IASB Meeting | Agenda reference **5A**

Staff Paper | Date **September 2009**

Project **Revenue Recognition**

Topic **Control**

Introduction and purpose

1. This paper focuses on when an entity recognizes revenue in the proposed revenue recognition model. The Boards have proposed that an entity should recognize revenue only when it satisfies its performance obligations to a customer by transferring goods and services to the customer. An entity has transferred a good or a service when the customer, rather than the entity, owns the promised asset (whether a good or a service).

2. The Boards' existing definitions of an asset use "control" as the accounting tool for determining ownership of an asset for financial reporting purposes. Therefore, in the Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers*, the Boards proposed that an entity should recognize revenue when it has transferred control of a good or a service to the customer.

3. Respondents to the Discussion Paper generally accept control as the accounting tool for determining the transfer of goods and services. However, nearly all respondents requested that the Boards clarify what control of a good or a service is and how an entity would determine when control has transferred to the customer. Appendix A summarizes feedback on the topic of control from responses to the Discussion Paper.

4. Therefore, the purpose of this paper is to clarify control in the proposed model and to seek the Boards' tentative decisions on a definition of control and

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

indicators of when control of a promised asset (whether a good or a service) has transferred to a customer.

Summary of staff recommendations

5. This paper recommends that:

    (a) 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.

    (b) An entity should assess the transfer of control from the perspective of the customer.

    (c) Management of an entity must exercise judgment and consider all relevant facts and circumstances when determining whether a customer has obtained control of a promised asset (whether a good or a service). Indicators that the customer has obtained control of the promised asset include:

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

        (ii) The customer has legal title to the asset

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

        (iv) The customer has physical possession of the asset

        (v) The customer has the practical ability to take possession of the asset

        (vi) The customer specifies the design or function of the asset

        (vii) The customer has continuing managerial involvement with the asset

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

Structure of this paper

6. This paper is organized as follows:

   (a) What is control? (paragraphs 9–30)

      (i) Existing definitions of control

      (ii) Control versus derecognition of a financial asset

      (iii) Control and the Conceptual Framework

      (iv) A proposed definition of control

   (b) From whose perspective should control be assessed? (paragraphs 31–41)

      (i) Entity versus customer perspective

   (c) What are the indicators that the customer has obtained control of a good or a service? (paragraphs 42–50)

      (i) Role of risks and rewards when assessing control

      (ii) Proposed indicators of control

   (d) How do the proposed indicators apply to services and construction contracts? (paragraphs 53–63)

      (i) Evaluation of the proposed indicators for services contracts

      (ii) Construction and real estate contracts

7. This paper does not focus on the identification and measurement of performance obligations. However, the staff notes the importance of identifying performance obligations before determining when they are satisfied. This paper should be read in conjunction with Memo No. 5B, which contains several examples of how an entity might apply the recommendations of this paper to various transactions.

8. This paper also does not address the accounting for contracts in which an entity grants a customer the right to use an asset of the entity (e.g. leases, intellectual property, and software). The staff plans on further analyzing the nature of the

assets transferred in those contracts before asking the Boards to consider when the customer obtains control of those assets.

What is control?

Existing definitions of control

9. The term "control" is used frequently in contexts other than financial reporting. In an ordinary sense, control is:

> The power or authority to guide or manage. [Merriam-Webster's online dictionary]
>
> 1 The power to influence people's behaviour or the course of events. 2 the restriction of an activity or phenomenon. 3 a means of limiting or regulating something. [Oxford's online dictionary]

10. In the context of financial reporting, control similarly refers to a power or ability to guide, influence, or restrict. However, that power or ability is exercised over an economic resource such as a particular asset, group of assets, or an entity.

11. In the glossary of the FASB's Accounting Standards Codification, control of an entity is defined as:

> The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

12. The IASB defines control of an entity in IAS 27 *Consolidated and Separate Financial Statements*:

> Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [paragraph 4]

13. More recently, the IASB has proposed in the Exposure Draft *Consolidated Financial Statements* that a reporting entity is deemed to control another entity when the reporting entity:

> …has the power to direct the activities of that other entity to generate returns for the reporting entity. [paragraph 10]

14. Both the FASB's definition of control and the IASB's definition (and proposed definition) refer to control *of an entity* for purposes of consolidated financial statements. In fact, most existing guidance on control relates to control of an entity.

15. For revenue recognition, the Boards need to clarify control of a particular asset—i.e. an entity's promised good or service. Conceptually, it might be possible for an entity to assess control of another entity and control of a good or service using a single definition of control.[1] Practically, however, the staff thinks it is necessary to the proposed model for the Boards to define control of a good or a service.

Control versus derecognition of a financial asset

16. The Boards have considered control of an asset in their deliberations on the derecognition of financial assets. Arguably, the concept for an entity derecognizing a financial asset should be similar to that for an entity derecognizing a non-financial asset (i.e. transferring a good or a service).

17. The IASB's Exposure Draft *Derecognition* proposes the following guidance on the derecognition of financial assets:

> An entity shall derecognise the Asset if:
> (a) the contractual rights to the cash flows from the Asset expire;
> (b) the entity transfers the Asset and has no continuing involvement in it; or
> (c) the entity transfers the Asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the Asset for the transferee's own benefit. [paragraph 17A]

18. An important notion in that proposed guidance is the continuing involvement of the entity. If the entity has continuing involvement in the asset, it does not derecognize that asset. Applying that guidance to revenue recognition, the staff thinks that a product sold with a right of return might fail to meet the third criterion. The right of return (a put option) would result in the selling entity

[1] Paragraphs 51 – 62 of the Discussion Paper *Preliminary Views on the Conceptual Framework for Financial Reporting: The Reporting Entity* (issued May 2008) discuss the relationship between control of an entity and control of an asset.

having "continuing involvement" in the product after it is sold. That is because the right of return is at a fixed price rather than at the fair value of the product at the date of return. The right of return also could result in the customer being deemed to not have "the practical ability to transfer the asset" (product) for its own benefit. That is because the customer might not want to give up the benefit of the return right (put option) by transferring the product to another party without the return right. In other words, the right of return might economically constrain the customer from transferring the product in isolation. Hence, the product would not qualify for derecognition by the seller.

19. A strong minority of the IASB objected to the approach to derecognition of financial assets that is proposed in the Exposure Draft *Derecognition*. They prefer an approach that would focus on the transferor's contractual rights and obligations obtained in connection with a transfer. That approach would result in the derecognition of a transferred financial asset (or part thereof) if the transferor no longer has access to all of the economic benefits of the asset (or part) after the transfer. Applying that alternative approach to the sale of a product with a right of return, the staff thinks that the seller would derecognise the product and recognise the right of return as a contract liability (assuming the customer paid upon delivery of the product). That is because after the transfer, the customer has received all of the benefits of the product.

20. In the Revenue Recognition project, the Boards have not yet made a decision on how an entity would account for return rights. However, the Discussion Paper requested input from constituents on the topic. Responses to the Discussion Paper indicate strong support for derecognition of products when they are sold, provided an entity can reasonably estimate the returns (similar to existing standards and practice). If the Boards agree with those responses, some people might think there is an inconsistency between the Derecognition project and the Revenue Recognition project. That potential inconsistency appears to relate to instances in which an entity transfers an asset but retains risks related to that asset. Paragraphs 44–48 further discuss the role of risks and rewards when assessing control.

Control and the Conceptual Framework

21. The Boards also have deliberated control in their Conceptual Framework project. In that project, the Boards tentatively agreed to a working definition of an asset that omits reference to control. That definition is:

> An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.

22. One reason for omitting reference to control is that some users misinterpret the term control and think of it only in terms of control of an entity. Hence, when determining control of an asset, the Boards decided tentatively to focus instead on whether the entity has some "right or other access" to the economic resource.

23. Although the Boards use "right or other access" in the working definition of an asset, the staff thinks the Boards should use the term "control" in the Revenue Recognition project. One reason is that the Elements and Recognition phase of the Conceptual Framework project presently is not active. And once active, the working definition of an asset is subject to redeliberation.

24. Another reason is that the "right or other access" in the working definition of an asset seems broadly consistent with the notion of control of a good or a service. Both terms refer to the link between an entity and an economic resource. It is that linkage of an entity and an economic resource that makes the resource an asset of the entity.

25. Another part of the working definition of an asset is an "economic resource". In the context of revenue recognition, the economic resources transferred to customers typically are thought of as goods and services. Hence, in the proposed model, "goods and services" are referenced rather than economic resources.

A proposed definition of control

26. The proposed definition of control of an entity in the IASB's Exposure Draft *Consolidated Financial Statements* (paragraph 12) has two main components.

The first component is an entity's power or ability to direct and/or restrict (which the other definitions above also have). The second component is a potential economic benefit, or return, to the entity as a result of that power or ability.

27. The UK Accounting Standards Board's *Statement of Principles* also notes those two aspects of control in its description of control:

> Control has two aspects: the ability to deploy the economic resources involved and the ability to benefit (or to suffer) from their deployment. To have control, an entity must have both these abilities. [paragraph 2.8]

28. The staff agrees that for an entity to have control of an asset, the entity must have both of those abilities. Therefore, for purpose of revenue recognition, the staff recommends a definition of control that includes both of those components with regard to a particular good or service.

29. The staff recommends the following definition of control of a good or a 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.**

30. Consider the various components of that recommended definition:

    (a) *Present ability*: The staff thinks it is important for a definition of control to emphasize that a customer must *presently* have the ability to direct the use of and receive the benefit from a good or a service for the selling entity to recognize revenue. For example, in a contract in which a manufacturer produces an asset for a particular customer, it might be clear that the customer ultimately will have the ability to direct the use and benefit of the asset. However, the entity should not recognize revenue until the customer has that ability (which might occur during production or after, depending on the contract).

    (b) *To direct the use of*: The ability to direct the use of a good or a service refers to an entity's power to (a) deploy that asset in the entity's business activities, (b) allow another entity to deploy that asset in its

business activities, or (c) restrict other entities from deploying that asset.

The source of that power in the context of revenue recognition typically is an enforceable right as a consequence of a contract. The ability to direct the use of a good or a service implicitly includes the ability to restrict or limit another entity's ability to direct the use of that good or service.

Directing the use of a good typically involves using that good in a business process, consuming it, disposing of it, or storing it and preventing other entities from using it. Directing the use of a service might include specifying how and when that service is provided, and determining who receives the services.

(c) *To receive the benefit from*: For a customer to obtain control of a good or a service, the customer must have the ability to receive the economic benefit from that good or service. The economic benefit of a good or a service is a potential cash flow (either an increase in cash inflows or a decrease in cash outflows). An entity can obtain those benefits directly or indirectly in many ways such as by using, consuming, disposing of, selling, exchanging, pledging, or holding an asset.

Staff recommendation and question for the Boards

Question 1 The definition of control of a good or a service
Do the Boards agree that 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? If not, how should control of a good or a service be defined?

From whose perspective should control be assessed?

31. Because only one entity can control a particular good or service at a time, some might think that it doesn't matter from whose perspective control is assessed. That is, some might think that when a selling entity surrenders control of an asset, the seller's customer immediately obtains control of that asset. Although that may be the case conceptually, the staff thinks that the Boards should specify from whose perspective control should be assessed. The proposed definition of control (and indicators of control discussed later in this paper) could be applied from the perspective of either the entity selling the good or service, or the customer purchasing that good or service.

Entity versus customer perspective

32. Arguably, control should be assessed from the perspective of the reporting entity. If so, then the entity would focus on determining when it surrenders control of a good or a service, rather than on when the customer obtains control of that good or service. One reason for the entity perspective is that the performance obligation is *of the entity*; hence, the focus should be on when that obligation no longer exists for the entity.

33. However, other people might have concerns with the entity perspective and note that the performance obligation is *to the customer*. Hence, the performance obligation is not satisfied until the customer has what the customer contracted for.

34. Existing standards are not consistent on the perspective from which to assess the transfer of control. The IASB's proposed guidance on the derecognition of financial assets seems to focus generally on the entity perspective. Existing standards on revenue recognition often take the perspective of the customer (Appendix B summarizes some of those standards).

35. One reason for taking the customer's perspective when assessing the transfer of control is that it is more intuitive when accounting for services contracts. In

accordance with the FASB's Conceptual Framework, services cannot be stored and therefore are assets of an entity only momentarily—as the entity receives and uses them (CON 6, paragraph 31). IFRS 2 *Share-based Payment* similarly states that services are assets when *received*.

36. Therefore, the Discussion Paper used terminology that is consistent with the customer perspective:

> …a performance obligation is an entity's promise in a contract with a customer to transfer an asset to that customer. Hence, the satisfaction of a performance obligation depends on when the promised asset is transferred to the customer. *When the customer receives the asset*, the entity's obligation to transfer the asset no longer exists and, thus, is satisfied. [paragraph 4.4, emphasis added]

> …the customer has the promised asset when it controls the resource underlying that promised asset. Accordingly, to determine when a good is transferred to a customer, an entity assesses whether the customer controls the good so that the good is the *customer's* asset. [paragraph 4.5]

37. The Discussion Paper also discussed the role of customer intent when determining the satisfaction of performance obligations. In assessing control from the customer's perspective, it can sometimes appear that the customer's intended use of a good or service determines whether the customer controls that good or service. Customer intent is a factor to consider but it is not determinative when assessing control in the proposed model. Consider the following quote from the Discussion Paper:

> In the Boards' view, in assessing whether an asset has been transferred, an entity should focus on whether the customer controls the asset rather than on whether the customer can use that asset as intended. It is difficult, if not impossible, for an entity to know the customer's intent in any given contract. Hence, if the transfer of an asset is based on the customer's intent, then two otherwise similar contracts could result in different patterns of revenue recognition depending on what an entity presumes to be the intentions of each customer (thus impairing the comparability of revenue). [paragraph 4.26]

38. In many cases, an entity likely would reach the same conclusion whether focusing on the customer's obtaining of control or the seller's surrender of control. However, in some cases the entity might reach a different conclusion

depending on the perspective. In those cases, the staff thinks that taking the entity's perspective introduces risks that outweigh any conceptual advantages of that perspective.

39. The primary risk of taking the entity's perspective is the risk of confusing a transfer model (one that recognizes revenue on the basis of goods and services transferred to the customer) with an activities model (one that recognizes revenue on the basis of an entity's activities)[2]. An entity undertakes various activities to fulfil a contract. But not all of those activities transfer goods and services to the customer. To illustrate, consider the following:

Company A enters into a contract to provide services to a client. To fulfil that contract, Company A undertakes various activities including the assembling and training of a workforce, the procurement of materials, the mobilization of the workforce, and the provision of the promised services.

40. In this example, Company A's price will reflect the various activities that it needs to undertake to fulfil the contract. However, the customer does not necessarily receive services as Company A undertakes all of those activities. If control is assessed from the entity's perspective, Company A is more likely to conclude that it is providing services to the customer when it undertakes the activities that precede the provision of services. If Company A assesses control from the customer's perspective, it would be more likely to conclude that the client does not receive any services until the workforce provides the services. In other words, the entity's perspective might result in entities focusing on *what they do* rather than on *what they transfer* to the customer.

41. For the reasons discussed above, the staff thinks that in the proposed revenue recognition model, an entity should consider control from the perspective of the customer.

[2] See IASB Agenda Paper 14B from the joint FASB-IASB Board Meeting in July, 2009. The appendix to that paper highlights the consequences of an activities model.

Staff recommendation and question for the Boards

Question 2 The perspective when assessing control
Do the Boards agree that an entity should assess control of a good or a service from the perspective of the customer?

What are the indicators that the customer has obtained control of a good or a service?

42. Many respondents to the Discussion Paper recommended that the Boards provide indicators to accompany a definition of control. The staff agrees that indicators of control would help entities to apply the proposed model consistently.

43. Existing standards on revenue recognition contain various indicators of delivery (transfer of goods and services) for various industries and transactions. Many of those indicators relate to an assessment of the risks and rewards of ownership. Often, assessing the risks and rewards of ownership of an asset coincides with an assessment of control of that asset. Sometimes, however, those notions may conflict.

Role of risks and rewards when assessing control

44. In the Discussion Paper, the Boards noted that they think a focus on control, rather than risks and rewards, will result in more consistent decisions about when goods and services are transferred (paragraph 4.18). Many respondents to the Discussion Paper agreed with the Boards. However, some respondents thought that control is too legalistic and form-based. Other respondents thought that risks and rewards should be an indicator of control.

45. One concern with a risks and rewards approach to determining the transfer of goods and services is that it can result in different accounting for economically similar contracts. For example, to recognize revenue for the sale of goods, IAS 18 requires that an entity transfer to the buyer “the significant risks and rewards

of ownership of the goods". In practice, two entities might sell a similar product with a similar warranty. One entity might not recognize any revenue when the customer obtains control of the product because the entity concludes that it retains significant risks of ownership. In contrast, the other entity might recognize some revenue because it concludes that the remaining risks of ownership are not significant. A common challenge when applying a risks and rewards model is answering questions such as "how much risk is significant?"

46. Another concern with including risk-based indicators of control is that it might confuse the satisfaction of performance obligations with the identification of performance obligations. For example, consider the example of a retailer that sells a product with a right of return. Most people would agree that the customer walking out of the store with the product owns that product. However, the retailer still retains the risk that the product will be returned. Is that risk of return (including the risk of obsolescence) an indicator that the customer does not control the product? Or is it evidence of another performance obligation to the customer? Similar examples exist with performance and financial guarantees.

47. The staff thinks that the risks mentioned in the previous paragraph relate to another performance obligation (e.g. to provide an option or a guarantee) rather than an indicator that the entity has not satisfied a performance obligation (e.g. for the delivery of the product to which the guarantee or option relates).

48. Another concern with using risks to assess the transfer of control is the ability of entities to share risks. For example, the owner of an asset typically bears the risk of that asset being lost, damaged, or stolen. Therefore, in practice, the risk of loss often is considered an indicator of ownership of an asset. However, an assessment of risk of loss can be complicated by the existence of a third party (e.g. an insurance company) that bears some of those risks in exchange for a premium. Because risks can be diversified and shared more easily than ownership of a particular asset, the staff thinks that indicators of control that

refer to risk (e.g. risk of loss) are not particularly helpful when determining the transfer of control.

Proposed indicators of control

49. Many respondents to the Discussion Paper suggested indicators of control. The staff agrees with many respondents to the Discussion Paper that the proposed model needs indicators of when control of a good or service is transferred to the customer.

50. An entity must exercise judgment when considering indicators of whether a customer has obtained control of an asset. In exercising that judgment, an entity must consider the terms and conditions of the contract and all relevant facts and circumstances. Any indicators that accompany a definition of control must be considered only in the light of the principle of the proposed model—i.e. to determine whether a customer has obtained control of a promised asset.

51. As with any list of indicators, it can be difficult for an entity to determine the relative importance of each indicator. The staff acknowledges that difficulty but thinks the benefit of providing indicators of control in the light of a clear principle outweighs the difficulties of weighing those indicators.

52. The staff proposes the following indicators of when an entity has transferred control of a good or a service to a customer:

    (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. The Boards suggested such an indicator in the Discussion Paper:

> In the Boards' proposed model, customer payment does not determine when an entity would recognize revenue. However, in some cases, considering customer payment terms may help the entity to assess whether the customer has an asset. For instance, consider an entity's contract to build an asset for a customer. Over the life of the contract, the customer is obliged to pay for the partially completed asset and cannot recover that payment even if the entity fails to build the rest of the asset. In the absence of other indicators, the fact that the entity has a right to a nonrefundable payment from the customer may suggest that the customer controls the partially completed asset. Typically, a customer would not make a nonrecoverable payment without receiving an asset in exchange. [paragraphs 4.32–4.33]

(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 has 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.

(e) *The customer has the practical ability to take possession of the asset*—an indicator that an asset has transferred (or is being transferred continuously) is if the customer has the practical ability to take possession of the asset. In many cases, if the customer has that ability, 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.

(h) *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.

Staff recommendation and question for the Boards

Question 3 Indicators of control
Do the Boards agree that management of an entity must exercise judgment and consider all relevant facts and circumstances when determining whether a customer has obtained control of a promised asset (whether a good or a service)? If so, do the Boards agree to the following indicators? • The customer has an unconditional obligation to pay for the asset (and the payment is non-refundable) • The customer has legal title to the asset • The customer can sell the asset to (or exchange the asset with) another party • The customer has physical possession of the asset • The customer has the practical ability to take possession of the asset • The customer specifies the design or function of the asset

- The customer has continuing managerial involvement with the asset
- The customer can secure or settle debt with the asset.

How do the proposed indicators apply to services and construction contracts?

Evaluation of the proposed indicators for services contracts

53. Applying the proposed indicators to determine the transfer of a good might seem more intuitive than applying them to determine the transfer of a service. One reason for that is that the indicators refer to an *asset* (whether a good or a service) and for many people it is awkward to think of services as an asset if they are not recognized as an asset (or if the services do not enhance the value of a recognized asset). Nonetheless, services are assets when an entity receives and uses them (paragraph 35).

54. Because services are consumed once received, some of the proposed indicators are less relevant to services contracts. For example, it is difficult to imagine how a customer could sell, have the legal title to, or have the physical possession of a rendered service. Moreover, a customer cannot use a received service as collateral for a loan (unless the service created or increased the value of a recognized asset of the customer).

55. If some indicators are less relevant to a particular contract, that naturally increases the relevance of other indicators. Hence, when applying the proposed indicators to a services contract, the indicator regarding a customer's obligation to pay consideration becomes increasingly important. In the Discussion Paper, the Boards made that point:

> Considering customer payment terms may be particularly helpful in contracts for services when, in some cases, it can be difficult for an entity to determine whether the customer receives an asset over the life of the contract. [paragraph 4.34]

56. The other indicators that become increasingly relevant in a services contract are the extent to which the customer specifies the design or function of the service,

and the extent of the customer's managerial involvement in the service being provided.

Construction and real estate contracts

57. Many services contracts also include tangible products. In those contracts, an entity often can determine whether a customer has control of a service by determining whether the customer has control of the tangible product. For example, consider construction and real estate contracts.

58. Many responses to the Discussion Paper indicated that the proposed model might result in revenue recognition only upon the completion of long-term construction contracts. The staff thinks that the Boards' intention was not to require the completed contract method for all construction contracts. Rather, the Boards' intention was to emphasize that an entity would recognize revenue in the proposed model only when the customer receives promised goods and services.

59. Many respondents to the Discussion Paper indicated support for the guidance in IFRIC 15 *Agreements for the Construction of Real Estate* for determining when a customer continuously obtains control of a promised asset. The staff thinks that guidance is consistent with the indicators proposed in this paper—in particular, the customer's ability to specify the design or function of the asset.

60. The customer's ability to specify the design of an asset is an indicator in IFRIC 15 of when a contract meets the definition of a construction contract—and therefore is accounted for on a percentage of completion basis.

> An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability). [paragraph 11]

61. In some cases, the customer's ability to influence the design is limited. For example, the customer may have only the ability to select from a range of

options specified by the entity, or to specify minor variations to a design. In those cases, the agreement is accounted for as the sale of goods in accordance with IFRIC 15 paragraph 12.

62. The staff thinks that the proposed model is broadly consistent with that guidance of IFRIC 15. However, the principle of the proposed model arguably is clearer—it is to determine when the customer has received a promised asset rather than to determine whether a particular arrangement meets the definition of a construction contract.

63. With that clear principle, some long-term contracts that today are accounted for on a percentage of completion basis might not qualify for continuous revenue recognition in the proposed model. But that would occur only if the customer in those contracts does not continuously obtain control of goods or services.

Appendix A Feedback on the topic of control from responses to the Discussion Paper

A1. This appendix summarizes the feedback received from comment letters with respect to the notion of control. Control was the topic most often discussed in comment letters.

Respondents' reactions to the notion of control

Form of a contract

A2. Respondents' comments on the notion of control often focused on how they interpreted control as it was used in the Discussion Paper. Respondents often assumed that control of an asset is transferred to the customer when the customer receives legal title to, or physical possession of, the good or service. The following issues were raised with that interpretation of control:

(a) *Economic Form over Substance*—Respondents were concerned that the proposed model would account for transactions based on the form of a contract, rather than the economic substance of a contract. In accounting for the form of a contract, respondents were concerned that companies would be able to structure contracts to obtain particular accounting treatments and, hence, improperly manage the recognition of revenue.

(b) *Elimination of Risks and Rewards*—Respondents were concerned with the premature recognition of revenue in situations in which the risks and rewards of the assets remained with a party different from the party who had physical possession of those goods. Companies which determine the transfer of control based on physical possession (or legal title) of a good may have the opportunity to accelerate revenue in arrangements such as sale and repurchase agreements and consignment sales.

(c) *Jurisdictional Differences*—Respondents were concerned with how control would be applied in jurisdictions throughout the world. Respondents were concerned that a strict legal interpretation of control may result in different

accounting for similar transactions depending on the jurisdiction in which the transaction occurred. For example, a seller often retains legal title to a delivered good until the customer pays, in order to provide security against the promised payment; however, this does not preclude the customer from owning the asset.

Application to continuous-transfer contracts

A3. The majority of respondents thought that the model would provide less decision useful information for users of financial statements if the model permits recognition of revenue only upon completion of a long-term services contract. In particular, respondents were concerned about the application of the model to construction contracts.

A4. Respondents provided many reasons why they think goods and services are transferred continuously to the customer in a construction contract before legal title or physical possession is obtained by the customer. In particular, respondents iterated that the underlying asset in most construction contracts is unique and specified by a customer before and during a contract. Customer acceptance and transfer of legal title often is a mere formality.

A5. Respondents explained why they thought it is imperative for their businesses to retain the percentage of completion method, ie continuous revenue recognition in a construction contract. Most often, they noted that it is used for managerial decisions, and is well understood by auditors, users, sureties, and management.

A6. Respondents noted that if the accounting for long term construction contracts significantly changes, and revenue is recognized solely upon the transfer of legal title or physical possession of the constructed asset:

(a) Preparers would still use the percentage-of-completion method of accounting for internal record keeping, surety requirements, loan processing (the significant deferral of revenue would most likely affect loan covenants), and for providing useful information to users in the form of additional non-GAAP information in the financial statements.

(b) Accounting rules would drive business practices, as contractors may be less likely to take on long-term projects.

(c) Construction companies would be required to overhaul their accounting systems, both for financial reporting and for tax reporting purposes.

A7. Many respondents noted that in addition to long-term construction contracts, they were not sure how the proposed model would apply to and affect the accounting for other contracts, including long term maintenance, services, IT arrangements, auditing services, consulting services, legal services and software services.

The relationship between control and risks and rewards

A8. Many respondents interpreted control to mean the possession of legal title, or physical possession of the asset by the customer. Those respondents argued that an assessment of risks and rewards would more properly account for and depict the substance of a contract, rather than focusing on the form of the contract.

A9. Some respondents did not think that control was meant to only represent the passing of legal title or physical possession of an asset. Those respondents noted that the notion of risks and rewards is not necessarily inconsistent with the notion of control. They agreed with the Discussion Paper's view that control of an asset by the customer should determine when an asset has transferred to the customer. However, they thought that the transfer of risks and rewards of ownership could be used as an indicator to help determine when control has transferred.

Other issues

A10. Respondents requested that the notion of control in a revenue recognition standard be consistent with other standards and projects. Respondents also asked for clarification of how the use of control in the revenue recognition

model relates to the Boards' tentative decision to eliminate control from the definition of an asset in the conceptual framework project.

Respondent's recommendations to clarify the meaning of control

A11. Respondents suggest that the Boards provide further clarification of the meaning of control by (a) providing a clear definition of control, (b) providing a list of indicators to determine when control has transferred to the customer, or (c) a combination of (a) and (b).

Definition of control

A12. Many respondents recommend that the Boards provide a clear definition of control. Some thought the proposed model should state that transfer of control has occurred when the customer has the ability to pledge, assign, restrict access to or use of, or dispose of the asset. Others noted that they think the definition of control should be linked with the derecognition project and should state that a customer has control of an asset when the supplier derecognizes that asset.

A13. Consider the following quotes:

> We believe the Boards should develop the existing idea of a distinction between goods and services. That distinction should focus on those factors that determine whether an incomplete item is an asset of the seller (goods) or of the customer (services). We believe that this distinction can be drawn by focusing on whether, in substance, the item is a 'standard' item made by the seller (goods) or is bespoke by the customer (services). We note that IFRIC 15 already draws a similar distinction. [CL #110]

> The principle might state, for example, that control has transferred when the customer has the right to direct, use, or access at will the resource underlying the asset (whether a good or a service) so as to enjoy the economic benefits of that asset or preclude or limit its use by others. This principle should be accompanied by indicators of when control is transferred. [CL #68]

Indicators for when control as transferred

A14. Many respondents noted that the Boards should provide indicators of when control of a good or service has transferred to the customer.

> Additional guidance is required as to what are the indicators of control. We believe that transfer of legal ownership is (ordinarily) an indicator that control has passed, however it should not preclude earlier recognition of revenue if other strong indicators show that control has passed. [CL #50]

A15. Some respondents suggested indicators of when control has transferred such as:

(a) The customer has the ability to make substantial changes or modifications to the underlying asset before, during, or after construction of the asset.

(b) The customer has continuous oversight and actively monitors progress of the project.

(c) The underlying asset is highly customized to the customer.

(d) The customer has the right to reject the good until acceptable in their perspective.

(e) The customer has the right to terminate the contractor under certain conditions and take over the work-in-progress or engage another contractor to complete it.

(f) It is not practical or feasible to put the asset requested by the customer into use for another contract, or the supplier has no ability to scrap the work in process.

(g) The partially created asset is included on the books of the customer.

(h) If the customer breaches the contract, it is required by law to remedy the situation.

(i) The customer has the right to pledge the asset or restrict access to it.

(j) The customer has the right to dispose of or assign the asset.

(k) The customer possesses legal title to the asset.

(l) The customer bears the risk of loss associated with the asset.

(m) The customer has physical possession of all or part of the asset.

(n) The customer has the right to direct use or consume the asset as services are performed.

Appendix B Existing Standards on Control

Topic	U.S. GAAP	Control	IFRS	Control
Revenue (general)	ASC 605-10-S99 (SAB 104)	"Delivery" is one of four criteria for revenue recognition. A footnote on delivery states that revenue should not be recognized until the seller has substantially accomplished what it must do pursuant to the terms of the arrangement, which usually occurs upon delivery or performance of the services.	IAS 18	To recognize revenue for the sale of goods, an entity must have met various criteria, including: a. The significant risks and rewards of ownership must have transferred to the buyer. b. The entity does not retain continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold. For services, the transaction shall be recognized by reference to the stage of completion of the transaction at the end of the reporting period.
Transfer of title	ASC 605-10-S99 (SAB 104)	Delivery is not considered to have occurred until the customer has (1) taken title to and assumes ownership of the product (s) – typically upon shipment and (2) assumed the risks and rewards of ownership. Title transfer is generally a precursor to revenue recognition with the exception of (1) sales-type lease transactions covered by ASC 840. (2) certain transactions outside of the U.S. where title is retained for security interest purposes only.	IAS 18	In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. In other cases, the transfer of risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.
Bill and hold	ASC 605-10-S99	In order to recognize revenue when delivery has not occurred, criteria must be met (as well as all	IAS 18	Revenue is recognized when the buyer takes title provided:

	(SAB 104)	requirements for revenue recognition): a. Risks of ownership must have passed to the buyer. b. The customer has made a fixed commitment to purchase the goods. c. The buyer, not the seller, request that the transaction be on a bill and hold basis and has a substantial business purpose for a bill and hold basis. d. There is a reasonable, fixed schedule for delivery of the goods that is consistent with the buyer's business purpose. e. The seller has not retained any specific performance obligations such that the earning process is not complete. f. The ordered goods have been segregated from the seller's inventory and not used to fill other orders. g. The equipment [product] is complete and ready for shipment.		a. It is probable that delivery will be made. b. The item is on hand, identified and ready for delivery to the buyer at the time the sale is recognized. c. The buyer specifically acknowledges the delivery instructions. d. The usual payment terms apply. No revenue is recognized when there is only an intention to acquire or manufacture the goods in time for delivery.
Consignment sales	ASC 605-10-S99 (SAB 104)	Goods delivered to a consignee are not considered sales and do not qualify for revenue recognition because the seller retains the risks and rewards of ownership of the product and title usually does not pass to the consignee. Once substantial risk of loss, rewards of ownership, as well as control of the asset have transferred to the consignee, revenue recognition would then be appropriate assuming all other criteria for revenue recognition have been satisfied. Entities should consider various indicators to determine whether substantial risk of loss, rewards of ownership, as well as control of the asset have	IAS 18	Revenue is recognized by the shipper when the goods are sold by the recipient to a third party. For sales to intermediate parties such as distributors, dealers or others for resale, revenue is generally recognized when the risks and rewards of ownership have passed. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale.

		transferred.		
Layaway sales	ASC 605-10-S99 (SAB 104)	Recognition of revenue depends upon who retains the risk of ownership of the goods or service. In addition, factors must be considered such as if the seller has an enforceable right to the remainder of the purchase price (other than what was provided as an upfront deposit). The customer must have made a fixed commitment to purchase the goods.	IAS 18	Revenue from such sales is recognized when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognized when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.
Customer acceptance	ASC 605-10-S99 (SAB 104)	Customer acceptance provisions may be included in a contract to enforce a customer's rights to: a. Test the delivered product. b. Require the seller to perform additional services subsequent to delivery of an initial product or performance of an initial service (e. g., a seller is required to install or activate delivered equipment). c. Identify other work necessary to be done before accepting the product. The staff presumes that such contractual customer acceptance provisions are substantive, bargained-for terms of an arrangement. Generally, the seller should not recognize revenue until customer acceptance occurs or the acceptance	IAS 18	Revenue is normally recognized when the buyer accepts delivery, installation and inspection are complete. However, revenue is recognized immediately upon the buyer's acceptance of delivery when: a. The installation process is simple in nature or b. The inspection is performed only for purposes of final determination of contract prices.

<table>
<tr><td></td><td></td><td>provisions lapse.

Generally, customer acceptance should occur before the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.</td><td></td><td></td></tr>
<tr><td>Installation</td><td>ASC 605-10-S99 (SAB 104)</td><td>Generally, installation is considered a separate deliverable. In cases where installation is not considered a separate unit of accounting, revenue from the sale of the product would generally be recognized upon the completion of the installation.

Examples of indicators that installation is essential to the functionality of equipment include:
a. The installation involves significant changes to the features or capabilities of the equipment or building complex interfaces or connections;
b. The installation services are unavailable from other vendors.

Conversely, examples of indicators that installation is not essential to the functionality of the equipment include:
a. The equipment is a standard product;
b. Installation does not significantly alter the equipment's capabilities;
c. Other companies are available to perform the installation.</td><td>IAS 18</td><td>An entity may retain significant risks and rewards of ownership when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity.

Installation fees are recognized as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product, in which case they are recognized when the goods are sold.</td></tr>
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