Project	**Revenue Recognition**
Topic	**Background: Summary of proposed revenue recognition model**

Introduction

1. This is a background paper that summarizes the boards' proposed revenue recognition model. The summary is based on tentative Board decisions and staff recommendations up to November 2009.

2. The proposed model applies to contracts with customers. **The objective when applying the proposed model is for an entity to recognise revenue to depict the transfer of goods and services to customers in an amount that reflects the consideration the entity receives in exchange for those goods and services.**

3. The paper is organised in accordance with the main steps to apply the model:

   (a) **Step 1—identify the contract with a customer** (paragraphs 4–10)

   (b) **Step 2—identify performance obligations in the contract** (paragraphs 11–21)

   (c) **Step 3—determine and allocate the transaction price** (paragraphs 22–38)

   (d) **Step 4—recognise revenue when performance obligations are satisfied** (paragraphs 39–45)

   (e) **Step 5—account for contract costs** (paragraphs 46–50)

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Step 1—identify the contract with a customer

4. The Boards have defined "contract" and "customer" as follows:

   (a) *Contract*—an agreement between two or more parties that creates enforceable rights and obligations.

   (b) *Customer*—a party that has contracted with an entity to obtain a good or a service that represents an output of the entity's ordinary activities.

5. A contract consists of an entity's rights to consideration from the customer and obligations to provide goods and services to the customer. The combination of those remaining rights and obligations in a contract gives rise to a net contract position.

6. A net contract position can be a contract asset or a contract liability depending on the relationship between the entity's and the customer's performance. A contract asset is the result of an entity performing (transferring goods and services) in advance of the customer paying for that performance. A contract liability is the result of a customer performing (paying consideration) in advance of the entity performing (transferring goods and services).

Combination of contracts

7. In most cases, a single contract gives rise to a single net contract position. However, in some cases, an entity's pattern of revenue recognition would vary depending on whether an entity combines two or more contracts.

8. An entity should combine two or more contracts, and account for them as a single net contract position, if the prices of those contracts are interdependent. An entity should consider various indicators and exercise judgment when determining whether prices are interdependent.

9. Typically, contracts with interdependent prices are contracts that:

   (a) are entered into at or near the same time with the same customer (or related parties),

(b) are negotiated as a package with a single commercial objective,

(c) constitute a single project with interrelated activities, products, services, costs, technologies, locations, etc., and

(d) are performed either concurrently or continuously.

Contract modifications

10. When an entity modifies an existing contract, the modification should be accounted for as a separate contract if it is priced independently of the original contract. If the prices are interdependent, an entity should account for the original contract and modification together, recognising the effect of the modification on a cumulative catch-up basis.

Step 2—identify performance obligations in the contract

11. An entity should identify the performance obligations in a contract. A performance obligation is a promise in a contract with a customer to transfer a good or a service to that customer. That promise can be explicit or implicit. Hence, an entity's past business practice can give rise to performance obligations even if a contract does not explicitly promise a particular good or service.

12. In some contracts, it is clear what the entity's performance obligations are. In other contracts, however, it can be difficult to identify performance obligations. To help entities identify performance obligations consistently, the Boards have made tentative decisions on the following:

    (a) Principal versus agent considerations,

    (b) Options to acquire additional goods and services, and

    (c) Licenses and rights to use.

Principal versus agent considerations

13. When other parties are involved in providing goods and services to an entity's customer, the entity must determine whether its performance obligation is to provide goods and services itself, or to arrange for another party to provide those goods and services. That affects whether the entity recognises revenue in the gross amount collected from the customer or the net amount the entity retains after compensating those other parties for their goods and services.

14. Factors to consider when determining whether the entity, or the other party, has the performance obligation to the customer for the good or service of the other party include:

    (a) Responsibility for fulfilment of the contract,

    (b) Inventory risk,

    (c) Discretion in establishing prices, and

    (d) Customer credit risk.

15. If an entity transfers a performance obligation to another party so that the entity is no longer obliged to provide the underlying good or service to the customer, the entity should not recognise revenue for that performance obligation.

Options to acquire additional goods and services

16. Entities sometimes grant a customer the option to acquire additional goods and services. Those options come in many forms including, but not limited to, sales incentives, discounts on future goods and services, and contract renewal options.

17. If an entity grants a customer the option to acquire additional goods and services, that promise gives rise to a performance obligation only if the option provides a material right to the customer that the customer would not receive without entering into that contract.

Licenses and rights to use

18. Entities sometimes grant licenses in contracts with customers. In general, licensing refers to an entity granting a customer the right to use, but not own, intellectual property of the entity. Licenses and rights to use come in many forms, including:

    (a) Software licenses

    (b) Franchises, such as the right to operate a business using a franchise name or right-to-use a franchise process

    (c) Rights to music, film, and video games.

19. In a contract in which an entity grants an *exclusive* license to a customer, the promised asset is the continuing access to the entity's intellectual property. That access is transferred continuously and, hence, represents a series of performance obligations that are satisfied over time.

20. In a contract in which an entity grants a *non-exclusive* license to a customer, the promised asset is the license and the promise to grant that license represents a single performance obligation that the entity satisfies when the customer is able to use and benefit from the license.

21. If a customer obtains control of the licensed intellectual property, the contract should be considered a sale, rather than a license or lease, of the intellectual property. That would be the case if the entity grants a customer the right to use its intellectual property for the duration of its economic life.

Step 3—determine and allocate the transaction price

Determining the transaction price

22. At contract inception, an entity should determine the amount of consideration to allocate to performance obligations—that amount is the transaction price. An entity should update the transaction price throughout the contract to reflect changes in the promised consideration.

23. In some contracts, the transaction price is readily determinable because the customer promises to pay a fixed amount of cash that is due when the entity transfers the promised goods and services. In other contracts, an entity should consider the effects of the following when determining the transaction price:

    (a) Uncertain consideration,

    (b) Time value of money, and

    (c) Noncash consideration.

Uncertain consideration

24. When the customer consideration is uncertain (variable) in amount, the transaction price at inception is the amount of the expected customer consideration, defined as the probability-weighted estimate of customer consideration. A probability weighted estimate of uncertain consideration requires an entity to assess the possible outcomes (i.e. consideration amounts) in a contract and estimate the probabilities of those outcomes.

25. The transaction price should be constrained only if the entity's estimated consideration amount lacks reliability. An estimate is reliable if an entity:[1]

    (a) has experience with identical or similar types of contracts, and

    (b) expects that circumstances surrounding those types of contracts will not change significantly.

26. If the entity has no experience of its own, it should refer to the experience of other entities in the same business. An entity should consider various factors when assessing whether circumstances surrounding a contract will change significantly. Those factors include the susceptibility of the consideration amount to external factors (e.g. volatility in the market, judgment of third parties) and the amount of time until the uncertainty is expected to be resolved.

[1] The guidance on when an estimated amount is "reliable" is discussed in Agenda Paper 3C/Memo 124C.

Time value of money

27. The transaction price should be adjusted for the time value of money whenever that effect is material. The entity should use the discount rate that would be reflected in a financing transaction between the entity and its customer that did not involve the provision of other goods and services. The entity should report the effect of financing separately from the revenue from other goods and services.

Noncash consideration

28. An entity should measure noncash consideration at fair value. If an entity cannot reliably estimate the fair value of noncash consideration, it should measure the consideration indirectly by reference to the selling price of the promised goods and services. An entity should recognise revenue for a nonmonetary exchange only if the contract has commercial substance and the purpose of the contract is not merely to facilitate a sale to another party.

Allocating the transaction price

29. At contract inception, an entity should allocate the transaction price to performance obligations in the contract relative to the standalone selling prices of the goods and services underlying those performance obligations (i.e. on a relative standalone selling price basis). The standalone selling price of a good or service is the price at which the entity would sell that good or service if it was sold separately at contract inception.

30. After contract inception, an entity should allocate any changes in the transaction price to the performance obligations. Amounts allocated to satisfied performance obligations should be recognised as revenue in the period during which the transaction price changes. An entity should reallocate the transaction price after contract inception if it receives additional information about the selling prices at contract inception of the promised goods and services. However, an entity should not reallocate the transaction price to reflect changes in standalone selling prices after contract inception.

Contract segmentation

31. A contract in effect comprises a single performance obligation if all the promised goods and services are transferred to the customer at the same time. In those contracts, an entity would allocate the transaction price to the single performance obligation.

32. In contrast, a contract has many performance obligations if the promised goods and services are transferred at different times. In some of those contracts (e.g. continuous-delivery contracts), it might not be practicable for an entity to allocate the transaction price to each performance obligation relative to the standalone selling price of each incremental good or service. In those cases, the entity should group performance obligations into contract segments for the purposes of allocating the transaction price.

33. A contract segment includes one or more performance obligations that have similar margins and similar patterns of transfer of goods and services. Therefore, if an entity does not have evidence of different margins for a good or service, the entity should combine the performance obligation for that good or service with other performance obligations until the entity has a group of performance obligations for which there is evidence of a margin.

34. The best evidence that goods and services have different margins is when the entity, or another entity, sells identical or similar goods and services separately.

Estimated selling prices

35. The best evidence of a standalone selling price is the observable price of a good or service when the entity actually sells that good or service separately. However, in some cases, standalone selling prices are not directly observable. In those cases, the entity should estimate standalone selling prices.

36. An entity can use various methods to estimate a standalone selling price of a promised good or service. Observable inputs should be maximised regardless of the estimation method. Suitable estimation methods include (but are not limited to):

(a) *expected cost plus a margin approach*—an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity would require for that good or service.

(b) *adjusted market assessment approach*—an entity could evaluate the market in which it regularly sells goods and services, and could estimate the price that customers in that market would be willing to pay for those goods and services. That approach might also include referring to quoted prices from the entity's competitors and adjusting them as necessary to reflect the entity's costs and margins.

37. When estimating a standalone selling price for a customer's option to acquire additional goods and services, that estimate should reflect the discount the customer would obtain when exercising the option, adjusted for the following:

(a) The discount that the customer could receive without exercising the option, and

(b) The likelihood that the option will be exercised.

38. With renewal and cancellation options, an entity could allocate the transaction price to the optional goods and services by reference to the goods and services expected to be provided and the corresponding expected consideration.

Step 4—recognise revenue when performance obligations are satisfied

39. An entity should recognise revenue only when it satisfies a performance obligation to the customer by transferring a promised good or service to the customer. The amount of revenue an entity should recognise is the amount of the transaction price allocated to the satisfied performance obligation.

Control and indicators of control

40. A good or a service is transferred (and an entity satisfies a performance obligation) when the customer obtains control of that good or service. Control of a good or a service is an entity's present ability to direct the use of and receive the benefit from that good or service. Management of an entity must

exercise judgment and consider various facts and circumstances when determining whether a customer has obtained control of an asset (whether a good or a service).

41. Indicators that the customer has obtained control include:

(a) The customer has an unconditional obligation to pay for the asset (and the payment is non-refundable).

In an exchange transaction, if a customer is unconditionally obliged to pay consideration (and that payment is non-refundable), typically that is because the customer has received a good or a service in exchange. Unconditional means that nothing other than the passage of time is required before the payment is due. Non-refundable means that the payment is not subject to refund depending on future performance.

(b) The customer has legal title to the asset.

Legal title often serves as evidence of which party has the ability to direct the use of and receive the benefit from an asset. That is, legal title often is the mechanism for giving an entity that ability. However, in some cases possession of legal title is a protective right and may not coincide with the transfer of control to a customer (e.g. cases in which a seller retains title of a product as protection against the customer's failure to pay for the product). Hence, in some cases a customer has the ability to direct the use of and receive the benefit from an asset, even if the seller has retained legal title.

(c) The customer can sell the asset to (or exchange the asset with) another party.

A benefit of having an asset is the ability to convert it to cash through a sale or the ability to convert it to another asset through exchange. If the customer presently has that benefit, that indicates the customer's control of the good or service. The ability to sell or exchange an asset does not necessarily require the existence of an active market for that asset.

(d) The customer can secure or settle debt with the asset.

A customer's ability to pledge an asset (e.g. as collateral to secure a loan) indicates that the customer has the benefit of the asset. Likewise, a customer's ability to transfer an asset to another party in settlement of the customer's debt indicates that the customer has the benefit of that asset because it reduces future cash outflows of the customer.

(e) The customer has physical possession of the asset or the practical ability to take physical possession of the asset.

In many cases, the customer's physical possession of an asset gives the customer the ability to direct the use of that asset. In some cases, however, physical possession does not coincide with control of the asset. For example, in many construction contracts, the contractor has physical possession of an asset but the customer owns the asset. Similarly, in some bill and hold arrangements, the entity has physical possession of a product that belongs to a customer. Conversely, in a consignment arrangement, an entity may have transferred physical possession of a good but clearly has the ability to direct the use of and receive the benefit from the good.

In many cases, if the customer has he practical ability to take possession of the asset, it is because the customer directs the use of and receives the benefit from that asset. That is, the customer can direct the asset to another use or can receive the benefit from that asset by selling it to another entity. However, sometimes that right of the customer is merely a protective right that provides the customer with protection against an entity that is not fulfilling its contractual obligations (e.g. a customer might have the right to take over an asset in the case of the selling entity's bankruptcy).

(f) The customer specifies the design or function of the asset.

If the customer specifies the design of an asset (i.e. the promised asset is customer-specific), that may indicate that control of the good or service has transferred (or is being transferred continuously) to the customer. A customer-specific design or function decreases the value of an asset to

the entity or any other customer. For instance, an entity might not be able to sell a customer-specific asset to another customer (or at least not for the same price). Therefore, to protect itself against an investment in a customer-specific asset, an entity likely would require that the customer obtain control of that asset as it is created (and pay for any work to date). A customer's ability to choose from a range of options specified by the entity typically would not be a customer-specific asset.

(g) The customer has continuing managerial involvement with the asset.

If a customer has ongoing managerial involvement with an asset throughout a contract, the customer is more likely to have the ability to direct the use of and receive the benefit from that asset. For example, in some manufacturing contracts, the customer is involved directly in the management and oversight of the manufacturing process. That involvement often results from the customer's interest in its asset that is being manufactured by the selling entity. Continuing involvement often coincides with a customer's ability to change the design and specifications of the asset.

42. An entity should consider the indicators of control in relation to the objective of determining whether the customer has obtained control of a promised good or service. None of the indicators are determinative on a standalone basis and some indicators may not be relevant to a particular contract (e.g. physical possession is irrelevant to a services contract).

Continuous delivery of goods and services

43. When goods and services in a contract segment are transferred at different times (or continuously), an entity must determine how much revenue to recognise as each performance obligation is satisfied.

44. An entity should select a method of measuring performance that best depicts the transfer of goods and services to the customer. Acceptable methods include methods based on units of output (e.g. units delivered), units of input (e.g. ratio of costs incurred to total costs expected to be incurred), or the passage of time.

45. An entity should select one method per segment and apply that method consistently throughout the contract and across segments with similar characteristics in other contracts.

Step 5—account for contract costs

46. An entity should expense all contract costs as incurred unless they are eligible for capitalisation in accordance with other standards (e.g. inventory, capitalised software, property, plant or equipment).

47. A contract segment is onerous if an entity's expected costs to satisfy the remaining performance obligations in the contract segment exceed the amount of the transaction price allocated to those performance obligations.

48. An entity should recognise a liability and a corresponding contract loss for an onerous contract segment in the amount by which the expected costs to satisfy the remaining performance obligations in that contract segment exceed the amount of the transaction price allocated to those performance obligations.

49. At each subsequent financial statement date, an entity should update the liability for the onerous segment (i.e. to the amount by which the expected costs to satisfy the remaining performance obligations in the contract segment at that date exceed the amount of the transaction price allocated to those performance obligations).

50. For purposes of the onerous test and remeasurement, an entity's expected costs include the costs are the direct or incremental costs, ie all costs that relate directly to the specific contract or that would not have been incurred without entering into the contract.