Project	**Revenue recognition**
Topic	**Examples on control**

Purpose

1. This paper accompanies Agenda Paper 5A *Control* and illustrates how an entity would use the proposed definition and indicators of control to determine when a customer obtains control of a good or a service. This paper considers only the satisfaction of performance obligations, and not their measurement. Hence, the examples in this paper illustrate how an entity would determine when to recognize revenue in the proposed model.

2. The examples are intended to be illustrative of the proposed model and are not necessarily representative of any particular industry.

   Example 1: Transfer of legal title

   Example 2: Bill and hold

   Example 5: Consignment

   Example 3: Long-term construction

   Example 4: Consulting services

   Example 6: Principal vs. agent (gross vs. net)

Example 1: Transfer of legal title

3. Consider the following:

> **Scenario A**: On March 1, Company A enters into a contract to sell office furniture to Customer U for CU1,000. The shipping terms are FOB Shipping point (i.e. legal title to the furniture passes to Customer U at the point of shipment). Company A uses a third-party carrier to deliver the furniture. The carrier bears the risk of loss while the furniture is in transit. If the furniture is lost or damaged while in transit, Customer U must deal directly with the carrier. The customer is invoiced upon shipment and payment is due within 30 days. There is no warranty or right of return.
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> **Scenario B**: Assume the same fact pattern as above, except that Company A's policy and past business practice is to bear the risk of loss of a good while in transit. If a good is damaged or lost while in transit, Company A will provide the customer with a replacement good at no additional cost. (Company A has determined that its policy and past business practice have implicitly created an enforceable obligation.)
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> **Under scenarios A and B above, when has the customer obtained control of the office furniture?**

Scenario A analysis

4. Company A has a performance obligation to provide Customer U with office furniture. Company A also has an obligation to arrange for shipment of the office furniture.

5. At the point of shipment, the customer obtains control of the office furniture and also receives the benefit of Company A arranging for shipment of the furniture.

6. Although at the point of shipment Customer U does not have physical possession of the furniture, it has legal title and therefore can sell the furniture to (or exchange it with) another party. At that time, Customer U can secure or settle debt with the furniture. Moreover, Customer U has an unconditional obligation to pay Company A for that furniture regardless of whether the furniture is damaged or lost while in transit. That is, nothing other than the passage of time makes that payment due.

7. Hence, Company A has no outstanding performance obligations to Customer U at the point of shipment and recognizes CU1,000 revenue at that point.

Scenario B analysis

8. Similar to Scenario A, Company A has a performance obligation to provide Customer U with office furniture and to arrange for shipment of the furniture. In contrast to Scenario A, however, Company A has determined that its policy and past practice have created a performance obligation to cover the risk of loss during transit.

9. The additional performance obligation for risk coverage does not affect when Customer U obtains control of the furniture. However, it does result in Customer U receiving a service from Company A while the furniture is in transit. Hence, Company A has not satisfied all of its performance obligations at the point of shipment and would not recognize all of the CU1,000 as revenue at that point. Some revenue would be recognized as it covers the risk of loss during transit. (The question of whether the remaining performance obligation is material enough to be accounted for separately is an issue not addressed in this paper.)

Example 2: Bill and hold

10. Consider the following:

> On April 1, Company B enters into a contract to sell a printing press to Customer V. Customer V does not have enough physical space at its warehouse to store the printing press. Therefore, Customer V requests that Company B store the press until a specified date when Company B will deliver it. Customer V has the right to request delivery at an earlier date if warehouse space becomes available.
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> On April 2, Company B segregates the printing press at its warehouse and invoices Customer V with payment due within 30 days. The invoice associates a specific printing press with Customer V (Company B cannot direct that press to another customer after that point). Legal title passes to Customer V upon payment.
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> **When has the customer obtained control of the printing press?**

Analysis

11. Customer V has the ability to direct the use of and receive the benefit from the printing press at the time of invoicing. After invoicing, Customer V has the ability to take possession of the press at any time and Company B cannot direct the press to any other customer. The physical segregation of an asset does not necessarily indicate that a customer obtains control of it. In this example, the identification of the specific printing press on the invoice gives the customer the ability to preclude Company B from selling that press to other customers.

12. Customer V also has managerial involvement because it determines where and for how long the printing press is stored. Although Customer V does not have legal title (and cannot secure debt on it), Company B's retention of title is a protective right—i.e. it protects Company B from the risk of non-payment. Possession of legal title by Company B does not give it the ability to direct the use and receive the benefit from the press. In addition, Customer V could sell the press to another party.

13. Company B would recognize revenue for the press on April 2. It then has remaining performance obligations to store and deliver the printing press and would recognize revenue subsequently when it satisfies those obligations.

Example 3: Consignment

14. Consider the following:

> Company E is a watch manufacturer. On February 1, it enters into a contract with wholesale Customer Z to deliver watches on a consignment basis. Under the terms of the contract, Customer Z promises to market the products to other parties (end customers) in exchange for a fixed commission from Company E for any watches sold. Title to the watches passes to Customer Z only when the watches are sold to end customers. Company E determines the prices to the end customers.
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> On February 5, Company E delivers the watches to Customer Z but can take them back at any time (except for any that may have been sold to an end customer).
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> On each sale to an end customer, Customer Z is paid in full from the end customer and then passes that payment to Company E less a 3% commission.
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> **When, if ever, does Customer Z obtain control of the watches?**

Analysis

15. Upon delivery of the watches, Customer Z does not direct the use of and receive the benefit from the watches. Customer Z does not have an unconditional obligation to pay Company E until a sale has been made to an end customer. Although Customer Z has physical possession of the watches, it does not have legal title to them and cannot use them to secure or settle debt.

16. Customer Z does have some managerial involvement with the watches because it has some discretion in marketing the watches. Nevertheless, Customer Z does not have the ability to preclude Company E from taking back the watches. Therefore, Customer Z does not obtain control of the watches upon their physical delivery.

17. Legal title to the watches passes momentarily to Customer Z upon the sale to an end customer. At that time, however, Customer Z is constrained in its ability to direct the use of and receive the benefit from the watches. For example, at the point of sale, Customer Z must direct the watches to a particular end customer (and is not able to direct them elsewhere). Customer Z does receive a commission for selling the watches; but that benefit is constrained by the prices determined by Company E. Hence, Customer Z does not ever obtain control of the watches. It only receives payment from Company E in exchange for providing marketing services to Company E. Company E would recognize revenue for the watches only when the end customers obtain control of the watches. At the same time, Customer Z would recognize its commission as revenue.

Example 4: Long-term construction contract

18. Consider the following:

> **Scenario A:** Company C is an engineering company. On January 1 it enters into a contract with Customer W to build highly customized engineering equipment to be delivered on December 31 by Company C for a fixed price of CU240,000. Non-refundable progress payments are made on a quarterly basis for work completed in the quarter.
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> The equipment is manufactured at Company C's facility. Because the equipment is customized, Customer W is involved in the design and in the manufacturing process. Customer W can negotiate with Company C and make changes to the equipment throughout the manufacturing process. Legal title to the equipment passes to Customer W upon delivery of the equipment. If the contract is terminated before manufacturing of the equipment is finished, Customer W retains the part-completed equipment and must pay Company C for any work completed to date.
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> **Scenario B**: On January 1 Company C enters into a contract with Customer W for engineering equipment to be delivered on December 31 by Company C for a fixed price of CU240,000. Payments on account of CU60,000 are made on a quarterly basis.
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> The equipment is manufactured at Company C's facility. It is of a standard design, and so Customer W does not have any ability to specify major aspects of the design of the equipment, but Company C typically manufactures the equipment only when it has a contract. Legal title to the equipment passes to Customer W upon delivery of the equipment. If Customer W cancels the contract before the equipment is delivered, Customer W compensates Company C for any loss of profit.
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> **Under scenarios A and B, when does the customer obtain control of the equipment?**

Scenario A analysis

19. Company C promises to provide Customer W with engineering services (and materials) together with delivery services. Customer W has the ability to direct the use of and receive the benefit from the equipment throughout the manufacturing process.

20. Customer W has an unconditional obligation to pay throughout the contract as evidenced by the required progress payments (with no refund of payment for any work performed to date). In addition, the customer specifies the design of the equipment and has continuing managerial involvement in the manufacturing process. Customer W also has the ability to take possession of the equipment during manufacturing and engage another company to complete the manufacturing. Therefore, it has limited Company C's ability to direct the use and receive the benefit of the equipment. Although Customer W does not obtain legal title of the equipment until delivery of the complete or part-complete equipment, Company's C retention of title is a protective right.

Scenario B analysis

21. Company C has a performance obligation to provide Customer W with engineering equipment. Customer W does not have the ability to direct the use of and receive the benefit from the equipment until final delivery of the equipment.

22. Customer W is not involved in the design of the equipment and does not have managerial involvement throughout the contract. Also, Customer W cannot take possession of the equipment until delivery. Although Customer W has unconditional obligations to make payments to Company C over the duration of the contract, those payments would be recoverable in full if Company C did not deliver the equipment. Hence Customer W does not have the ability to limit Company C's rights to the equipment and, therefore, does not direct the use of and receive the benefit from any work completed to date. Company C could sell the equipment to another customer if it was able to deliver the specified equipment to Customer W on December 31.

Example 5: Consulting services

23. Consider the following:

> Company D is a consulting company. On January 1, it enters into a contract with Client Y to analyze its history of sales trends in order to assist Client Y in developing its yearly budget for 2010 for a fixed fee of CU60,000. Company D will provide Client Y with a final report on June 30. The contract requires non-refundable progress payments of CU10,000 on a monthly basis. Client Y can change the specification of its requirements throughout the contract and has the ability to take over any analysis prepared by Company D.
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> **When does Client Y obtain control of the consulting services?**

Analysis

24. Client Y has the ability to direct the use of and receive the benefit from the consulting services as they are performed. Because the contract does not involve a tangible product, some of the proposed indicators are less relevant to this example. For example, it is not possible for Client Y to take legal title of the services, although Client Y does have the ability to take over any analysis prepared by Company D.

25. Hence, the payment terms and the client's involvement in the services become more relevant. Client Y has an unconditional obligation to pay Company D throughout the contract as evidenced by the non-refundable progress payments. In addition, Client Y specifies the services to be provided throughout the contract and hence has managerial involvement on a continuous basis throughout the contract—i.e. Client Y directs the nature of the services to be performed which affects Company D's final report.

Example 6: Principal vs. agent (gross vs. net)

26. Consider the following:

> Company F provides information technology services. It enters into a contract with a customer on January 1 and promises to upgrade the customer's hardware and then to provide support services for that hardware for three years. The customer selects the hardware from a range of options specified by Company F. The customer is obligated to pay Company F for the hardware within 30 days of its delivery. Company F has discretion over the prices it charges customers for third-party hardware.
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> The contract states that Company F will procure the hardware from a third-party vendor. Company F enters into a separate contract with the vendor and arranges for the hardware to be shipped directly to Company F's customer. Title to the hardware passes to Company F on shipment. After shipment, the third-party vendor is responsible only for any manufacturing defects.
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> **When, if ever, does Company F obtain control of the hardware?**

Analysis

27. 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 those goods and services itself, or to arrange for another party to provide those goods and services. That determination depends on whether the entity controls, at any point, the goods and services provided by the other party. Therefore, in this example Company F must determine whether it obtains control of the vendor's hardware.

28. Company F has an unconditional obligation to pay the third-party vendor for the hardware as soon as it is shipped from the vendor. Any payment made to the vendor is not recoverable, even if Company F's customer does not pay. Although Company F does not take physical possession of the hardware (because it is shipped directly to the customer), it does have legal title and the ability to sell or exchange the hardware. In fact, Company F could direct the hardware to another customer. Company F also has discretion over the price it

charges for the hardware and hence is not constrained in the benefit it can obtain from the hardware.

29. Therefore Company F directs the use of and receives the benefit from the hardware when it is shipped to the customer and, hence, has a performance obligation to provide the hardware itself, rather than to arrange for the vendor to provide the hardware.