obtain the paint that is recorded in inventory.

	Dr	Cr
Dr Inventory	800	
Cr Cash		800

Period ended July 31

38. During the reporting period ended July 31, PainterCo completes the house painting services and receives payment in full for those services. The payment of cash satisfies PainterCo's right to the customer's future performance and the completion of the painting service satisfies PainterCo's remaining performance obligation.

	Dr	Cr
Dr Cash	3,000	
Cr Revenue		3,000

39. PainterCo also recognises the costs of providing the painting service, including the cost of the paint sold.

	Dr	Cr
Dr Cost of sales (expense)	2,400	
Cr Cash		1,600
Cr Inventory		800

40. Summarising the above journal entries results in the following:

	Inception	June 30	July 31	Total
Revenue	-	-	3,000	3,000
Cost of sales	-	-	(2,400)	(2,400)
Margin	-	-	600	600
Cash	-	(800)	600	
Inventory	-	800	-	
Retained earnings	-	-	600	

Current practice (U.S. GAAP and IFRS)

41. Under current practice, the elements of this arrangement (that is, the paint and the painting services) are considered separate units of accounting because the *paint* can be sold separately (by PainterCo or by other suppliers) and PainterCo often sells the painting *service* separately. However, none of the arrangement consideration is allocated to the paint for revenue recognition because the payment terms of the contract suggest that payment for the paint is contingent on successful completion of the painting service.[2] Even if consideration was allocable to the paint, it is possible that revenue may not be recognised upon delivery because it is unclear whether PainterCo has relinquished significant risks and rewards of owning the paint (that is, it can be argued that PainterCo does not earn the related revenue at the time of delivery).

Reporting period ended June 30

42. Upon signing the contract, no revenue is recognised because it is not considered to have been earned and realised. In this case, revenue is earned as the painting services are rendered. No painting services were performed at contract inception; so revenue is not recognised.

43. During the reporting period ended June 30, the paint is delivered. But PainterCo does not recognise any revenue for this delivery because none of the contract consideration was originally allocated to this element of the arrangement. That is, revenue was determined to arise from the painting service and no painting services have been rendered at this point.

44. PainterCo records the following entry to reflect the costs of acquiring the paint and delivering it on June 30.

Dr Inventory	800	
Cr Cash		800

Reporting period ended July 31

45. PainterCo rendered the painting service during the month of July and also received payment in full from the customer. Because realisation has occurred and the earnings process is complete, the full amount of consideration received from the customer is recognised as revenue.

Dr Cash	3,000	
Cr Revenue		3,000

46. PainterCo also recognises the corresponding cost of sales.

Dr Cost of sales	2,400	
Cr Inventory		800
Cr Cash		1,600

[2] EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverable,* Example 10 and Paragraph 14

47. Summarising the above journal entries results in the following:

	Inception	June 30	July 31	Total
Revenue	-	-	3,000	3,000
Cost of sales	-	-	(2,400)	(2,400)
Margin	-	-	600	600
Cash	-	(800)	600	
Inventory	-	800	-	
Retained earnings	-	-	600	

BOAT

48. Consider the following facts and assumptions:

> On September 30, 2007, a customer contracts with a boat builder (Entity) for a boat to be delivered to the customer on April 1, 2008, for a fixed price of CU50,000. Under the terms of the contract, the customer is not obligated to pay Entity until delivery of the boat, at which point the title to the boat transfers to the customer. If the customer chooses to cancel the contract prior to delivery, payment must be made to Entity for any work completed up to that time.
>
> The boat is a standard design offered by Entity as well as other boat builders. However, Entity does not typically hold boats in inventory (that is, all boats are built to fulfill specific customer orders).
>
> Entity incurs direct contract acquisition costs of CU1,000. Entity also incurs other costs associated with obtaining the customer and the contract, but these costs are ignored in this example because they are not tied directly to the contract. Entity's expected and actual costs to build the boat are CU36,000, which consist of raw materials of CU20,000 and labor costs of CU16,000.
>
> The raw materials are all purchased on October 1, 2007. The labor costs are incurred, and the raw materials are consumed, evenly over the period October 1 to March 31. That is, the boat is 50 percent complete at December 31.
>
> The time value of money is ignored for simplicity and Entity reports quarterly.

49. The staff chose this example for the following reasons:

- This example is a construction type contracts in that the entity provides materials and utilises those materials in the satisfaction of a subsequent obligation. This scenario highlights the difficulty in identifying (for accounting purposes) whether a contract is for the delivery of a good or for a service.

- This example also highlights the relationship between satisfying obligations in a contract and the derecognition of assets as they are transferred to a customer to satisfy those obligations. This example differs from the paint example because the inventory is being built for the

customer on Entity's site (as opposed to the painting example that featured delivery of paint and painting services on the customer's site).

Customer Consideration model

50. Revenue arises when the contractual performance obligation is satisfied through a transfer of goods or services to the customer. In this case, a performance obligation arises for the construction and delivery of a boat. The contract must be reviewed to determine whether this particular contract is in the form of the delivery of a finished good, or is in the nature of a contract to provide boat constructing services. The boat as a good would not transfer to the customer until it is completed and delivered, whereas boat construction services may transfer to the customer continuously thereby satisfying the performance obligation continuously.

51. This contract states that Entity is entitled to payment if the customer cancels the contract prior to delivery of the boat. Proponents of the Customer Consideration model assume that this guaranteed compensation for the WIP indicates that the boat is essentially the customer's throughout the contract. Thus, Entity promises to provide a service on the customer's boat. That performance obligation is satisfied as the benefit of the service transfers to the customer (i.e. as the rights to the WIP continuously transfer to the customer).

Period ended September 30, 2007

52. At contract inception, Entity identifies and measures its rights and obligations under the contract. Entity has a right to the customer's future performance measured at CU50,000. Entity also has an obligation for boat construction services that is measured at the same amount as the consideration promised from the customer. The amount of rights and obligations are equal, so no contract asset or liability is recognised at inception

53. Entity also incurs direct contract acquisition expenses of CU1,000 that are expensed as incurred.

	Dr	Cr
Dr Contract acquisition expense	1,000	
Cr Cash		1,000

Period ended December 31, 2007

54. On October 1, 2007, Entity purchases all of the materials required to build the boat.

	Dr	Cr
Dr Inventory (raw materials)	20,000	
Cr Cash		20,000

55. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account

	Dr	Cr
Dr Boat (WIP)	18,000	
Cr Cash		8,000
Cr Inventory (raw materials)		10,000

56. Based on the work completed to date, Entity determines that half of the performance obligation has been satisfied by transferring ownership rights of the WIP to the customer. The total performance obligation was measured at CU50,000 at inception and this amount is not subsequently remeasured. The satisfaction of half this obligation is measured in the amount of CU25,000. This transfer thereby reduces the performance obligation for the same amount and generates revenue. Reducing the contract obligations while the rights remain unchanged gives rise to a contract asset.

	Dr	Cr
Dr Contract asset	25,000	
Cr Revenue		25,000

57. If the risks and rewards of ownership of the boat have transferred to the customer, then the WIP boat balance is derecognised.

	Dr	Cr
Dr Cost of sales (expense)	18,000	
Cr Boat (WIP)		18,000

Period ended March 31, 2008

58. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labor costs of CU8,000. These amounts increase the WIP boat inventory account.

	Dr	Cr
Dr Boat (WIP)	18,000	
Cr Cash		8,000
Cr Inventory (raw materials)		10,000

59. Based on the work completed to date, Entity also determines that the remaining CU25,000 of the performance obligation has been satisfied as ownership rights to the boat have transferred to the customer. This transfer of rights reduces the performance obligation and generates revenue.

	Dr	Cr
Dr Contract asset	25,000	
Cr Revenue		25,000

60. As the ownership rights to the boat have transferred to the customer, the remaining boat balance is derecognised.

	Dr	Cr
Dr Cost of sales (expense)	18,000	
Cr Boat (WIP)		18,000

Period ended June 30, 2008

61. Upon delivery of the boat, no entry is required to derecognise the boat because it has already been derecognised throughout the life of the contract (that is, the customer receives ownership rights as the boat is constructed). The satisfaction of the performance obligation, while the rights have remained unchanged, has given rise to a contract asset equal to the measurement of the rights at inception (CU50,000). The contract rights are satisfied on payment by the customer and the contract asset is derecognised.

	Dr	Cr
Dr Cash	50,000	
Cr Contract asset		50,000

62. Summarising the above journal entries results in the following:

	Inception	Dec 31	Mar 31	Jun 30	Total
Revenue	-	25,000	25,000	-	50,000
Cost of sales (expense)	-	(18,000)	(18,000)	-	(36,000)
Direct contract acquisition expense	(1,000)	-	-	-	(1,000)
Contract loss	-	-	-	-	-
Margin	(1,000)	7,000	7,000	-	13,000
Cash	(1,000)	(29,000)	(37,000)	13,000	
Inventory (raw materials)	-	10,000	-	-	
Boat (WIP)	-	-	-	-	
Contract asset	-	25,000	50,000	-	
Retained earnings	(1,000)	6,000	13,000	13,000	

Current practice (U.S. GAAP and IFRS)

63. Under U.S. GAAP, this contract qualifies for percentage-of-completion (POC) accounting under the AICPA's Statement of Position No. 81-1, which provides guidance for construction-type and other production-type contracts. Likewise, this contract qualifies as a construction contract under IFRS (IAS 11) that recognises revenue and expenses under the POC method.

64. The POC method results in the recognition of revenue (and related costs) as Entity performs under the contract and makes progress toward the completion of the contract. In this case, assume Entity uses an input method to determine progress toward completion. This method is based on costs incurred to date as a proportion of total costs expected to be incurred. This ratio yields the percentage of total revenue recognised during each reporting period.

Period ended September 30, 2007

65. At contract inception, Entity has not done any work under the contract and has not made any progress toward completion of the contract. In other words, Entity has not earned any revenue.

66. Entity incurs direct contract acquisition costs of CU1,000. Assume these costs are not included as inputs in the POC calculation because they are selling-related and do not relate to contract performance (see paragraph 50 of SOP 81-1 and paragraph 20 of IAS 11).

Dr Contract acquisition expense	1,000	
Cr Cash		1,000

Period ended December 31, 2007

67. On October 1, 2007, Entity purchases materials required to build the boat.

Dr Inventory (raw materials)	20,000	
Cr Cash		20,000

68. Entity begins constructing the boat during this period. In the process, Entity consumes half of the raw materials (CU10,000) while incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

Dr Cost of sales (boat-in-process)	18,000	
Cr Cash		8,000
Cr Inventory (raw materials)		10,000

69. The CU18,000 of costs directly assigned to the boat-in-process are included as the inputs to the POC calculation. In other words, CU18,000 of costs have been incurred relative to total expected costs of CU36,000. Based on these amounts, Entity has progressed 50 percent toward contract completion and should therefore recognise 50 percent of the total consideration as revenue.

Dr Accounts receivable (unbilled)	25,000	
Cr Revenue		25,000

Period ended March 31, 2008

70. Entity completes the construction of the boat, using the remainder of the raw materials (CU10,000) and incurring labour costs of CU8,000. Such amounts increase the cost of the boat-in-process.

Dr Cost of sales (boat-in-process)	18,000	
Cr Cash		8,000
Cr Inventory (raw materials)		10,000

71. Entity finishes the boat and therefore recognises the remaining 50% of the total contract consideration as revenue.

Dr Accounts receivable (unbilled)	25,000	
Cr Revenue		25,000

Period ended June 30, 2008

72. On April 1, Entity bills the customer and delivers the boat. The customer pays in full at which point Entity derecognises the outstanding receivable. For simplicity, this entry ignores the reclassification from unbilled to billed accounts receivable.

Dr Cash	50,000	
Cr Accounts receivable		50,000

73. Summarising the above journal entries results in the following:

	Inception	Dec 31	Mar 31	Jun 30	Total
Revenue	-	25,000	25,000	-	50,000
Cost of sales	-	(18,000)	(18,000)	-	(36,000)
Contract acquisition expense	(1,000)	-	-	-	(1,000)
Contract loss	-	-	-	-	-
Margin	(1,000)	7,000	7,000	-	13,000
Cash	(1,000)	(29,000)	(37,000)	13,000	
Inventory (raw materials)	-	10,000	-	-	
Accounts receivable	-	25,000	50,000	-	
Retained earnings	(1,000)	6,000	13,000	13,000	

WIDGET WITH RETURN RIGHT

74. Consider the following facts and assumptions:

> On December 31, 2007, Entity sells and delivers 100 widgets to 100 customers for CU10 each. These widgets were carried in Entity's inventory at CU8 each. The customers pay cash at the time of sale but the terms of the contract allow each customer to return the widget within one year for any reason and to receive a full refund of the consideration.
>
> At contract inception, Entity expects five of the 100 widgets sold to be returned. Any returned widget can be resold but only at a discounted price of CU5. The fair value of a returned widget is CU3.
>
> Assume five widgets were actually returned during the year.
>
> Entity reports annually.

Customer Consideration model

Period ended December 31, 2007

75. At inception of the 100 contracts, Entity obtains rights to the customers' consideration. These rights are measured at the amount of consideration expected to be retained. In this example, Entity expects to ultimately retain consideration of CU950 (CU1,000 - CU50) based on the expectation of 5 refunds. Hence, CU950 is allocated to the identified performance obligations.

76. The performance obligations giving rise to revenue in this example are the obligations to deliver widgets to the customers, net of those widgets expected to be returned. These performance obligations are satisfied on December 31, 2007 when the widgets are delivered to the customer, at which point Entity recognises revenue in the amount of the customer consideration (CU950) that was allocated to these performance obligations.

77. The CU50 (CU10 × 5) consideration that Entity receives but expects to refund to customers, is not allocated to a revenue-generating performance obligation because it represents a failed sale. In other words, this portion of the contracts is expected to be cancelled by the customer. This expected refund amount (CU50) is recorded as a refund liability.[3]

78. Based on the explanations above, the journal entry at this date is as follows:

	Dr	Cr
Dr Cash	1,000	
Cr Refund liability		50
Cr Revenue		950

[3] Differing views might exist on how to measure this refund liability. Consideration of these views, however, is outside the objective of this paper.

79. The widget inventory of CU800 is de-recognised when it transfers to the customers.

	Dr	Cr
Dr Cost of sales	800	
Cr Inventory		800

80. Retailer then adjusts the cost of sales for the value of the widgets expected to be returned (CU3 per unit X 5 units). (As an alternative, this entry could be combined with the entries above; and the goods to be returned amount of CU15 could be netted against the original refund liability of CU50.) However, discussion of these display alternatives is not within the scope of this paper.

	Dr	Cr
Dr Goods to be returned	15	
Cr Cost of sales		15

Period ended December 31, 2008

81. During the period ended December 31, 2008, Entity processes five widget returns, refunds the associated customer consideration (CU50), and receives the widgets into inventory at their reduced value (CU15). The refund liability (CU50) and goods to be returned of CU15 created at contract inception are thereby extinguished. The satisfaction of the refund liability does not give rise to revenue, however, because it was not identified as a revenue-generating performance obligation. Rather, the expected returns were treated as a failed sale at contract inception.

	Dr	Cr
Dr Refund liability	50	
Cr Cash		50

82. Retailer then records the receipt of the returned inventory at its diminished value of CU15 (CU3 X 5).

	Dr	Cr
Dr Inventory	15	
Cr Goods to be returned		15

83. Summarising the above journal entries results in the following:

	2007	2008	Total
Revenue	950	-	950
Cost of sales (expense)	(785)	-	(785)
Margin	165	-	165
Cash	1,000	950	
Goods to be returned	(15)		
Inventory	(800)	(785)	
Refund liability	50	-	
Retained earnings	165	165	

Current practice (U.S. GAAP and IFRS)

Period ended December 31, 2007

84. Under current practice, Entity recognises revenue upon delivery of the widgets if specific requirements are met.[4] One of these requirements states that Entity must be able to reasonably estimate the future returns and must recognise a liability at the time of sale for those expected returns. Entity is deemed to meet these requirements and therefore recognises revenue of CU1,000 (CU10 × 100) upon delivery of the widgets.

	Dr	Cr
Dr Cash	1,000	
Cr Revenue		1,000

85. Cost of sales of CU800 (CU8 × 100) is also recognised for the delivered widgets.

	Dr	Cr
Dr Cost of sales	800	
Cr Inventory		800

86. For the units expected to be returned, Entity then reduces revenue by CU50 (CU10 × 5) and recognises a liability. This liability is measured at CU7 per unit which is the CU10 expected refund less the CU3 fair value of the returned widget.[5] Hence the total liability is CU35 (CU7 × 5) and cost of sales is adjusted for the residual CU15 (CU50 - CU35).

	Dr	Cr
Dr Revenue	50	
Cr Refund liability		35
Cr Cost of sales		15

Period ended December 31, 2008

87. During the period ended December 31, 2008, Entity processes five widget returns, which satisfies the refund liability. Entity also records the returned widgets in inventory at their fair value and refunds the customers' cash. For simplicity, this example ignores product handling and other incremental administrative expenses that Entity may have incurred.

	Dr	Cr
Dr Refund liability	35	
Dr Inventory	15	
Cr Cash		50

[4] See FASB Statement No. 48 *Revenue Recognition When Right of Return Exists* and International Accounting Standard No. 18 *Revenue*.

[5] The staff acknowledges that differences in practice might exist between U.S. GAAP and IFRS (and possibly within one or the other) in terms of measuring this liability. For example, some entities might record the liability for the gross amount of consideration expected to be refunded (CU50) rather than the net amount of CU35 (CU50 – CU15) as done here in this example. However, analysis of these differences is outside the scope of this paper.

88. Summarising the above journal entries results in the following:

	2007	2008	Total
Revenue	950	-	950
Cost of sales (expense)	(785)	-	(785)
Margin	165	-	165
Cash	1,000	950	
Inventory	(800)	(785)	
Refund liability	35	-	
Retained earnings	165	165	