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STAFF PAPER

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Project	**Revenue Recognition**		
Paper topic	Constraining the cumulative amount of revenue recognised – application of the requirements		
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Purpose of this paper

1. This paper considers possible improvements to the application of the proposals in the 2011 Exposure Draft *Revenue from Contracts with Customers* (the "2011 ED") for determining the circumstances in which an entity should constrain the cumulative amount of revenue recognised.

2. This paper should be read in conjunction with the cover note to this topic at Agenda Paper 7A/164A.

Staff recommendation

3. The staff recommend that the revenue standard should clarify the objective of the constraint in paragraph 81 of the 2011 ED. That objective should state that, when a performance obligation has been satisfied (or partially satisfied), but there is a reasonable expectation that the amount of revenue that the entity is ultimately entitled to for that satisfied performance obligation could be significantly less than the amount of the transaction price allocated to that performance obligation, an

entity should recognise revenue only up to the amount that the entity is confident will not be subject to significant revenue reversals. The staff think that objective will be achieved when the following criteria are met:

(a) the entity has relevant experience with similar types of performance obligations (or has other evidence, such as access to the experience of other entities) to be able to estimate the cumulative amount of revenue for a satisfied performance obligation; and

(b) based on its experience and/or evidence, the entity does not reasonably expect a significant reversal (ie downward adjustment) in the cumulative amount of revenue recognised for a satisfied (or partially satisfied) performance obligation.

4. The staff also recommend the Boards retain the indicators proposed in paragraph 82 of the 2011 ED (subject to minor drafting revisions) to assist the assessment of whether an amount of revenue should be constrained.

Structure of the paper

6. This paper is organised as follows:

(a) Background (paragraphs 7 – 10)

(b) Feedback since September 2012 (paragraphs 11 – 18)

(c) Improving the constraint (paragraphs 19 – 42)

(i) Clarifying the objective (paragraphs 20 – 26)

(ii) Applying the constraint – indicators or criteria? (paragraphs 27 – 42)

(d) Illustrative examples (paragraphs 43 – 65)

Background

7. The staff originally discussed possible improvements to the constraint on the cumulative amount of revenue recognised (paragraphs 81 – 84 of the 2011 ED) at the September 2012 meeting (refer to Agenda Paper 7A/162A). That paper provided a detailed summary of the feedback received on the constraint proposed in the 2011 ED. Additionally, a summary of user outreach is posted on the FASB website.[1]

8. In brief, preparers and auditors generally agreed with the 2011 ED proposals on how the constraint would be applied. However:

   (a) some respondents, including many users, had concerns that the guidance in the 2011 ED would allow entities to recognise as revenue variable consideration, which would then be subject to reversal in a future period. These users indicated that they would prefer a high degree of confidence by the entity before the entity recognises any portion of revenue related to variable consideration; and

   (b) some regulators were concerned that the constraint would not be applied consistently because:

      (i) the indicators in paragraph 82 of the 2011 ED appear to be discretionary and subject to significant management judgement; and

      (ii) paragraph 83 of the 2011 ED adds to the discretionary nature of the indicators because it states that the existence of any one of the indicators in paragraph 82 does not necessarily mean that the entity does not have predictive experience.

9. At the September 2012 Board meeting, the staff presented three options for addressing those concerns about the application of the constraint:

[1] See the Summary of User Feedback, available at www.fasb.org > Projects > Revenue Recognition

(a) *Option 1 – 2011 ED qualitative assessment:* Retain the qualitative assessment in the 2011 ED by reinforcing the principle in paragraph 81 of the 2011 ED and retaining the indicators in paragraph 82 of the 2011 ED.

(b) *Option 2 – determinative approach:* Amend the guidance in paragraph 82 of the 2011 ED to provide an objective and determinative methodology to ensure that revenue is not recognised when there is a reasonable possibility of an outcome that would result in a significantly different amount of consideration from that determined as the transaction price in Step 3.

(c) *Option 3 – confidence threshold*: Retain the 2011 ED indicators in paragraph 82 of the 2011 ED and introduce a threshold for the level of confidence an entity must have when assessing whether or not the entity's experience is predictive.

10. However, shortly before the September meeting, several constituents contacted the staff because they were concerned that some of the options outlined in that agenda paper for applying a constraint might result in a significant change to current practice and also a change in how they had previously understood and interpreted the 2011 ED proposals. In light of that feedback, the Boards discussed the application of the constraint in the revenue proposals and asked the staff to perform further analysis and bring the topic back to a future meeting.

Feedback since September 2012

11. Following the September meeting, the staff and some Board members consulted with the constituents who had raised concerns with the analysis in the September 2012 agenda paper. Those constituents were predominantly preparers representing industries that typically engage in long-term production and construction contracts (Aerospace & Defense and Engineering & Construction), and some preparers with long-term service arrangements.

12. The objective of the consultation with those constituents was to:

(a) explain the staff's views on the intended objective of the constraint and how the alternatives presented in the September agenda paper were intended to apply; and

(b) obtain feedback from preparers on their assessment of the extent of change to existing practice that might arise if any of those options were implemented.

13. The preparers commented that the staff's recommended objective for the constraint appeared to change the application of the constraint so that an entity would need to have predictive experience for the entire transaction price rather than the cumulative amount of revenue recognised. They stated that this would make it more difficult to recognise revenue, particularly in some long-term service contracts and construction contracts where there is often significant uncertainty about the ultimate amount of consideration to which the entity will be entitled (ie, the total transaction price), but less so on the cumulative revenue recognised at any point in time over the contract life. The staff did not intend to change this aspect of the constraint.

14. The preparers also explained that, in many construction and long-term service contracts, there are 'reasonably possible' outcomes that can be different from management's estimate of the transaction price, but that under current IFRSs and US GAAP (ie IAS 11 *Construction Contracts* and Topic 605-35) there is a presumed ability that management can estimate the transaction price in these types of contracts. (For instance, ASC paragraph 605-35-25-58 states that "the presumption is that [entities] have the ability to make estimates that are sufficiently dependable ...".)

15. The preparers were concerned that moving away from the indicator approach that was proposed in the 2011 ED would result in revenue recognition patterns that would not best depict the performance of an entity engaged in construction or long-term production contracts. Several examples were provided to help us understand their concerns. For example:

> An entity enters into a contract to construct a radar. The contract is structured with a fixed price of CU100M plus a performance incentive fee of CU50M related to early delivery if construction is completed by year 3. The entity estimates it will cost CU80M to complete the contract by year 4, however, the entity could elect to spend an additional CU30M (CU110M total) to accelerate the schedule to complete the contract by year 3 and earn the performance incentive fee. Costs to accelerate are due to working extra shifts and incurring increased supplier costs to ensure early delivery. The entity's best estimate is that it will achieve the incentive because it has previously met similar deadlines on similar contracts and it has the capacity to incur additional costs to allocate extra resources to accelerate the construction activity.
>
> The preparers consulted indicated that they thought in the above example:
>
> a) the 2011 ED would allow the entity to conclude that the constraint would not apply to the transaction price of CU150M; however
>
> b) the staff proposal for Option 2 or Option 3 in Agenda Paper 7A/162A would result in the constraint being applied resulting in the entity being able to recognise only CU100M.

16. The staff understand that those preparers interpreted that the determinative approach (Option 2 in Agenda Paper 7A/162A) would preclude revenue recognition for long-term contracts because there is always a reasonable possibility that the transaction price could be significantly different than the entity's estimate. In other words, those preparers had a different understanding of the term 'reasonable possibility' than the staff's intended meaning in Agenda Paper 7A/162A.

17. Some have questioned whether the constraint should serve as a recognition hurdle in instances where variable consideration is contingent on an underlying event that, when it occurs or is reached, the entity would have an unconditional right to consideration. For example, should the constraint preclude recognition of a bonus contingent on completing a project by a deadline until the project has been completed by the deadline? The model requires an entity to determine whether the underlying event is a promised good or service that is distinct (and therefore a separate performance obligation). Assuming the event is not a distinct good or

service, the variable consideration would be included in the transaction price that is allocated to the separate performance obligations in the contract, and the constraint would preclude revenue unless the entity has relevant experience relating to that variability and a significant revenue reversal is not expected. The entity would consider all of the indicators, including whether the event is outside of the entity's control, when making this determination. If the constraint was modified to consider whether the entity obtains unconditional rights to consideration, it would be a fundamental change to the transfer of control notion. The core principle of the model does not recognise revenue as the entity obtains unconditional rights to consideration, but as goods and services are transferred to the customer.

18. The staff spoke with constituents in the Engineering & Construction and Aerospace & Defense industries about this issue. In current practice, entities are not precluded from including a bonus in their total contract price (used in the percentage of completion calculation). However, they indicated that they would not include the bonus unless they were confident it would be achieved.

Improving the constraint

19. In the light of the concerns of the constituents who responded on the application of the constraint, this paper separately considers the following issues:

   (a) whether the revenue standard should specify an objective for the constraint; and

   (b) whether the revenue standard should specify indicators or criteria to determine if revenue should be constrained in accordance with the objective.

Clarifying the objective

20. In determining the transaction price, the 2011 ED proposes that an entity should use an estimation method that best predicts the consideration to which the entity

will be entitled in exchange for its goods or services. Depending on the circumstances, that method would be either an expected value or the most likely outcome. This measurement objective in determining a transaction price was a change from the 2010 ED because the Boards observed that users are most interested in knowing the amount of revenue that the entity will ultimately be entitled to in exchange for transferring the promised goods or services to the customer.

21. As previously noted in the September agenda paper on the constraint, the staff continues to think the constraint is an extension of the measurement objective for determining the transaction price. Although the use of estimates is commonplace in financial reporting, the importance placed on the revenue line by users of financial statements means that they typically want estimates that affect the amount of revenue that an entity can recognise to be based on a relatively high degree of certainty. Consequently, the staff thinks that the objective of the constraint should be to ensure that, when a performance obligation has been satisfied, but there is a reasonable expectation that the amount of revenue that the entity is ultimately entitled to for that satisfied performance obligation could be significantly less than the amount of the transaction price allocated to that performance obligation, an entity should recognise revenue only up to the amount that the entity is confident will not be subject to significant revenue reversals.

22. Based on the feedback received to date, the staff think that the objective for the constraint could be specifically mentioned in the revenue standard to clearly articulate the Boards' intent. Specifying an objective should address the apparent confusion on whether the constraint proposed in paragraph 81 of the 2011 ED is trying to ensure that:

    (a) the entity can make a quality estimate of the cumulative amount of revenue to recognise; or

    (b) the entity can make a quality estimate of the cumulative amount of revenue to recognise *and* the entity does not reasonably expect there to be a significant reversal of the revenue recognised based on its estimate.

23. The staff think that the objective of the constraint could be embedded in the proposed criteria in paragraph 81 of the 2011 ED. As a result, the revenue standard could state that, if the amount of consideration to which the entity expects to be entitled is variable, an entity would recognise an amount of variable consideration allocated to a satisfied performance obligation to the extent that both of the following criteria are met:

    (a) the entity has relevant experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities) to be able to estimate the cumulative amount of revenue for a satisfied performance obligation; and

    (b) based on its experience and/or evidence, the entity does not reasonably expect a significant reversal (ie downward adjustment) in the cumulative amount of revenue recognised for a satisfied (or partially satisfied) performance obligation.

24. Clarifying the objective of the constraint in this way should help address those requests that the application of the constraint be made more robust. The staff note that when dealing with estimates, there will always be a level of judgement that an entity will need to apply to determine the most appropriate accounting (as there is today under US GAAP and IFRSs for revenue recognition). Consequently, the staff think that providing a clear objective for an entity to follow when the application of judgment is required is the best method for ensuring consistent accounting.

25. Some entities, particularly those who currently apply IAS 11 or ASC 605-35, may view the above clarification as a change to current practice because it increases the level of confidence that an entity would need to achieve before amounts of variable consideration could be recognised as revenue. The staff think that the above clarification should not automatically result in those entities recognising revenue at a later point in time than under the current requirements – the existence and extent of any change to the amount and timing of revenue recognised would depend on the specific facts and circumstances, including the processes and

methodologies that those entities currently employ in determining if revenue should be recognised for variable consideration.

26. If the Boards do not agree with the staff recommendation that the objective of the constraint should be approved, the objective in the 2011 ED (paragraph 81) could be retained. If the Boards decide to retain the objective in the 2011 ED, the Boards could make the phrase "the entity does not reasonably expect a significant revenue reversal (ie downward adjustment) in the cumulative amount of revenue recognised for a satisfied (or partially satisfied) performance obligation" into an indicator.

Questions 1 and 2 for the Boards

1) Do the Boards agree that the objective of the constraint should be clarified?

2) If so, do the Boards agree that the objective of the constraint is as follows:

When a performance obligation has been satisfied (or partially satisfied) but there is a reasonable expectation that the amount of revenue that the entity is ultimately entitled to for that satisfied performance obligation could be significantly less than the amount of the transaction price allocated to that performance obligation, an entity should recognise revenue only up to the amount that the entity is confident will not be subject to significant revenue reversals. The objective will be achieved when the following criteria are met:

(a) the entity has relevant experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities) to be able to estimate the cumulative amount of revenue for a satisfied performance obligation; and

(b) based on its experience and/or evidence, the entity does not reasonably expect a significant reversal (ie, downward adjustment) in the cumulative amount of revenue recognized for a satisfied (or partially satisfied) performance obligation.

If not, do the Boards prefer paragraph 81 of the 2011 ED?

> If the Boards prefer paragraph 81 of the 2011 ED, do the Boards prefer adding the following indicator:
>
> The entity does not reasonably expect a significant revenue reversal (ie, downward adjustment) in the cumulative amount of revenue recognised for a satisfied (or partially satisfied) performance obligation.

Applying the constraint—indicators or criteria?

27. Having clarified the objective, the staff think that there are two options for the Boards' consideration for how an entity could meet the objective:

    (a) *Option 1 – Indicator approach:* Supplement the improved objective outlined above with the indicators that were proposed in paragraph 82 of the 2011 ED.

    (b) *Option 2 – Criteria approach:* Replace the indicators in paragraph 82 of the 2011 ED with a determinative methodology that would require an entity to assign probabilities to alternative possible outcomes or provide something of a similar nature.

28. As noted in paragraph 9(c) above, the September agenda paper also included a third option for applying the constraint. Because that option received little support from Board members at the September meeting, the staff have not considered that option further.

Option 1 - Indicator approach

29. After establishing the objective of the constraint, the guidance would go on to provide the indicators an entity should consider when assessing if the constraint should apply. The indicators that an entity should consider would be broadly the same as the indicators proposed in the 2011 ED, which were:

    (a) The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgement of third parties, weather conditions and a high risk of obsolescence of the promised good or service.

(b) The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

(c) The entity's experience (or other evidence) with similar types of performance obligations is limited.

(d) The contract has a large number and broad range of possible consideration amounts.

30. This approach acknowledges that any assessment of variable consideration would be subject to a degree of estimation judgement. Option 1 is consistent with many other areas of IFRSs and US GAAP whereby an entity is required to use judgement (often guided by a robust principle supplemented by factors to consider in applying the principle) in order to make and assess the quality of its estimates used in financial reporting.

31. Arguments in support of Option 1 (and therefore the 2011 ED indicators) are:

(a) it is principles-based with a clear objective and supporting indicators, which is consistent with other areas of IFRSs and GAAP (for example, the agent/principal assessment);

(b) many respondents (including auditors) did not raise concerns with the indicator approach in paragraph 82 of the 2011 ED and similar indicators to those proposed in paragraph 82 are currently used in US GAAP in estimating customer returns;

(c) some judgement is used today to recognise revenue associated with estimates of variable consideration—for instance, current guidance, including that of the US SEC, requires a qualitative assessment of some key thresholds, for example 'fixed or determinable', 'reasonably assured', and 'probable'; and

(d) although not required, an entity could prepare a quantitative analysis to support its conclusion that it does not reasonably expect a significant reversal of revenue.

32. Arguments against Option 1 are:

(a) some may still think that it does not address the issue raised by those constituents that requested the robustness of the constraint be enhanced to achieve consistent application. However, the staff note that revenue will require some level of estimation unless revenue is contingent on cash collections. The constraint is providing a framework for making those judgements; and

(b) some of the indicators may be redundant or even contradictory depending on the facts and circumstances. However, that concern could apply to most indicator-led assessments in financial reporting.

Option 2 – Criteria approach

33. After establishing the objective of the constraint, the revenue standard would prescribe how an entity determines if the objective of the constraint is met. Without prescribing the method that an entity should follow, an entity might apply different methods to determine if there was a reasonable expectation that the revenue recognised might be subject to significant reversals in the future. Option 2 attempts to reduce the possibility that different entities might reach different conclusions as to whether the constraint should apply by standardizing the way in which an entity would make that determination.

34. The indicators that were proposed in paragraph 82 of the 2011 ED would be replaced with a requirement (quantitative assessment) that an entity should be able to demonstrate the following in complying with the objective:

(a) it has experience (or similar information) that enables it to make an estimate, based on relevant information, of the amount to which it is entitled for the satisfied performance obligation;

(b) it has considered the probabilities of the other reasonably possible outcomes based on its relevant experience; and

(c) it has assessed the significance of the possible revenue reversal if one of those reasonably possible outcomes occurred.

35. In other words, if a regulator or auditor asked an entity to demonstrate how the entity concluded that it did not reasonably expect a significant reversal of the revenue recognised, the entity could provide a quantitative assessment (with probabilities and outcomes).

36. The arguments in support of Option 2 are:

    (a) the methodology that entities would use to determine if the constraint applied would be more prescriptive, and consequently the application of the constraint may be more robust; and

    (b) the constraint would be applied in a more consistent manner across different entities and industries .

37. The arguments against Option 2 are:

    (a) this option could be more complex and costly to apply than Option 1;

    (b) because the probabilities allocated to the other possible outcomes would still be based on management judgement, some may argue that this approach is no more robust than the approach under Option 1; and

    (c) there is a presumption under current US GAAP and IFRSs (ASC 605-35-25-58 and IAS 11 paragraph 29) that entities engaged in long-term production and construction contracts are able to make reasonable estimates and any uncertainty is taken into account in their determination of the transaction price. Option 2 could be perceived as adding another layer of restriction onto this process resulting in an unintended change to the current revenue recognition practices for these types of entities.

Comparison of the options

38. Both options require the entity to consider its experience with similar performance obligations (or other relevant information) to ensure that it can make an estimate that is based on relevant data.

39. Both options will require a level of management judgement and the use of estimates.

40. The key difference between the two options is that Option 1 allows the entity to consider all of the indicators in a qualitative manner to determine if revenue recognition meets the objective of the constraint, whereas Option 2 requires the entity to apply some form of quantitative approach in assessing whether revenue recognition would meet the objective of the constraint.

41. In considering the views from all constituents, the staff think that the key issue is to clarify the objective of the constraint, whereas the method in which an entity demonstrates how it has achieved the objective is less relevant. The staff think that although there are benefits in requiring entities to perform an assessment in a consistent manner (ie Option 2), this needs to be compared with the incremental costs of always requiring this level of analysis.

42. The staff does not think that the incremental benefit of requiring a prescribed approach, when that approach will itself be subject to a degree of subjectivity in determining the inputs, justifies the incremental cost. Consequently, the staff recommend Option 1—that is, that indicators should be used to assess whether the amount of revenue should be constrained.

Question 3 for the Boards
3) Do the Boards agree with the staff recommendation that, after specifying the objective of the constraint, an entity should consider the indicators in paragraph 82 of the 2011 ED when assessing if the constraint should apply?

Illustrative examples

43. This section of the paper illustrates how the staff think the proposals under Option 1 and Option 2 would be applied to some common fact patterns. It is important to note that although the staff does not think the answers are different under Option 1 compared to Option 2 for most of the examples, the process for determining if the constraint applies *is* different.

44. The examples are as follows:

    (a) Example 1 – construction contract with multiple incentives

(b) Example 2 – construction contract with relatively significant variable consideration

(c) Example 3 – right of return

(d) Example 4 – asset manager

Example 1 – construction contract with multiple incentives

45. An entity enters into a contract to deliver ABC radar. The contract price includes a fixed amount of CU100 plus three possible incentive fees for different aspects of the construction. The construction is expected to take two years to complete. The entity has constructed similar assets in the past and, based on its experience, its analysis of the possible contract outcomes is as follows:

			Possible outcomes			
	Amount	**Probability**	**Most likely**	**Expected value**	**Best case**	**Worst case**
Fixed fee	100	100%	100	100	100	100
Variable payment 1	10	90%	10	9	10	0
Variable payment 2	10	80%	10	8	10	0
Variable payment 3	10	70%	10	7	10	0
Total			130	124	130	100

46. Because of the interaction of multiple variable payments, the entity determines that the best depiction of the amount of consideration to which it is entitled is to estimate the transaction price using an expected value method. Accordingly, the entity determines the transaction price to be CU124.

Option 1 – indicator approach

47. The entity considers the indicators for whether it could reasonably expect a significant revenue reversal:

	Proposed indicator	Conclusion

A	The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions and a high risk of obsolescence of the promised good or service.	The entity does not think it is significantly exposed to factors outside its control. That conclusion is supported by the entity's experience with similar contracts.
B	The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.	Construction is expected to take two years during which time unexpected delays could occur which would affect the entity's ability to achieve the performance milestones to be entitled to the bonuses. However, the entity's experience with similar contracts suggests that it is unlikely that there will be significant delays.
C	The entity's experience (or other evidence) with similar types of performance obligations is limited.	The entity has constructed similar types of assets in the past.
D	The contract has a large number and broad range of possible consideration amounts.	The entity incorporates the possibility and significance of not achieving some of the bonuses into the way in which it determines the transaction price.

48. In considering the indicators and the objective of the constraint, the entity determines that the constraint does not apply to the cumulative amount of revenue that will be recognised based on the transaction price of CU124 because:

(a) the entity has relevant experience with similar types of performance obligations; and

(b) the experience indicates that the entity does not reasonably expect there to be a significant revenue reversal to the cumulative revenue recognised.

Option 2 – criteria approach:

49. The entity determines that the constraint does not apply to the cumulative amount of revenue that will be recognised based on the transaction price of CU124 because:

(a) the entity has relevant experience (because it has dealt with similar types of performance obligations in the past) that supports its estimate of the transaction price; and

(b) the entity does not reasonably expect a significant revenue reversal to occur based on its historical experience – in analysing the possible contractual outcomes, there is:

(i) a 0.6% chance of achieving none of the incentive bonuses which would result in a 19% reversal of the cumulative revenue recognised;

(ii) a 9% chance of achieving only one of the incentive bonuses resulting in a 11% reversal of the cumulative revenue recognised; and

(iii) a 40% chance of achieving two of the incentive bonuses resulting in a 3% reversal of the cumulative revenue recognised.

Example 2 – construction with relatively significant variable consideration

50. An entity enters into a CU500 fixed-price ‘turnkey’ contract to engineer, procure, and construct a gas-fired power plant. The contract specifies a minimum level of power output that the plant must be able to generate. If, upon completion, the plant is capable of generating more power than the specified minimum level, a

bonus payment of up to a maximum of CU100 will be payable. However, if the power plant does not meet the specified level of power output, the entity will have to pay the customer a penalty up to a maximum of CU100. The entity expects the construction to take two years.

51. The entity does not have previous experience in building power plants with a similar configuration or with procuring the main components needed in construction. However, the entity has extensive experience in the construction industry and has the expertise available to construct the power plant. The entity estimates the transaction price to be CU500 based on the most likely amount (with a range of CU400 – CU600).

52. The entity assessed the probabilities of the other possible consideration amounts as follows:

Outcome	Probability
CU400	20%
CU500	50%
CU600	30%

Option 1 – indicator approach

53. The entity considers the indicators for whether it could reasonably expect a significant revenue reversal:

	Proposed indicator	Conclusion
A	The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions and a high risk of	The entity is significantly exposed to factors outside its control, including the minimum power level output.

	obsolescence of the promised good or service.	
B	The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.	Construction is expected to take two years during which time unexpected delays could occur.
C	The entity's experience (or other evidence) with similar types of performance obligations is limited.	The entity has not constructed a similar power plant of the current configuration, but has extensive experience in construction.
D	The contract has a large number and broad range of possible consideration amounts.	The entity used the most likely amount when estimating the transaction price, but there are other outcomes (CU400 and CU600) that have a reasonably possible chance of occurring.

54. In considering the indicators and the objective of the constraint, the entity would need to apply its judgement to determine if the constraint applied to the cumulative amount of revenue recognised based on the transaction price of CU500. After an assessment of the indicators, an entity may conclude that the constraint is met to recognize CU500, but cannot recognize CU600. In making that determination, the entity looked to its experience with construction of power plants, while noting that other entities may use similar technology and subcomponent parts to achieve the minimum level of power output which may allow the entity to assess that a significant revenue reversal would not occur if recognizing CU500; however, based on its experience and the experience of others achieving the power output to recognize the additional CU100 (for a total of CU600) does not meet the constraint threshold. Alternatively, another entity might assess the indicators and think that only CU400 could be recognized as the entity's experience in construction coupled with other entities' experience in

constructing power plants does not achieve the constraint threshold. As the contract progresses, the entity would reassess the indicators to determine whether the constraint would continue to apply.

Option 2 –criteria approach

55. The entity determines that the constraint would apply to the cumulative amount of revenue that will be recognised based on the transaction price of CU500 because, although the entity has relevant experience in construction that enables it to make a quality estimate of the transaction price of CU500, there is a 20% probability of a significant revenue reversal to the cumulative revenue recognised. Similar to the analysis above, entities will use judgement to determine whether the potential revenue reversal is significant. As the contract progresses, the entity would need to reassess its estimate of the outcome where a penalty is required and reconsider whether the constraint should apply.

Example 3: right of return

56. An established men’s clothing retailer has a policy to accept returns of its product for 60 days from the original sale. The entity has been in the business of selling men’s clothing for several years and at any point in time has a large portfolio of homogenous contracts. The entity’s experience indicates that, as a long-term average, 15% of goods are returned. Historically, the variability around the 15% return rate has been low. Although men’s clothing styles change, the company has steadily increased sales without significantly changing its strategy. Consequently, the company determines that the most predictive transaction price is 85% of the amount received at the time of each sale with a refund liability for 15% of the amount received.

Option 1 – indicator approach

57. The entity considers the indicators for whether it could reasonably expect a significant revenue reversal:

	Proposed indicator	Conclusion
A	The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions and a high risk of obsolescence of the promised good or service.	The entity does not think it is significantly exposed to factors outside its control. That conclusion is supported by the entity's experience with similar contracts.
B	The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.	Returns are expected to be known within 60 days of the date of sale.
C	The entity's experience (or other evidence) with similar types of performance obligations is limited.	The entity has significant historical experience with product returns.
D	The contract has a large number and broad range of possible consideration amounts.	While on a single contract the range of outcome is significant, on a portfolio basis the variability in the outcome is not significant.

58. In considering the indicators and the objective of the constraint, the entity determines that the constraint does not apply to the transaction price of 85% of the consideration per sale because:

(a) the entity has relevant experience with similar types of performance obligations because it regularly sells clothing of the same type and has an average return rate of 15%; and

(b) the experience indicates that the entity does not reasonably expect there to be a significant revenue reversal to the cumulative revenue recognised.

Option 2 –criteria approach

59. The entity determines that the constraint would not apply. Therefore, the entity could recognise revenue based on the transaction price of 85% of the consideration received because:

(a) the entity has relevant experience with similar types of performance obligations because it regularly sells clothing of the same type and has an average return rate of 15%; and

(b) the experience indicates that the entity does not reasonably expect the cumulative revenue recognised to be subject to a significant reversal because, based on historical returns data for similar historical sales, the *level of variability* around the 15% return rate has been low. If the entity was asked to demonstrate how it overcame the constraint, it could produce the historical returns data to justify its assertion that the transaction price of 85% of the amount received was predictive of the ultimate amount of revenue to which it would be entitled.

Example 4: treasury management services

60. An entity enters into a contract with a client to provide treasury management services for two years. The entity receives a performance-based fee of 20% of the fund's return in excess of the return of an observable index at the end of the two year period.

Option 1 – indicator approach

61. The entity considers the indicators for whether it could reasonably expect a significant revenue reversal:

	Proposed indicator	Conclusion
A	The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors include volatility in a market, the judgment of third parties, weather conditions and a high risk of obsolescence of the promised good or service.	The consideration is highly susceptible to volatility in the market which is outside of the entity's control.
B	The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.	The amount of time until the uncertainties are resolved is two years.
C	The entity's experience (or other evidence) with similar types of performance obligations is limited.	The entity's previous experience with the market index is not indicative of the future performance of the market.
D	The contract has a large number and broad range of possible consideration amounts.	There is broad range of possible outcomes because the performance fee could fluctuate significantly over the life of the contract.

62. In considering the indicators and the objective of the constraint, the entity determines that the constraint applies and does not recognise the performance fee until the end of the two-year contract.

Option 2 –criteria approach

63. The entity does not have predictive experience (or similar information) that enables it to make an estimate, based on relevant information, of the amount to which it is entitled for the satisfied performance. The entity's previous experience with similar contracts is not relevant when considering the performance fee

because past experience of the market is no indication of future market performance.

64. Consequently, the entity would not recognise revenue for the performance fee until the end of the two year period.

65. The staff note feedback received from some asset managers and, as acknowledged in the cover memo, we are still analyzing those fact patterns and will assess the need to bring back any aspects of those contracts to a future board meeting.