

June 2010

Basis for Conclusions  
Exposure Draft ED/2010/6

# Revenue from Contracts with Customers

Comments to be received by 22 October 2010



International  
Accounting Standards  
Board®

**Basis for Conclusions on  
Exposure Draft  
REVENUE FROM CONTRACTS  
WITH CUSTOMERS**

*Comments to be received by 22 October 2010*

**ED/2010/6**

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Revenue from Contracts with Customers* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **22 October 2010**. Respondents are asked to send their comments electronically to the IASB website ([www.iasb.org](http://www.iasb.org)), using the 'Open to Comment' page.

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ISBN for this part: 978-1-907026-78-2

ISBN for complete publication (set of two parts): 978-1-907026-76-8

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REVENUE FROM CONTRACTS WITH CUSTOMERS

**Sales of assets that are not an output of an entity's  
ordinary activities**

**BC248–BC252**

## **Basis for Conclusions on the exposure draft *Revenue from Contracts with Customers***

*This Basis for Conclusions accompanies, but is not part of, the draft IFRS.*

### **Introduction**

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- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in developing the proposed requirements for revenue from contracts with customers, including the reasons for proposing particular approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC2 This Basis for Conclusions discusses the following matters:
- (a) background (paragraphs BC3–BC8);
  - (b) scope (paragraphs BC9–BC26);
  - (c) recognition of revenue (paragraphs BC27–BC75);
  - (d) measurement of revenue (paragraphs BC76–BC129);
  - (e) onerous performance obligations (paragraphs BC130–BC148);
  - (f) contract costs (paragraphs BC149–BC158);
  - (g) presentation (paragraphs BC159–BC166);
  - (h) disclosure (paragraphs BC167–BC185);
  - (i) application guidance (paragraphs BC186–BC230);
  - (j) transition (paragraphs BC231–BC235);
  - (k) effective date and early adoption (paragraphs BC236–BC238);
  - (l) costs and benefits (paragraphs BC239–BC247); and
  - (m) consequential amendments (paragraphs BC248–BC252).

## Background

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- BC3 The IASB and the FASB initiated a joint project to improve the financial reporting of revenue under International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP). The boards decided that their existing requirements on revenue were in need of improvement because:
- (a) US GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions; and
  - (b) the two main revenue standards in IFRSs have different principles and can be difficult to understand and apply to transactions beyond simple transactions. In addition, IFRSs have limited guidance on important topics such as revenue recognition for multiple-element arrangements.
- BC4 The boards decided to eliminate those inconsistencies and weaknesses by developing a single revenue recognition model that would apply to a wide range of industries. The boards concluded that this approach also would:
- (a) provide a more robust framework for addressing revenue recognition issues;
  - (b) improve comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets; and
  - (c) simplify the preparation of financial statements by reducing the number of requirements to which entities must refer.
- BC5 In December 2008, the boards published for public comment the discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers*. In that paper, the boards proposed the general principles of a contract-based revenue recognition model with a measurement approach based on an allocation of the transaction price. The boards received more than 200 comment letters in response.
- BC6 After publishing the discussion paper, the boards continued to develop the proposed model. In November and December 2009, the boards held workshops in London, Melbourne, Norwalk and Tokyo to discuss the proposals with preparers from a wide range of industries. Members and



staff of the boards have also been consulting users and preparers across a wide range of industries and jurisdictions around the world. Auditors and securities regulators have also been consulted throughout the development of the proposed requirements.

- BC7 Most respondents have expressed support for the boards' objective to improve the financial reporting of revenue. However, some respondents have questioned whether there is a need to replace existing standards on revenue recognition—in particular those requirements that seem to work reasonably well in practice and provide useful information about the different types of contracts for which they are intended.
- (a) For US GAAP, some question whether a new revenue recognition model is necessary because Accounting Standards Update No. 2009-13 *Multiple-Deliverable Revenue Arrangements* (ASU 2009-13) has resolved some of the issues that the revenue recognition project set out to resolve. Furthermore, the *FASB Accounting Standards Codification*<sup>TM</sup> (ASC) has simplified the process of accessing and researching existing requirements on revenue.
  - (b) For IFRSs, some believe that the IASB could improve its existing standards by developing additional requirements on critical issues (for example, multiple-element arrangements) without replacing existing standards.
- BC8 The boards acknowledge that it would be possible to improve many existing revenue recognition requirements without replacing them. However, the boards think that, even after the recent changes to US GAAP, the existing requirements in IFRSs and US GAAP would continue to result in inconsistent accounting for revenue and, consequently, would not provide a robust framework for addressing revenue recognition issues in the future. Furthermore, amending existing requirements would fail to achieve one of the goals of the revenue recognition project—to develop a common revenue standard for IFRSs and US GAAP that entities can apply consistently across industries, jurisdictions and capital markets. Because revenue is a crucial number to users of financial statements, the boards think that having a common standard on revenue for IFRSs and US GAAP is an important step towards achieving the goal of a single set of high quality global accounting standards.

## Scope (paragraphs 6 and 7)

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- BC9 Revenue, as defined in each of the boards' conceptual frameworks, includes revenue arising from contracts with customers and revenue arising from other transactions or events. The proposed requirements would apply only to a subset of revenue—revenue from contracts with customers. The boards had two reasons for developing a model that would apply only to contracts with customers. First, contracts to provide goods or services to customers are important economic phenomena and are the lifeblood of most entities. Secondly, most revenue recognition requirements in IFRSs and US GAAP focus on contracts with customers. Because the boards' objective is to develop a model that can replace most of the existing revenue requirements, that model needs to be at least as broad in scope as those requirements.
- BC10 Revenue that does not arise from a contract with a customer would not be affected by the proposed requirements. For example, in accordance with other standards, revenue would continue to be recognised from changes in the value of biological assets, investment properties and the inventory of commodity broker traders, and from dividends.
- BC11 Some respondents to the discussion paper asked the boards to clarify the existing definitions of revenue or develop a common definition of revenue. The boards decided that the definition of revenue is a matter for consideration in their joint Conceptual Framework project. However, the IASB decided to carry forward into its exposure draft the description of revenue from the IASB *Framework* rather than the definition of revenue from IAS 18 *Revenue*. The IASB noted that the IAS 18 definition refers to 'gross inflow of economic benefits' and the IASB had concerns that some may misread that reference as implying that an entity should recognise as revenue a prepayment from a customer for goods or services. As described in paragraphs BC27–BC34, revenue is recognised in accordance with the proposed requirements only as a result of an entity satisfying a performance obligation in a contract with a customer.

## Contracts and customers (Appendix A)

- BC12 The definitions of a *contract* and a *customer* establish the scope of the proposed requirements. The proposed requirements adopt the definitions of a contract and a customer that were proposed in the discussion paper. Respondents generally agreed with those definitions.

### Definition of a contract

- BC13 The definition of a contract is based on common legal definitions of a contract in the United States and is similar to the definition of a contract used in IAS 32 *Financial Instruments: Presentation*. Some respondents to the discussion paper suggested that the IASB should adopt a single definition of a contract for both IAS 32 and the proposed requirements. However, the IASB decided not to adopt the IAS 32 definition because that definition implies that contracts can include agreements that are not enforceable by law. Including such agreements would be inconsistent with the boards' proposal that an agreement must be enforceable by law for an entity to recognise the rights and obligations arising from that contract. The IASB also noted that amending the IAS 32 definition posed the risk of unintended consequences in accounting for financial instruments.
- BC14 The definition of a contract emphasises that a contract exists when an agreement between two or more parties creates enforceable obligations between those parties. The boards noted that such an agreement does not need to be in writing to be a contract. Whether the agreed terms are written, oral or evidenced otherwise, if the agreement creates obligations that are enforceable against the parties, it is a contract.
- BC15 Some respondents requested additional guidance to clarify the meaning of *enforceable rights and obligations* in the definition of a contract. The boards noted that whether a contractual right or obligation is enforceable is a question of law and the factors that determine enforceability may differ between jurisdictions. However, the boards decided to specify (in paragraph 10) the attributes of a contract that must be present before an entity would apply the proposed revenue requirements. Those attributes are derived mainly from existing requirements:
- (a) *The contract has commercial substance*—the boards first considered this attribute of a contract when discussing whether revenue should be recognised for non-monetary exchanges. Such transactions have been an area of financial reporting abuse in the past, with entities transferring goods or services back and forth to each other (often for little or no cash consideration), thereby artificially inflating their revenues. Therefore, the boards concluded that an entity should not recognise revenue from a non-monetary exchange if the exchange has no commercial substance. Because other types of contracts also could lack commercial substance, the boards decided that all contracts should have that attribute before revenue can be

## REVENUE FROM CONTRACTS WITH CUSTOMERS

recognised. The boards considered existing guidance on commercial substance when describing it in terms of an entity's expectation of future cash flows changing as a result of the contract.

- (b) *The parties to the contract have approved the contract and are committed to satisfying their respective obligations*—if the parties to a contract have not approved the contract, it is questionable whether the contract is enforceable. In addition, the boards thought this requirement would be useful when there is significant doubt about the collectibility of consideration from the customer. In some cases, that doubt indicates that the parties are not committed to the contract and that the entity does not have an enforceable right to consideration. If the entity does have an enforceable right, then uncertainty about the collectibility of consideration would generally be reflected in the measurement of revenue.
- (c) *The entity can identify each party's enforceable rights regarding the goods or services to be transferred*—the boards decided that an entity would not be able to assess the transfer of goods or services if the entity cannot identify each party's enforceable rights regarding those goods or services.
- (d) *The entity can identify the terms and manner of payment for those goods or services*—the boards decided that an entity would not be able to determine the transaction price if the entity cannot identify the terms and manner of payment in exchange for the promised goods or services.

### Definition of a customer

- BC16 The purpose of defining a customer is to distinguish a revenue contract within the scope of the proposed requirements from other contracts into which an entity enters. Some respondents asked the boards to clarify the meaning of *ordinary activities* in the definition of a customer. However, that notion was derived from the existing definitions of revenue. As noted in paragraph BC11, the boards are not reconsidering those definitions in the revenue project.
- BC17 When considering the definition of a customer, the boards observed that revenue could be recognised from transactions with partners or participants in a collaborative arrangement. Those arrangements would be within the scope of the proposed requirements only if the other party to the arrangement meets the definition of a customer. Some industry respondents asked the boards to clarify whether common types of

arrangements in their industries would meet the definition of a contract with a customer. However, the terms and conditions of a specific arrangement may determine the assessment of whether the parties to the arrangement have a supplier-customer relationship or some other relationship (for example, as collaborators or as partners). Therefore, the boards decided that it would not be possible to develop application guidance that would apply uniformly to various industries. An entity would need to consider all relevant facts and circumstances in assessing whether the counterparty meets the definition of a customer. Examples of arrangements in which an entity may need to make such an assessment include:

- (a) collaborative research and development efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defence industry; and
- (b) arrangements in the oil and gas industry in which partners in an offshore oil and gas field may make payments to each other to settle any differences between their proportionate entitlements to production volumes from the field during a reporting period.

### **Contracts outside the scope of the proposed requirements (paragraph 6)**

BC18 The boards decided to exclude from the scope of the proposed requirements three types of contracts with customers that the boards are addressing in other standard-setting projects:

- (a) leases;
- (b) insurance contracts; and
- (c) financial instruments and other contracts within the scope of the financial instruments standards.

That decision is consistent with the proposals in the discussion paper, which were supported by most respondents.

BC19 The FASB also decided to exclude from the scope of the proposed requirements guarantees (other than product warranties) that are within the scope of ASC Topic 460 on guarantees. The focus of the existing accounting requirements for those guarantee arrangements relates primarily to recognising and measuring a guarantee liability.

## REVENUE FROM CONTRACTS WITH CUSTOMERS

- BC20 Some respondents have reasoned that excluding some contracts with customers from the scope of the proposed requirements could perpetuate the development of industry-specific or transaction-specific revenue requirements, which would be inconsistent with the revenue recognition project's stated objective. The boards disagreed. The proposed requirements provide the boards with a framework for considering revenue issues in other standard-setting projects. Any departure from the proposed requirements in those projects would arise from a decision by the boards that a different basis of accounting for those contracts with customers would provide users of financial statements with more useful information.
- BC21 Many respondents expressed concerns with how the proposed revenue recognition model would apply to construction-type contracts and asked the boards to retain existing requirements for those contracts. After discussing those concerns with various preparers from the construction industry, the boards concluded that this response was in part attributable to a misperception that the proposed model would require completed contract accounting for all contracts currently within the scope of IAS 11 *Construction Contracts* or ASC Subtopic 605-35 on construction-type and production-type contracts. As discussed below, with the proposed requirements, the boards have clarified that not all construction contracts would result in an entity recognising revenue only at contract completion. The boards concluded that there were no reasons to apply a different revenue recognition model to construction contracts; revenue from a construction contract should be recognised as the entity transfers goods or services to the customer. Hence, the boards affirmed the proposal in the discussion paper that the proposed requirements would apply to construction contracts.

### **Contracts partially within the scope of other standards (paragraph 7)**

- BC22 Some contracts with customers would be partially within the scope of the proposed requirements and partially within the scope of other standards (for example, a lease with a distinct service). In those cases, the boards decided it would not be appropriate for an entity to account for the entire contract in accordance with one or the other standard. If that were possible, different accounting outcomes could result depending on whether the goods or services were sold on a stand-alone basis or together with other goods or services.

- BC23 The boards think that the proposed requirements should be the default approach for separating a contract and allocating consideration to each part. However, specific issues could arise in separating contracts that are not within the scope of the proposed requirements. For example, a financial instrument or an insurance contract might require an entity to provide services that are best accounted for in accordance with the standards on financial instruments or insurance contracts.
- BC24 Therefore, the boards decided that if other standards specify how to separate and/or initially measure parts of a contract, an entity should first apply those requirements. Under that approach, which is consistent with the guidance on multiple-element arrangements in ASC Subtopic 605-25, the more specific standard would take precedence in accounting for a component of a contract. The boards are not aware of any practice issues that would justify a departure from the approach in ASC Subtopic 605-25. The boards have simplified and condensed the requirements in ASC Subtopic 605-25 because the proposed requirements would replace some of the specific revenue recognition requirements in US GAAP (for example, for software and construction-type contracts) that otherwise would need to be considered when assessing scope.

### **Exchanges of products to facilitate a sale to another party (paragraph 6(e))**

- BC25 In industries with homogeneous products, it is common for entities in the same line of business to exchange products to facilitate sales to customers other than the parties to the exchange. An example is when an oil supplier swaps inventory with another oil supplier to reduce transport costs, meet immediate inventory needs or otherwise facilitate the sale of oil to the end customer. The boards noted that a party exchanging inventory with an entity would meet the boards' definition of a customer because it has contracted with the entity to obtain an output of the entity's ordinary activities. As a consequence, an entity might (in the absence of specific requirements) recognise revenue once for the exchange of inventory and then again for the sale of the inventory to the end customer. The boards concluded that outcome would be inappropriate because:
- (a) it would gross up revenues and expenses and make it difficult for users to assess the entity's performance and gross margins during the reporting period; and
  - (b) some view the counterparty in those arrangements as a supplier and not as a customer.

- BC26 The boards considered modifying the definition of a customer. However, they rejected that alternative because of concerns about unintended consequences. Therefore, the boards propose to exclude from the scope of the proposed requirements transactions involving non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange.

## **Recognition of revenue (paragraphs 8–33)**

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### **Contract-based revenue recognition principle**

- BC27 In the discussion paper, the boards proposed a principle to recognise revenue based on the accounting for the asset or liability arising from a contract with a customer. The boards concluded that focusing on the recognition and measurement of that asset or liability, and the changes in that asset or liability over the life of the contract, would bring discipline to the earnings process approach. Consequently, it would result in entities recognising revenue more consistently than when applying existing standards.
- BC28 On entering into a contract with a customer, an entity obtains rights to receive consideration from the customer and assumes obligations to transfer goods or services to the customer (performance obligations). The combination of those rights and performance obligations gives rise to an asset or liability depending on the relationship between the remaining rights and performance obligations. If the measure of the remaining rights exceeds the measure of the remaining performance obligations, the contract is an asset (a contract asset). Conversely, if the measure of the remaining performance obligations exceeds the measure of the remaining rights, the contract is a liability (a contract liability).
- BC29 By definition, revenue from a contract with a customer cannot be recognised until a contract exists. Revenue recognition could, in concept, arise at the point at which an entity enters into a contract with a customer. For an entity to recognise revenue at contract inception (ie before either party has performed), the measure of the entity's rights must exceed the measure of the entity's performance obligations. That would lead to revenue recognition because of an increase in a contract asset. However, as discussed in paragraphs BC76–BC78, the boards proposed in the discussion paper that performance obligations should be measured at the same amount as the rights in the contract, thereby precluding the recognition of a contract asset and revenue at contract inception.



- BC30 Hence, in the discussion paper, the boards proposed that revenue should be recognised only when an entity transfers a promised good or service to a customer, thereby satisfying a performance obligation in the contract. That transfer results in revenue recognition because on satisfying a performance obligation, an entity no longer has that obligation to provide the good or service. Consequently, its position in the contract increases—either its contract asset increases or its contract liability decreases—and that increase leads to revenue recognition.
- BC31 Although in concept revenue arises from an increase in a contract asset or a decrease in a contract liability, the boards have articulated the proposed requirements in terms of recognition and measurement of revenue rather than recognition and measurement of the contract. The boards thought that focusing on the timing and amount of revenue would simplify the articulation of the proposed requirements. Feedback from respondents to the discussion paper and others confirmed that view.
- BC32 Nearly all respondents to the discussion paper agreed with the boards' view that, in general, an entity should not recognise revenue in the absence of a contract with a customer. Once a contract exists, however, some respondents supported an activities model in which revenue would be recognised when the entity undertakes activities to fulfil a contract, regardless of whether those activities result in the transfer of goods or services to the customer (ie regardless of whether a performance obligation is satisfied). Those respondents reasoned that recognising revenue continuously throughout long-term construction or other service contracts, regardless of whether goods or services are transferred to the customer, would provide users of financial statements with more useful information.
- BC33 However, the boards noted the following concerns with an activities model:
- (a) Revenue recognition would not be based on accounting for the contract—in an activities model, revenue arises from increases in the entity's assets, such as inventory or work in progress, rather than from the contract. Therefore, conceptually, an activities model does not require a contract with a customer for revenue recognition, although revenue recognition could be deferred until a contract exists. However, that would result in revenue being recognised at contract inception for any activities completed to that point.
  - (b) It would be counter-intuitive to many users of financial statements—an entity would recognise consideration as revenue

when the customer has not received any promised goods or services in exchange.

- (c) There would be potential for abuse—an entity could accelerate revenue recognition by increasing its activities (for example, production of inventory) at the end of a reporting period.
- (d) It would result in a significant change to existing standards and practices—in many of those standards, revenue is recognised only when goods or services are transferred to the customer. For example, in IAS 18, revenue from the sale of a good is recognised when the entity has transferred the ownership of the good to the customer. The boards also observed that the principle of percentage of completion accounting in existing standards can also be consistent with the proposed revenue recognition principle in many cases. Paragraph 22 of AICPA Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (ASC Subtopic 605-35) states that the basis for percentage of completion is that ‘the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses’.

BC34 Accordingly, the boards did not develop an activities model and maintained their preliminary view that a contract-based revenue recognition principle would be the most appropriate principle for a general revenue recognition standard for contracts with customers.

### **Combination and segmentation of contracts (paragraphs 12–16)**

BC35 The discussion paper assumed that an entity would apply the requirements of the proposed revenue recognition model to a single contract with a customer. That assumption is appropriate in most cases. However, in subsequent discussion, the boards observed that the pattern of revenue recognition from a contract might vary depending on whether an entity applies the proposed requirements to a contract on a stand-alone basis, to a contract together with other contracts, or to separate parts of a single contract.

BC36 The boards considered the requirements in existing standards (for example, IAS 11, IAS 18, ASC Subtopic 605-25 and ASC Subtopic 605-35) on combining contracts and concluded that the criteria and terminology reflect a consistent underlying principle for combining

contracts: namely, an entity should combine two or more contracts and account for them as a single contract if their prices are interdependent. The boards decided to provide indicators of when contracts have interdependent prices. Those indicators are similar to those in existing standards.

- BC37 The principle for combining contracts has an implication for segmenting a contract: an entity should segment a single contract with a customer and account for it as two or more contracts if the prices of some goods or services to be transferred to the customer are independent of the prices of other goods or services.
- BC38 During consultations following publication of the discussion paper, some preparers of financial statements questioned the need for a contract segmentation principle in addition to the requirements for identifying separate performance obligations in a contract (discussed in paragraphs BC45–BC59). The boards decided that a segmentation principle was needed:
- (a) to simplify the assessment of scope—if some goods or services in the contract are priced independently and are within the scope of other standards, the contract segmentation principle would require an entity to segment the contract and account for each of the resulting identified contracts in accordance with the relevant standard; and
  - (b) to determine the promised goods or services to which an entity should allocate proportions of the transaction price—if a contract has a variable transaction price, the proposals require an entity to allocate changes in the transaction price to all performance obligations in the contract. If the prices of some goods or services are independent, an entity would account for the goods or services (and the corresponding transaction price) as a separate contract. Hence, the entity would not allocate changes in the transaction price of one bundle of performance obligations identified as a contract to another bundle of performance obligations identified as another contract.

### **Contract modifications (paragraphs 17–19)**

- BC39 When a contract is modified, an entity would be required to determine whether the modification amends the existing contract or creates an additional contract.

- BC40 The boards decided that the principle for combining and segmenting contracts should also determine how to account for a contract modification. That principle would ensure similar accounting for similar rights and obligations, regardless of the form of a contract. The boards also decided that a contract modification must meet the same criteria specified in paragraph 10 for determining whether a contract exists for the purposes of applying the proposed revenue recognition requirements. The boards concluded that it would be inappropriate for an entity to recognise revenue unless the entity has satisfied a performance obligation and a right to consideration exists (even if the measurement of the right is uncertain).
- BC41 If the price of a contract modification is interdependent with the price of the existing contract, the boards decided that the entity should, at the time of the modification, recognise the cumulative effects of that modification on the original contract. Otherwise, an entity might account for similar rights and obligations differently depending on how the contract was structured and whether the contract's terms and conditions were negotiated at contract inception or renegotiated during the life of the contract. The boards' decision on allocating the updated transaction price arising from a contract modification is consistent with their views on accounting for subsequent changes in transaction price as discussed in paragraph BC87.

## **Identifying separate performance obligations (paragraphs 20–24)**

### **Definition of a performance obligation**

- BC42 In the discussion paper, the boards distinguished obligations to provide goods or services to a customer from other obligations by describing them as performance obligations. Performance obligations are similar to the notions of deliverables, components or elements of a contract in existing standards. Although the notion of a performance obligation is implicit in many existing standards, the term *performance obligation* has not been defined and, hence, the boards proposed a definition in the discussion paper. Respondents generally agreed with the boards' proposed definition. Therefore, the boards have used that definition in the proposed requirements with minor modification.
- BC43 Some respondents to the discussion paper argued that some promises to provide goods or services, although meeting the definition of a performance obligation, should be accounted for as marketing expenses. Examples include 'free' handsets given by telecommunication entities as

an incentive for customers to enter into service contracts and customer loyalty points awarded by supermarkets, airlines and hotels. Those respondents reasoned that revenue should be recognised only for the main goods or services that the customer is seeking to acquire.

- BC44 The boards concluded that all goods or services provided to a customer as a result of a contract give rise to performance obligations in that contract because they are part of the negotiated exchange between the entity and its customer. Although the entity might characterise those goods or services as marketing incentives, they are goods or services provided in the contract for which the customer pays. In contrast, marketing incentives are incurred independently of the contract that they are designed to secure. The boards also noted that even if a conceptual justification could be found to distinguish goods or services that are marketing incentives from those that give rise to performance obligations, it would be difficult to develop criteria to make that distinction in practice.

#### **Distinct goods or services**

- BC45 Contracts with customers can contain many performance obligations. In the discussion paper, the boards proposed that an entity should refer to the timing of transfer of the promised goods or services to identify the performance obligations that should be accounted for separately. Although many respondents to the discussion paper agreed with that principle, some respondents were concerned that applying that principle would not be practical when goods or services are transferred continuously because an entity would need to estimate a stand-alone selling price for numerous goods or services. The boards agreed and decided to clarify how an entity should identify separate performance obligations.
- BC46 Respondents to the discussion paper and participants at the boards' workshops had mixed views on determining whether to account for a promise of a good or service as a separate performance obligation. Representatives from the construction industry preferred to account for all the promised goods or services in a contract as a single performance obligation unless a part of the contract is regularly sold separately. Otherwise, they thought that the proposed revenue recognition model would not be practical and would not provide useful information to users of financial statements who, they believe, are more interested in the total contract profit margin than in the revenue and profit margin of an individual good or service in the contract.

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- BC47 In contrast, representatives from other industries (for example, the technology industry) preferred to account for an individual good or service as a separate performance obligation even if it is not sold separately. Those representatives thought that to do otherwise would result in an entity's financial statements not providing users with useful information about revenue and profit margins as the entity transfers goods or services to customers.
- BC48 Consequently, when considering how entities across various industries should identify separate performance obligations, the boards' objective was to develop requirements that would result in an entity recognising revenue and profit margins in a manner that faithfully depicts the transfer of goods or services to the customer and that would be practical. To achieve that objective, the boards decided that an entity should account for a promise of a good or service as a separate performance obligation only if that good or service is distinct.
- BC49 The best evidence that a good or service is distinct is when the good or service is sold separately. If a good or service is not sold separately, the boards decided that an entity should account for the promised good or service as a separate performance obligation only if it could be sold separately. In the absence of additional guidance, it would be difficult and highly subjective to assess whether a good or service could be sold separately. Part of that difficulty stems from the fact that, in theory, almost anything could be sold separately. Hence, for the purposes of revenue recognition, the boards decided to provide additional guidance on whether an entity could sell a good or service separately and, therefore, should account for that promised good or service as a separate performance obligation. The boards decided to require a promised good or service to have a distinct function and a distinct profit margin.

### *Distinct function*

- BC50 A good or service has a distinct function if it has utility either on its own or together with other goods or services. A good or service with utility on its own is an asset that, on its own, can be consumed, disposed of, held or otherwise used in a way that generates economic benefits. Even if a good or service does not have utility on its own, it nevertheless would be a distinct asset if it has utility together with other goods or services—either goods or services that the customer has acquired from the entity or goods or services that are sold separately by the entity or by another entity.

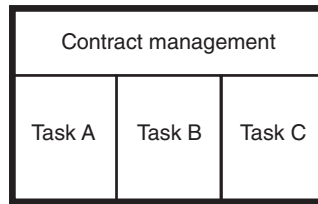
- BC51 If a good or service does not have a distinct function, it is questionable whether it is an asset. Hence, the boards thought that requiring a good or service to have a distinct function would emphasise that an entity can have a performance obligation only for contractual promises that, when fulfilled, result in the transfer of an asset to the customer.
- BC52 The boards noted that requiring a distinct function is consistent with the guidance on multiple-element arrangements in ASC Subtopic 605-25, which requires a delivered item to have 'value to the customer on a standalone basis' in order for an entity to account for that item separately. However, the boards decided against using that terminology because it could suggest that an entity must identify performance obligations on the basis of its assessment of the customer's intended use of the promised goods or services (which would affect the 'value to the customer'). It would be difficult, if not impossible, for an entity to know the customer's intentions in any given contract.

*Distinct profit margin*

- BC53 Even if a good or service has a distinct function, the boards decided that it should be accounted for as separate performance obligation only if it also has a distinct profit margin. If a good or service does not have a distinct profit margin, the boards were concerned that requiring an entity to estimate a selling price for that good or service might result in information that would not be useful to users of financial statements.
- BC54 The proposed requirement of a *distinct profit margin* is similar to the guidance on construction-type contracts in ASC Subtopic 605-35 that results in an entity accounting for elements of a contract separately only if each has a different rate of profitability.
- BC55 When a good or service is sold separately, the profit margin clearly is distinct and could be determined by subtracting the costs of the good or service from its stand-alone selling price. When a good or service is not sold separately, its selling price is not observable, which can make it more difficult for an entity to determine whether it has a distinct profit margin. In the absence of an observable selling price, the boards' view is that an entity would have sufficient basis for estimating a selling price only if the good or service is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service. Otherwise, the entity typically would not sell a good or service separately—not because it lacks a distinct function, but because the entity would lack a basis for determining the price at which it would sell the good or service separately.

BC56 In some contracts, a good or service would not have a distinct profit margin because it is not subject to distinct risks. For example, in some construction contracts, the contractor provides a significant contract management service in addition to providing, or subcontracting for, the individual construction tasks. That contract management service is provided because some of the individual construction tasks are highly interrelated, requiring the contractor to manage and co-ordinate the various tasks. Moreover, if the contractor employed subcontractors, the contract management service might also cover the risk that the tasks performed by the subcontractors are not in accordance with the contract specifications and do not combine with other services to provide the integrated construction services for which the customer contracted. The relationship between the contract management service and the individual construction tasks can be illustrated as follows:

Diagram 1 – Contract with one separate performance obligation



BC57 Diagram 1 above illustrates a contract consisting of three tasks that are sold separately (each could be performed by a subcontractor). However, Tasks A, B and C are highly related, thus requiring the entity to provide a significant contract management service to the customer that is associated with all of those tasks. Because the contract management service provided in conjunction with Tasks A, B and C is subject to the same risks as the underlying, related construction tasks, the contract management service does not have a distinct profit margin. Hence, the contractor would be required to combine that service with the tasks with inseparable risks (Tasks A, B and C) and account for all those promised goods or services as a single performance obligation.

BC58 In other contracts, the risks of the contract management service are either immaterial or they are attributable to specific tasks. In those contracts, the contract management service still would not have a distinct profit margin. However, the contractor would be able to combine a part of that service with a specific task. Hence, the entity would account for each task and part of the contract management service as a separate performance obligation. This is illustrated below in Diagram 2.



Diagram 2 – Contract with three separate performance obligations

Contract management	Contract management	Contract management
Task A	Task B	Task C

- BC59 The boards also decided that the resources required to provide a good or service must be distinguishable for an entity to account for the good or service as a separate performance obligation. If the resources needed to provide a good or service cannot be identified separately, the boards concluded that the profit margin of the good or service would not be distinct. Hence, the entity would not have a basis for estimating a selling price for that good or service and the entity should not account for that promised good or service as a separate performance obligation.

### **Satisfaction of performance obligations (paragraphs 25–33)**

#### **Control (paragraphs 25–31)**

- BC60 Assessing the transfer of a good or service is critical to the proposed revenue recognition model because it determines when an entity satisfies a performance obligation and, hence, recognises revenue. Most existing revenue standards require an entity to assess the transfer of an asset by considering the risks and rewards of ownership of the asset. However, the boards decided that an entity should assess whether a transfer of an asset has occurred by considering whether the customer obtains control, for the following reasons:
- (a) The boards' existing definitions of an asset use control to determine when an entity should recognise or derecognise an asset. Because the proposed requirements can be viewed as an asset derecognition model, the boards decided to rely on the existing definitions of an asset.
  - (b) A focus on control rather than risks and rewards should result in more consistent decisions about when goods or services are transferred. It can be difficult for an entity to judge whether a preponderance (or some other balance) of the risks and rewards of ownership of a good or service has been transferred to the

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customer if the entity retains some risks and rewards. Consequently, a risks and rewards approach for determining the transfer of goods or services can result in different accounting for economically similar contracts.

- (c) A risks and rewards approach could conflict with identifying separate performance obligations. For example, if an entity transfers a product to a customer but retains some risks associated with that product, an assessment based on risks and rewards might result in the entity identifying a single performance obligation that could be satisfied only after the risks are eliminated. However, an assessment based on control might appropriately identify two performance obligations—one for the product and another for a remaining service such as a fixed-price maintenance agreement. Those performance obligations would be satisfied at different times.

BC61 Respondents to the discussion paper generally supported control as the basis for determining the transfer of goods or services. However, nearly all respondents asked the boards to clarify what control of a good or service is and how an entity would determine when control has transferred to the customer.

BC62 In the light of those responses, the boards have specified in the proposed requirements that control of a good or service refers to the ability to direct the use of, and receive the benefit from, a good or service. This definition is based on the meaning of control in the asset definitions in the boards' respective conceptual frameworks. In developing that definition, the boards decided that the definition of control (of a good or service) should include the following components:

- (a) *ability*—a customer must have the *present* right to direct the use of, and receive the benefit from, a good or service for an entity to recognise revenue. For example, in a contract that requires a manufacturer to produce an asset for a particular customer, it might be clear that the customer will ultimately have the right to direct the use of, and benefit from, the asset. However, the entity should not recognise revenue until the customer has obtained that right (which might occur during production or after, depending on the contract).
- (b) *to direct the use of*—a customer's ability to direct the use of a good or service refers to the customer's right to deploy that asset in its activities, to allow another entity to deploy that asset in its activities, or to restrict another entity from deploying that asset.

The source of that right in the context of revenue recognition typically is an enforceable right as a consequence of a contract.

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

- BC63 The definition of *control* could be applied from the perspective of either the entity selling the good or service or the customer purchasing that good or service. Consequently, revenue could be recognised when the entity surrenders control of a good or service or when the customer obtains control of that good or service. Although, in many cases, both perspectives are likely to lead to the same result, the boards have articulated the proposed indicators of control from the perspective of the customer. That perspective would minimise the risk of an entity recognising revenue from undertaking activities that do not coincide with the transfer of goods or services to the customer.
- BC64 Respondents to the discussion paper were most concerned about the application of the control guidance to contracts in the construction industry currently accounted for using a percentage of completion method of revenue recognition. Many respondents thought the proposals in the discussion paper could result in revenue recognition for construction contracts only upon transfer of legal title or physical possession of the finished asset, which often is upon contract completion. Because those contracts can take many years to complete, respondents thought that users of financial statements would be deprived of useful information unless revenue is recognised throughout the contract.
- BC65 The boards did not intend that revenue should be recognised only upon contract completion. Nonetheless, the intention was that an entity would recognise revenue only when the customer receives promised goods or services and not necessarily as the entity undertakes activities to fulfil the contract. In the case of a construction contract, the customer receives the promised goods or services during construction only if the customer controls the work in progress. In contrast, if the customer does not receive the goods or services until the work is completed, the entity would not recognise revenue until then.

- BC66 The boards think that applying the proposed definition of control and the proposed indicators of control to a construction contract would be consistent with the requirements currently contained in IFRIC 15 *Agreements for the Construction of Real Estate* for determining when a customer continuously obtains control of a promised asset.

**Repurchase agreements (paragraphs B47–B53)**

- BC67 When developing the proposed requirements on control, the boards considered how an entity would apply the proposed requirements to contracts in which an entity sells an asset and also enters into a repurchase agreement (either in the same contract or in another contract).
- BC68 If the entity has an unconditional obligation or right to repurchase an asset (ie a forward or call option), the boards concluded that the customer does not obtain control of the asset and, therefore, no revenue is recognised. That is because the customer is constrained in its ability to direct the use of, and receive the benefit from, the asset. Because the customer is obliged to return, or to stand ready to return, the asset to the entity, the customer cannot use up or consume the entire asset. Moreover, the customer cannot sell the asset to another party (unless that sale is subject to a repurchase agreement, in which case the customer's benefit from the sale is constrained).
- BC69 In theory, the customer is not constrained in its ability to direct the use of, and receive the benefit from, the asset if the entity agrees to repurchase, at the prevailing market price, an asset from the customer that is substantially the same and is readily available in the marketplace. However, the boards noted that an entity would be unlikely to enter into such a transaction.
- BC70 If the customer has an unconditional right to require the entity to repurchase an asset (ie a put option), the boards concluded that the customer does obtain control of the asset. That is because the customer is neither obliged to return the asset nor obliged to stand ready to do so. Therefore, the customer has the ability to direct the use of, and receive the benefit from, the asset—it can sell, use up or consume the entire asset and choose not to exercise the put option.

- BC71 If the customer has an unconditional right to require the entity to repurchase an asset, the boards concluded that the entity should account for its obligation to stand ready to repurchase the asset. That is consistent with the proposed accounting for the sale of a product with a right of return (see paragraphs BC187–BC194), which results in the entity recognising:
- (a) a liability for its obligation to repurchase the asset measured at the amount of the expected (probability-weighted) consideration to be paid to the customer; and
  - (b) an asset for the entity's right to receive the asset upon settling that liability.
- BC72 Some argue that, in some contracts, the terms of the put option and the surrounding facts and circumstances economically constrain the customer so that the customer neither directs the use of, nor receives the benefit from, the asset. Although the customer is not obliged to exercise its put option, the customer could incur a loss if it did not exercise its right. Hence, they reason that in such contracts the customer does not obtain control of the asset and that, economically, the transaction is similar to a forward contract. However, the boards noted that if a customer is virtually certain to exercise its put option and receive a full refund, accounting for the put consistently with a right of return would result in recognising assets and liabilities similar to those that would be recognised if the contract were accounted for as a forward contract. In addition, virtually no revenue would be recognised at the point of sale. Therefore, the boards concluded that it would be preferable to deal with the likelihood of the customer exercising a put option through the measurement of the consideration allocated to the performance obligation to transfer the asset and to the liability to repurchase the asset, rather than by developing criteria to specify when a put option should be accounted for similarly to a forward contract.

**Continuous transfer of goods or services  
(paragraphs 32 and 33)**

- BC73 Some performance obligations, when satisfied, result in the transfer of a good or service to the customer at a point in time. Other performance obligations result in the transfer of goods or services to the customer continuously over a period of time. Examples of the latter include

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product maintenance services and construction services. To recognise revenue in those cases, an entity must determine the amount of performance obligations satisfied during each reporting period—ie the entity must measure its performance.

- BC74 The proposed requirements specify that an entity should select a revenue recognition method that best depicts the entity's performance under the contract. The definition of performance in the proposed model is not flexible—an entity performs only when it transfers goods or services to a customer. However, the proposed requirements for measuring performance cannot be too rigid if they are to be applied across various industries and transactions. In principle, the boards expect that methods based on outputs (for example, surveys of work performed) to the customer would provide the best depiction because they directly measure some attribute of the goods or services transferred to the customer. However, the boards acknowledged that output methods may not always be practical if, for instance, the output to the customer is not directly observable or if the output cannot be measured reliably in a cost-effective manner.
- BC75 The boards decided that an entity must select a method to measure performance for each separate performance obligation and must use that method consistently for that performance obligation and also across contracts that have performance obligations with similar characteristics. The boards do not want an entity to use different methods to measure its performance in satisfying the same or similar performance obligations because that could reduce the comparability of information for users of financial statements. Moreover, if an entity were to change how it measures performance throughout a contract, it would effectively bypass the requirements for segmenting a contract and identifying separate performance obligations.

### **Measurement of revenue (paragraphs 34–53)**

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- BC76 In the discussion paper, the boards proposed an allocated transaction price approach to measure performance obligations. Under that approach, an entity would allocate the transaction price to each performance obligation on the basis of the relative stand-alone selling price of the good or service underlying that performance obligation.
- BC77 The discussion paper also described an alternative approach whereby an entity would measure performance obligations directly at current exit price. The main reasons for rejecting that approach were:

- (a) The boards were concerned that an entity could recognise revenue before transferring goods or services to the customer. That could occur at contract inception if the measure of rights to consideration exceeds the measure of the remaining performance obligations. That would be a typical occurrence because entities often include in the transaction price amounts to recover their costs to obtain a contract.
  - (b) Any errors in identifying performance obligations or in measuring those performance obligations could affect revenue recognised at contract inception.
  - (c) A current exit price for the remaining performance obligations would typically not be observable and an estimated current exit price could be complex and costly to prepare and difficult to verify.
- BC78 Nearly all respondents to the discussion paper agreed with the boards' preference for the proposed allocated transaction price approach over the alternative current exit price approach.

#### **Determining the transaction price (paragraphs 35–49)**

- BC79 The proposed requirements specify that an entity should initially measure its rights and performance obligations at the transaction price—ie the amount of consideration that the entity receives, or expects to receive, from the customer. The discussion paper assumed that the customer promised to pay a fixed amount of cash consideration that did not need to be adjusted to reflect the customer's credit risk or the time value of money. Therefore, after publishing the discussion paper, the boards considered how an entity would determine the transaction price when the promised consideration is:
- (a) variable in amount (paragraphs BC80–BC95);
  - (b) uncertain to be collected because of the risk that the customer might not be able to pay (paragraphs BC96–BC101);
  - (c) paid at a time different from when the entity provides goods or services (paragraphs BC102–BC105); or
  - (d) in a form other than cash (paragraphs BC106 and BC107).

**Variable consideration**

BC80 The boards considered the following questions when developing the proposed requirements for contracts in which a customer promises consideration that is variable in amount:

- (a) how to define the transaction price (paragraphs BC81–BC83);
- (b) how to account for subsequent changes in the transaction price (paragraphs BC84–BC89); and
- (c) whether and how to constrain the transaction price (paragraphs BC90–BC95).

*Definition of the transaction price*

BC81 The boards decided to define the *transaction price* as the amount of consideration that an entity expects to receive from a customer in exchange for transferring goods or services. At contract inception, an entity's expectations reflect the full range of possible cash flow scenarios in the contract. Those expectations are the basis for the entity's negotiated price with the customer. In other words, an entity acting rationally would negotiate a contract price whereby, at contract inception, the consideration the entity expects to receive from the customer would reflect the expected costs to provide the goods or services to the customer plus the expected profit margin. A useful measure of a performance obligation reflects the entity's expected costs of providing the promised goods or services plus a margin. Therefore, the boards thought that a probability-weighted estimate of consideration would result in the most useful measure of the performance obligations in the contract.

BC82 The boards rejected the alternative of defining the transaction price as an amount that passes a specified threshold (for example, *certain*, *most likely* or *probable* consideration to be received from the customer). The boards thought that any specified threshold would be arbitrary and noted that contracts that pass that threshold would be accounted for differently from contracts that do not. That could result in different accounting for similar contracts, depending on how closely a contract passes or misses the specified threshold. Moreover, measuring the transaction price at an amount that passes a specified threshold may not necessarily be a useful measure of the entity's performance obligations.



BC83 Some respondents suggested that a probability-weighted estimate of the possible consideration amounts would not be appropriate if the entity is certain to receive one of only two possible consideration amounts. Those respondents indicated that a probability-weighted estimate would result in a transaction price that is not a possible outcome in accordance with the contract. However, the boards decided that a probability-weighted amount would provide more useful information because it appropriately reflects the conditions that are present at each reporting date. For example, consider an entity that has equal probabilities of receiving either CU60 or CU80 depending on whether the entity meets a specified performance condition. A transaction price of CU60 would not reflect the possibility of receiving additional consideration. Conversely, a transaction price of CU80 would not reflect the risk of receiving a lesser amount. Therefore, even though the probability-weighted amount of CU70 [(CU60 × 50 per cent) + (CU80 × 50 per cent)] does not reflect either of the possible consideration amounts, the boards think that it appropriately reflects the conditions at the reporting date.

*Subsequent changes in the transaction price*

BC84 After contract inception, an entity revises its expectations about the amount of consideration to be received as uncertainties are resolved or new information about remaining uncertainties becomes available. To depict conditions that exist at each reporting date (and changes in conditions during the reporting period), the boards decided that an entity should update its estimate of the transaction price throughout the contract. The boards believe that depicting current conditions would provide more useful information to users than retaining the initial estimates, especially for long-term contracts subject to significant changes in conditions during the life of the contract.

BC85 The boards considered whether, if the transaction price changes during a contract, an entity should:

- (a) recognise those changes in profit or loss when those changes occur;  
or
- (b) allocate those changes to all performance obligations.

BC86 The boards rejected the alternative of recognising the entire amount of a change in the estimate of the transaction price in profit or loss when that change occurs. In the boards' view, that alternative could result in a pattern of revenue recognition that does not faithfully depict the pattern of the transfer of goods or services. Moreover, recognising revenue immediately (and entirely) for a change in the estimate of the transaction

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price would be prone to abuse in practice. The boards considered whether changes in the estimate of the transaction price could be presented as a gain or loss separately from revenue, thus preserving the pattern of revenue recognition. However, the boards rejected that alternative because the total amount of revenue recognised for the contract would not equal the amount of consideration received from the customer.

- BC87 Instead, the boards decided that an entity should allocate a change in the transaction price to all performance obligations in the contract because the cumulative revenue recognised would depict the revenue that the entity would have recognised if, at contract inception, it had the information that was available at the subsequent reporting date. Consequently, the transaction price that is allocated to performance obligations that have already been satisfied would be recognised as revenue immediately.
- BC88 Some respondents suggested that the entire change in the transaction price should be allocated only to some performance obligations (for example, only to the remaining performance obligations or only to those performance obligations to which the uncertainty primarily relates). The boards rejected that alternative because the goods or services in a single contract (as identified using the segmentation principle in paragraph 15) have interdependent prices. Allocating a change in the transaction price to only some performance obligations would be inconsistent with the requirement to allocate the transaction price at contract inception to all performance obligations on a relative selling price basis. The boards thought that allocating subsequent changes in the transaction price differently from the initial allocation would result in a lack of discipline on how an entity should identify separate performance obligations and allocate consideration to them.
- BC89 Updating the estimate of the transaction price after contract inception (and reallocating it to the performance obligations) differs from remeasuring the performance obligations as discussed in paragraphs BC130–BC148 because the entity is remeasuring the customer consideration (ie the inflows). The entity does not remeasure the expected costs to satisfy the remaining performance obligations (unless the performance obligations become onerous).

*Constraining revenue recognition when consideration is variable*

- BC90 The boards considered whether to constrain revenue recognition if the customer promises a variable amount of consideration. The boards decided to constrain the transaction price because revenue is an important measure to users of financial statements when valuing an entity and because a significant portion of errors in financial statements have related to the overstatement or premature recognition of revenue.
- BC91 The boards considered existing standards and practices and obtained feedback from various parties, including users of financial statements, to identify the situations in which estimating the transaction price would provide useful information to users of financial statements. That feedback suggested that a probability-weighted estimate of the consideration to be received would be useful only if the entity can identify the possible consideration amounts and reasonably estimate the probabilities of those amounts.
- BC92 For an entity to identify possible amounts and reasonably estimate their probabilities, the boards concluded that the entity would need experience (either its own or the experience of others) with similar types of contracts. Without that experience, the level of uncertainty in the estimate of the variable consideration would be too high for users to find useful the measurement of any revenue recognised on the basis of that estimate. In other words, a user might find it more useful if an entity recognises revenue only when the uncertainty is resolved.
- BC93 The boards decided that experience was necessary but not sufficient to estimate variable consideration reasonably. The entity's experience must also be relevant to the contract because the entity does not expect significant changes in circumstances (ie the circumstances surrounding the current contract are similar to those surrounding the similar contracts in the past). To help an entity assess whether its experience is relevant to the contract, the boards decided to specify factors that would reduce the relevance of that experience. Those conditions were derived in part from existing guidance in US GAAP on estimating sales returns.

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BC94 The boards considered and rejected the following alternatives:

Alternative	Reasons for rejection
<p>Require estimates of the transaction price, but limit cumulative revenue recognised so that it does not exceed amounts that are certain</p>	<ul style="list-style-type: none"> <li>• It conflicts with the core principle of the proposed requirements because in some circumstances, an entity would not recognise revenue when a good or service is transferred to the customer.</li> <li>• It can result in the recognition of losses when the contract is profitable. If revenue is not recognised, an entity would recognise a loss unless the costs of providing the good or service are deferred. The boards think that the costs relating to a good or service already transferred to the customer would not give rise to a recognisable asset.</li> <li>• Although it would be consistent with the guidance on multiple-element arrangements in ASC Subtopic 605-25, it would be inconsistent with IFRSs and other guidance in US GAAP, such as ASC Subtopic 605-35.</li> </ul>
<p>Require estimates of the transaction price for only some types of uncertainty (for example, uncertainty that is primarily controlled by the entity)</p>	<ul style="list-style-type: none"> <li>• Uncertainty is rarely, if ever, controlled by just one party or attributable to one single factor. Hence, it would be difficult and subjective to distinguish the various types of uncertainty (for example, seller-controlled versus customer-controlled uncertainty).</li> <li>• Even if it were possible to distinguish the various types of uncertainty, some exceptions might still be necessary depending on the <i>amount</i> of uncertainty. For example, some might think that an entity should not estimate uncertain consideration that is primarily controlled by the customer. However, many are comfortable with estimates of customer-controlled uncertainty if the entity has extensive experience with those types of contracts (for example, commissions of an insurance agent).</li> <li>• The proposed requirements could become unnecessarily complex and would lack a clear principle for how to account for variable consideration.</li> </ul>

BC95 Some think that the boards should retain the existing requirement in the guidance on multiple-element arrangements in ASC Subtopic 605-25 that limits the amount of consideration allocated to a satisfied performance obligation to the amount that is not contingent on the satisfaction of performance obligations in the future (or meeting other specified performance conditions). They reason that if an entity recognises revenue in such situations, the resulting contract asset does not meet the definition of an asset. However, the boards disagreed and think that the contract asset recognised in such situations does meet the definition of an asset. Although the entity may not have the present right to collect consideration from the customer, it clearly has a valuable contractual right as a result of satisfying performance obligations. If the entity were to transfer the remaining rights and performance obligations in the contract to a third party, it would expect to be compensated for its past performance. The boards therefore think that, in concept, uncertainty in the amount of consideration should be reflected in the measurement of the contract asset rather than through recognition.

#### **Collectibility (paragraph 43)**

BC96 The core principle of the proposed requirements is for an entity to recognise as revenue the amount of consideration the entity receives, or expects to receive, in exchange for transferring goods or services to the customer. Therefore, the boards considered how an entity should account for any uncertainty arising from the possibility that the customer may be unable to pay—ie uncertainty about the collectibility of the promised consideration.

BC97 An entity's assessment of collectibility could affect either or both of the following:

- (a) the recognition of revenue (ie whether an entity recognises revenue when a good or service is transferred);
- (b) the amount of revenue (ie how much revenue an entity recognises when a good or service is transferred).

BC98 Some existing standards address collectibility through recognition. For example, ASC Section 605-10-S99 (SEC SAB Topic 13 *Revenue Recognition*) states that revenue can be recognised only if 'collectibility is reasonably assured'. In IFRSs, IAS 18 specifies that revenue is recognised only when 'it is probable that the economic benefits associated with the transaction will flow to the entity'. However, the boards noted the following consequences of having collectibility as a recognition criterion, similar to criteria in some existing standards:

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- (a) The boards would need to specify a probability threshold (for example, *reasonably assured* or *probable*) that must be passed before revenue would be recognised. However defined, that threshold could be viewed as arbitrary. In addition, it would result in no revenue being recognised if the threshold is not passed, but potentially all of the revenue being recognised if it is passed.
  - (b) It would not be consistent with the core principle of the proposed requirements because if the probability threshold is not passed, no revenue would be recognised when a good or service is transferred to the customer.
  - (c) Even with a threshold, the boards would need to decide whether and, if so, how collectibility would affect the amount of revenue once the specified threshold is passed.
  - (d) It would not be consistent with the accounting for a receivable, which incorporates uncertainty of collectibility in the measurement of that financial asset.
- BC99 Accordingly, the boards propose that uncertainty about the entity's ability to pay the consideration should be reflected in the measurement of the transaction price and, therefore, in the amount of revenue recognised when an entity satisfies a performance obligation.
- BC100 Including the uncertainty of collectibility in the measurement of revenue means that the transaction price reflects the amount of consideration that the entity expects to receive. For many contracts, an entity would expect to collect the full amount of promised consideration because the effect of the customer's credit risk would be immaterial. For those contracts, recognising the full amount as revenue would be consistent with IAS 39 *Financial Instruments: Recognition and Measurement*, which acknowledges that short-term receivables with no stated interest rate may be measured at the invoiced amount if the effect of discounting is immaterial. However, if the effect of the customer's credit risk is material, the transaction price would be the probability-weighted amount of consideration that the entity expects to receive. If the effect of the time value of money was also material to a contract, the adjustment for collectibility would be made through the discount rate (see paragraphs BC102–BC105).
- BC101 After the entity has obtained an unconditional right to consideration, the customer's credit standing could deteriorate or, alternatively, it could improve. If the entity has recognised revenue, the effects of the resulting reassessments of credit risk could be recognised in the period of change

as an adjustment to the revenue recognised or as an expense or income that is recognised separately from revenue. The boards decided that the latter approach was most consistent with the proposed requirements, which focus on the exchange between the entity and its customer. In effect, once the entity has satisfied the performance obligation, it has received an asset in exchange—a promise of payment. Hence, any reassessment of the customer's credit standing should be recognised as an impairment (or reversal of impairment) of the receivable rather than a change to the amount of revenue previously recognised. The boards noted that this accounting would be similar to the accounting for non-cash consideration received in exchange for a good or service—for example, an equity stake in another entity—if the value of that asset subsequently decreased. The revenue recognised would reflect the value of the equity stake at the date the good or service was transferred—ie the value of the asset the entity received in exchange for providing the good or service—and any subsequent change in the value of that equity stake would not affect revenue.

**The time value of money (paragraphs 44 and 45)**

- BC102 Some contracts contain a financing component (either explicitly or implicitly) because performance by an entity (ie satisfaction of a performance obligation) and payment by its customer occur at significantly different times.
- BC103 The boards propose that the amount of promised consideration from the customer should be adjusted to reflect the time value of money if the contract includes a material financing component. In other words, the amount of the transaction price that is allocated to the performance obligations should be the nominal amount of the consideration, adjusted for the financing component. Hence, when a performance obligation is satisfied, the amount of revenue recognised is the amount of the transaction price adjusted for the financing—in effect, the 'cash sales price' of the underlying good or service. Interest income or expense is recognised on the contract asset or contract liability. In support of this approach, the boards observed that:
- (a) Entities are not indifferent to the timing of the cash flows in a contract. Therefore, reflecting the time value of money portrays an important economic feature of the contract. A contract in which the customer pays for a good or service when that good or service is transferred to the customer is different from a contract in which the customer pays significantly before or after the good or service is transferred. Even if an entity charges its customer the same

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nominal amount in both cases, it has, in fact, charged different amounts in each case once the financing has been taken into account. Hence, to be useful to users, the accounting should reflect those differences.

- (b) Not recognising the financing component could misrepresent the profit of a contract. For example, if the financing component is ignored and a customer pays in advance, the entity would recognise income (in the form of interest earned on the cash received) from the contract before it transfers any good or service to the customer. In effect, this front-ends the recognition of profit from the contract. That is because, rationally, that interest was received as compensation for accepting a lower nominal price for the good or service. Similarly, if a customer pays in arrears, ignoring the finance component of the contract would result in full profit recognition on the transfer of the good or service, despite the ongoing cost to the entity of providing financing to the customer.
- (c) Contracts with explicitly identified financing components would be accounted for consistently with contracts in which the financing component is implicit in the contract price.

BC104 The boards considered whether the rate used to reflect the financing should be the risk-free rate. That rate would be observable and simple to apply, and it would avoid the costs of determining a rate specific to each contract. However, the boards concluded that using the risk-free rate would not result in useful information because the resulting interest would not reflect the characteristics of the parties to the contract. In addition, the boards noted that it would not necessarily be appropriate to use any rate explicitly specified in the contract because the entity might offer 'cheap' financing as a marketing incentive and, hence, using that rate would not result in an appropriate recognition of profit over the life of the contract. Therefore, the boards propose that an entity should use the rate that would be used in a financing transaction between the entity and its customer that did not involve the provision of goods or services because that rate would reflect the characteristics of the parties to the contract. However, because that rate also would reflect the customer's creditworthiness, the boards have specified that an entity should not also adjust the amount of the promised consideration for collectibility.



BC105 Some existing standards require an entity to recognise the effects of financing only if the time period exceeds a specified period, often one year. For example, ASC paragraph 835-30-15-3 excludes those ‘... transactions with customers or suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year’. The boards decided against that approach and instead decided to require management to use its judgement to assess whether the effects of the time value of money are material to the contract. The boards observed that the time value of money could be material for short-term contracts with high implicit interest rates and, conversely, may be immaterial for long-term contracts with low implicit interest rates.

**Non-cash consideration (paragraphs 46 and 47)**

BC106 When an entity receives cash from a customer upon delivery of a good or service, the transaction price and, hence, the amount of revenue is the amount of cash received—ie the value of the inbound asset. To be consistent with that approach when the customer pays non-cash consideration (for example, goods or services), the boards decided that the entity also should measure non-cash consideration (or promises of non-cash consideration) at fair value.

BC107 If an entity cannot estimate the fair value of the non-cash consideration reliably, the boards decided that it should measure the promised consideration indirectly by reference to the selling price of the goods or services promised in exchange for the consideration. That approach is consistent both with requirements in some existing revenue standards (for example, IAS 18) and with requirements for other situations in which the fair value of the assets surrendered in exchange for assets received may be estimated more reliably (for instance, both IFRS 2 *Share-based Payment* and ASC Topic 718 on stock compensation state that if the fair value of the goods or services received cannot be estimated reliably, then the entity measures them indirectly by reference to the fair value of the granted equity instrument).

**Consideration payable to the customer (paragraphs 48 and 49)**

BC108 In some cases, an entity pays consideration to one of its customers or to other parties that purchase the entity’s goods or services from its customers (for example, an entity may sell a product to a dealer or distributor and subsequently make a payment to a customer of that

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dealer or distributor). That consideration might be a payment in exchange for goods or services received from the customer, a discount or refund for goods or services provided to the customer, or a combination of both.

- BC109 To help an entity distinguish among those types of payments, the boards decided that an entity should account for any good or service received in the same way as for other purchases from suppliers only if the good or service is distinct, using the same criteria proposed to identify a separate performance obligation. Existing requirements in US GAAP (ASC Section 605-50-45) on vendor's consideration given to a customer use the term *identifiable benefit*, which is described as a good or service that is 'sufficiently separable from the recipient's purchase of the vendor's products such that the vendor could have entered into an exchange transaction with a party other than a purchaser of its products or services in order to receive that benefit'. The boards think that notion is similar to the principle in the proposed requirements for assessing whether a good or service is distinct.
- BC110 The amount of consideration received from the customer for goods or services and any payment of consideration to that customer for goods or services could be linked. For instance, a customer may pay more for goods or services from the entity than it would otherwise have done if it was not receiving a payment from the entity. Therefore, to depict revenue faithfully in such cases, the boards concluded that any amount accounted for as a payment to the customer for goods or services received should be limited to the fair value of those goods or services, with any amount in excess of the fair value recognised as a reduction to the transaction price.
- BC111 If the payment of consideration is accounted for as a reduction of the transaction price, the entity would recognise less revenue when it satisfies the related performance obligation(s). However, in some cases an entity promises to pay consideration to a customer only after the entity has satisfied the performance obligation and, hence, after it has recognised revenue. Accordingly, the boards have specified that the reduction to revenue is recognised at the later of when the entity transfers the goods or services to the customer or the entity promises to pay the consideration. By using the phrase *promises to pay*, the boards intend to clarify that an entity should reflect in the transaction price payments to customers that are conditional on future events (for example, a payment to a customer conditional on the customer making a specified number of purchases).

### **Allocating the transaction price to separate performance obligations (paragraphs 50–53)**

- BC112 In the discussion paper, the boards proposed that an entity should measure performance obligations in a contract by allocating the transaction price to those obligations. That allocation would determine the amount of revenue that an entity recognises as it satisfies each performance obligation and the measurement of the remaining performance obligations at each reporting date. The boards considered, but rejected, an alternative measurement approach, which would have been to measure the performance obligations directly at each reporting date. The boards concluded that this alternative would make accounting for the contract more complex. In addition, the boards expected that it would provide little additional information to users of financial statements in many cases, either because the values of goods or services promised are not inherently volatile or because the effect of any volatility that might exist is limited because an entity transfers the goods or services to the customer over a relatively short time.
- BC113 The discussion paper noted that the transaction price could be allocated using various bases, such as the stand-alone selling price of the promised goods or services or the expected cost of the promised goods or services, as estimated by the entity at contract inception. The boards proposed that an entity should allocate the transaction price in proportion to the stand-alone selling prices of the promised goods or services. They noted that an allocation based on stand-alone selling prices faithfully depicts the different margins that may apply to promised goods or services. In contrast, allocating the transaction price on the basis of the expected costs to provide the goods or services would be expected to result in a contract-wide margin being applied to all performance obligations in the contract.
- BC114 Most respondents agreed with the boards' proposals in the discussion paper, although some suggested that the boards should consider whether:
- (a) to constrain the use of estimates and specify a hierarchy for the basis of allocation (paragraphs BC115–BC121);
  - (b) to use the residual method as a basis for allocation (paragraphs BC122–BC125); or
  - (c) to change the basis for allocating a discount within a contract (paragraphs BC126–BC129).

### Use of estimates

- BC115 Some respondents were concerned that recognising revenue on the basis of estimated stand-alone selling prices of goods or services could result in arbitrary accounting, reduce comparability in financial reporting and enable management to manipulate those estimates to accelerate or defer revenue. Expressing similar concerns, other respondents suggested that the boards should prescribe a measurement hierarchy similar to that in ASC Subtopic 605-25 to provide greater discipline in estimating stand-alone selling prices. That hierarchy requires an entity to determine a stand-alone selling price using vendor-specific objective evidence (VSOE) of selling price, if it exists. Otherwise, an entity would use third-party evidence (TPE) of selling price, if it exists, or the best estimate of the selling price if neither VSOE nor TPE exists.
- BC116 The boards confirmed that stand-alone selling prices would sometimes need to be estimated in order to achieve the objective of recognising revenue when goods or services are transferred to the customer. An alternative approach of allocating consideration only to those performance obligations for which the entity has directly observable prices would not always meet that objective.
- BC117 Compared with the proposals in the discussion paper, there would be fewer instances under the proposed requirements in which the transaction price would be allocated using estimates of stand-alone selling prices. That is because under the proposed requirements, entities allocate the transaction price only to separate performance obligations for distinct goods or services rather than potentially to every performance obligation in the contract. As specified in paragraph 23, separate performance obligations are identified only for promises to transfer goods or services that either:
- (a) are sold separately—in which case there would be observable prices for goods or services that are identical or similar to the promised goods or services; or
  - (b) have a distinct function and a distinct profit margin—in which case an entity should have sufficient information to reasonably estimate a stand-alone selling price for the promised good or service.
- BC118 For this reason, the boards think that the proposed requirements should ease concerns expressed by respondents to the discussion paper relating to:

- (a) using estimates of stand-alone selling prices to allocate the transaction price; and
- (b) the practical difficulties with developing those estimates for individual performance obligations.

BC119 Furthermore, practice under US GAAP is becoming accustomed to a greater use of estimates in recognising revenue. That is because ASU 2009-13 amended ASC Subtopic 605-25 on recognising revenue in multiple-element arrangements to require an entity to estimate the stand-alone selling price of a good or service if neither VSOE nor TPE of a stand-alone selling price is available.

BC120 The boards reaffirmed the view they expressed in the discussion paper that they will not preclude or prescribe any particular method for estimating a stand-alone selling price so long as the method:

- (a) is consistent with the basis of a stand-alone selling price (ie the price at which the entity would sell the distinct good or service if it were sold separately to the customer); and
- (b) maximises the use of observable inputs.

BC121 The boards decided against specifying a hierarchy of acceptable estimation methods. The boards observed that even if there is third-party evidence of a selling price, that price might require adjustments to reflect differences either in (a) the good or service (because the third-party price could be for a similar, rather than identical, good or service) or (b) pricing strategies between the third party and the entity. Hence, there is little distinction between TPE and best estimate in the hierarchy in ASC Subtopic 605-25. The boards concluded that it was important to emphasise that when using estimates, an entity should maximise the use of observable inputs.

### **Residual method**

BC122 The residual method is an alternative way to allocate consideration in a multiple-element arrangement in the absence of an observable selling price (such as VSOE or TPE) for delivered items. With the residual method, remaining performance obligations in a contract are measured directly using objective and reliable evidence of the selling prices of the underlying goods or services. Any difference between that amount and the total transaction price is recognised as revenue for the satisfied performance obligations.

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- BC123 Some respondents to the discussion paper suggested that the proposed requirements should permit the residual method because it provides a less complex and, hence, less costly alternative to allocating the transaction price to separate performance obligations on a relative selling price basis.
- BC124 However, the boards noted that the residual method is unnecessary if an entity is required to estimate stand-alone selling prices. The boards noted that ASU 2009-13 amended ASC Subtopic 605-25 to preclude the use of the residual method as a consequence of the Emerging Issues Task Force's (EITF) decision to require entities to use estimated stand-alone selling prices for goods or services for which there is no VSOE or TPE.
- BC125 Consequently, the boards confirmed their view that the residual method should not be used to allocate the transaction price to separate performance obligations. However, the boards noted that a residual (or reverse residual) technique may be an appropriate method for estimating a stand-alone selling price if there is a directly observable price for one performance obligation but not the other.

### **The allocation of a discount within a contract**

- BC126 A consequence of allocating the transaction price to each performance obligation in proportion to the stand-alone selling prices of the underlying goods or services is that any discount in the contract is allocated to all performance obligations. A few respondents to the discussion paper were concerned with this outcome and suggested that the allocation should be based on either:
- (a) management's assessment of which goods or services are transferred to the customer at a discount to their stand-alone selling price; or
  - (b) the prices stated in the contract.
- BC127 The boards were not persuaded to provide an exception to the proposed requirement of allocating the transaction price on the basis of stand-alone selling prices. The boards' view is that the transaction price is for the contract as a whole. Therefore, any discount in the contract is attributable to the contract as a whole and should be allocated proportionally to the separate performance obligations in the contract.

- BC128 The boards disagreed with the suggestion that management should choose the performance obligations to which the discount is allocated because that would reduce the discipline of the process of allocating the transaction price. However, if an entity has evidence that a discount relates only to some goods or services in a contract, the contract may meet the criteria in paragraph 15 for segmentation of the contract.
- BC129 The boards also disagreed with the suggestion that the allocation of the transaction price should be based on the prices stated in the contract. In the boards' view, a contractually stated price for a good or service in a contract cannot be presumed to represent the selling price for those goods or services. Consequently, the boards decided that a stand-alone selling price would need to be determined for a good or service even if the stated contract price for that good or service is zero.

### **Onerous performance obligations (paragraphs 54–56)**

- BC130 The proposed requirements specify that an entity initially measures the separate performance obligations in a contract by allocating the transaction price to the performance obligations. Hence, as the entity satisfies each performance obligation, the reduction in the total amount of the entity's remaining performance obligations reflects the entity's transfer of goods or services to the customer.
- BC131 In the discussion paper, the boards noted that the amount of an entity's performance obligations could change for reasons other than an entity's performance (for example, for changes in the price or quantity of goods or services that an entity expects to transfer to the customer to satisfy its remaining performance obligations). The boards also noted that reflecting those changes in the measurement of the performance obligations would require an entity to remeasure its performance obligations at each reporting date. In the discussion paper, the boards rejected such an approach because they concluded that it would be unnecessarily complex for most contracts with customers.
- BC132 The boards observed that for most contracts with customers, the most significant change in an entity's performance obligations arises from the transfer of goods or services to the customer. Changes for other reasons are typically not significant. However, the boards acknowledged that sometimes those changes can be significant to the depiction of an entity's obligation to provide goods or services and that in such cases an entity would need to update the initial measurement of the performance obligations (ie remeasure them) for reasons other than an entity's

transfer of goods or services to the customer. Accordingly, in the discussion paper the boards proposed that an entity should remeasure a performance obligation and recognise a contract loss if the performance obligation is onerous (ie the entity's expected costs to satisfy the performance obligation exceed its carrying amount).

BC133 Most respondents agreed with the proposed approach of remeasuring performance obligations by exception only when they are onerous. Most agreed with the boards that remeasuring performance obligations over the life of the contract would be unnecessarily complex and also noted that such an approach would represent a significant change to current practice. A few respondents stated that performance obligations should never be remeasured and that losses on a contract should emerge over time as the revenue is recognised. However, the boards disagreed with that view, noting that:

- (a) both IFRSs and US GAAP include an onerous test for loss-making contracts (ie the amount allocated to the performance obligations must at least equal the expected costs to satisfy the performance obligations). Not having such a test would be a major change to current practice.
- (b) the onerous test can be viewed as the mirror image for liabilities of an asset impairment test (ie a test to ensure that the carrying amount of a performance obligation is not understated).

BC134 Therefore, the boards concluded that an onerous test is a necessary component of a revenue recognition model in which the initial measurements of performance obligations are not routinely updated. Moreover, including the onerous test in the proposed requirements would achieve greater convergence of IFRSs and US GAAP on the margins reported from contracts with customers.

### **Components of the onerous test**

BC135 In developing the onerous test for contracts with customers, the boards considered:

- (a) the unit of account for applying the onerous test (paragraphs BC136 and BC137);
- (b) when a performance obligation should be deemed onerous (paragraphs BC138 and BC139);
- (c) the measurement basis for the onerous test (paragraphs BC140 and BC141).



- BC136 The unit of account for applying an onerous test could be at the level of either the remaining performance obligations in the contract or each separate performance obligation. If an onerous test is applied at the contract level, a contract loss would be recognised only if the remaining performance obligations considered together are loss-making. In contrast, if the onerous test is applied to separate performance obligations, an entity would recognise adverse changes in circumstances affecting a separate performance obligation as soon as they result in that separate performance obligation being loss-making. They are not offset against the margin in other parts of the contract.
- BC137 The boards decided to apply the onerous test to each separate performance obligation to maintain consistency with the model's objective to reveal different margins on different parts of the contract. Those different margins are revealed by identifying separate performance obligations and consequently the same unit of account should apply to test whether those separate performance obligations are onerous. A consequence of this approach is that an entity might need to recognise a contract loss for a separate performance obligation even though the contract as a whole remains profitable. However, the boards concluded that this would be preferable to applying the onerous test at the level of the whole contract because this could delay reporting adverse changes in circumstances.
- BC138 In the discussion paper, the boards considered two approaches to determining whether a performance obligation is onerous:
- (a) when the *expected costs* to satisfy the performance obligation exceed the amount of the transaction price allocated to it (cost trigger);
  - (b) when the *current price* of the performance obligation (ie the expected costs plus a margin) exceeds the amount of the transaction price allocated to it (current price trigger).
- BC139 The boards noted that the main consequence of using a cost trigger is that any margin in the measurement of the performance obligation would act as a buffer to absorb adverse changes in the performance obligation. In other words, the amount of the performance obligation would remain unchanged until the entity expects that the satisfaction of that performance obligation would result in a loss. In contrast, a current price trigger would not result in the margin acting as a buffer to absorb adverse changes in circumstances, thereby potentially resulting in earlier recognition of the effects of adverse changes in circumstances. The boards rejected the current price trigger because, as well as increasing the frequency of remeasurements, it would more closely

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resemble an approach in which the performance obligations are remeasured at each reporting date, an approach that the boards had rejected (as discussed in paragraph BC131). Almost all respondents agreed with the boards.

- BC140 The boards concluded in the discussion paper that once a performance obligation is onerous, it should be remeasured on a basis that is consistent with the trigger. Accordingly, they decided that an onerous performance obligation should be measured at the expected cost of satisfying the performance obligation. The boards discussed whether a margin should be included in the remeasurement of a performance obligation. The rationale for including a margin is that a profit-oriented entity typically does not promise to transfer a good or service to a customer without a margin. However, the boards noted that including a margin in the remeasurement would be a significant change to the requirements for loss-making contracts in existing standards (for example, IAS 11 and ASC Subtopic 605-35) and would increase the complexity of measuring performance obligations, particularly when observable prices do not exist. Furthermore, some think that it would be counter-intuitive for an entity to recognise a profit when it satisfies an onerous performance obligation.
- BC141 Almost all respondents agreed with the boards. However, the discussion paper did not specify which costs should be included in the onerous test and in the remeasurement of an onerous performance obligation. Therefore, in developing the proposed requirements, the boards considered which costs should be included. The boards decided that, consistently with the proposed requirements on accounting for fulfilment costs (discussed in paragraphs BC149–BC155), costs for the onerous test should be restricted to those that relate directly to a contract. In the absence of specifying a value or a price for the remeasurement, the boards concluded that this approach would provide a clear objective for which costs should be included. The boards also clarified that the expected costs to satisfy the remaining performance obligations should reflect all possible outcomes (ie the amount should be a probability-weighted measure of costs) to be consistent with how an entity would determine the transaction price.

### **Presentation of the liability for onerous performance obligations**

- BC142 The discussion paper proposed that when an entity remeasures an onerous performance obligation, it should recognise the corresponding amount in profit or loss separately from revenue. The discussion paper was less clear on how the effects of the remeasurement would be reflected in profit or loss when the remeasured performance obligation is satisfied. Although the boards explained that the amount of revenue recognised for the entire contract is the amount of the transaction price, some respondents were concerned that the remeasured amount of the performance obligation would be recognised as revenue, not the amount initially allocated to the performance obligation.
- BC143 Because the remeasurement would need to be tracked separately for the purposes of reporting its effects in profit or loss separately from revenue, the boards concluded that it would be clearer if they specified that the remeasurement is recognised as a liability separate from the contract asset or contract liability. That would be consistent with existing standards and practice and would clarify that the remeasurement and its subsequent accounting should not affect revenue.

### **Rejection of an alternative measurement approach for some performance obligations**

- BC144 The discussion paper highlighted that the proposed measurement approach might not result in useful information for some contracts, particularly for those with highly variable outcomes. Such contracts include those in which:
- (a) uncertainty is a significant inherent characteristic of the contract;
  - (b) the prices of the underlying goods or services are volatile; or
  - (c) the duration of the contract is such that significant changes in circumstances are likely.
- BC145 Therefore, the boards sought views from respondents on whether it would be more useful to measure some performance obligations on another basis.

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- BC146 Most respondents from the insurance industry stated that insurance performance obligations should be remeasured at each reporting date (ie they should be subject to another measurement approach) rather than being remeasured by exception only when they are onerous. A few other respondents suggested that some or all of the following performance obligations should be remeasured at each reporting date:
- (a) warranties and similar maintenance contracts;
  - (b) other stand-ready and conditional performance obligations; and
  - (c) long-term and large service contracts for which relatively small changes in circumstances can have significant effects.
- BC147 A few respondents had concerns similar to those of the respondents from the insurance industry. However, those respondents thought that the concerns did not justify the use of a different measurement approach for some performance obligations. Those respondents concluded that all performance obligations within the scope of the revenue recognition standard should be subject to the same measurement approach.
- BC148 In the light of the feedback received, the boards concluded that all performance obligations within the scope of the proposed requirements should be subject to the same measurement approach. The boards noted that many of the concerns raised by respondents, in particular those raised by insurers, would be addressed by the scope of the proposed requirements. In addition, the boards noted that:
- (a) most warranties within the scope of the proposed requirements would be of short duration. Moreover, even if the warranties were included within the scope of the standard on insurance contracts, it is possible that many would be accounted for using a simplified measurement model that is similar to the allocated measurement approach in the proposed requirements.
  - (b) the most common type of stand-ready obligation other than a warranty is a guarantee contract. Those obligations typically meet the definition of a financial instrument or an insurance contract and therefore would not be within the scope of the proposed requirements.
  - (c) the remaining types of stand-ready obligations and long-term and large service contracts are currently measured using an allocated transaction price approach, rather than using a direct measurement approach (for example, current exit price).

## **Contract costs (paragraphs 57–63)**

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### **Costs of fulfilling a contract**

- BC149 In the discussion paper, the boards explained that they did not intend to include specific requirements on cost recognition in a revenue standard. Consequently, the boards proposed that costs would be recognised as expenses when incurred unless they would be eligible for capitalisation in accordance with other standards (for example, standards on inventory; property, plant and equipment; and capitalised software).
- BC150 Many respondents to the discussion paper were concerned about the boards' focus on revenue without considering the accounting for costs associated with contracts with customers. Some respondents, in particular those from the construction industry, said that guidance on profit margin recognition is as important as guidance on revenue recognition. Other respondents, mainly preparers using US GAAP, were concerned about the withdrawal of cost guidance that was developed specifically for their respective industries. Respondents asked the boards to reconsider the accounting for costs associated with contracts with customers.
- BC151 In reconsidering the accounting for those costs, the boards observed that existing standards would apply to some fulfilment costs (for example, costs incurred in creating inventory or acquiring property, plant and equipment). However, for other fulfilment costs (for example, contract set-up costs), the boards acknowledged the lack of clear guidance.
- BC152 In the absence of clear guidance, an entity applying US GAAP might analogise to the guidance on the deferral of direct loan origination costs in ASC paragraph 310-20-25-2. The FASB was concerned about an entity relying on that analogy because those requirements were developed for financial instruments rather than for goods or services in contracts with customers. An entity applying IFRSs would be required to evaluate costs in accordance with IAS 38 *Intangible Assets*, which was not developed for the specific context of contracts with customers. In addition, the boards were concerned that there would be no guidance replacing the existing guidance on pre-contract costs for construction contracts.
- BC153 Because of those concerns, the boards decided to develop common requirements for when an entity should recognise an asset that arises when an entity engages in activities that are necessary to enable it to satisfy a performance obligation. In developing those requirements, the

boards' intention is not simply to normalise profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. Rather, the intention is to focus on the recognition of assets associated with contracts with customers.

- BC154 To provide a clear objective for recognising and measuring any asset arising from contract fulfilment costs, the boards concluded that only costs that relate directly to a contract should be included in the cost of the asset.
- BC155 The boards considered testing for impairment any recognised asset arising from fulfilment costs using one of the existing impairment tests in their respective standards (for example, IAS 2 *Inventories* or inventory in ASC Section 330-10-35; IAS 36 *Impairment of Assets* or long-lived assets in ASC Section 360-10-35). However, the boards concluded that to be consistent with the measurement approach of the proposed requirements, the impairment test should be based on comparing the carrying amount of the asset with the remaining amount of consideration from the customer—ie the amount of the transaction price allocated to the remaining performance obligations. That also would be consistent with the test for identifying whether performance obligations are onerous (as discussed in paragraphs BC130–BC143).

### **Costs of obtaining a contract**

- BC156 The boards' decision to address the costs of fulfilling a contract does not affect the boards' decision that an entity should recognise the selling, marketing, advertising and other costs of obtaining a contract as expenses when the entity incurs those costs. The costs of fulfilling a contract relate to assets separate from the contract (for example, inventory; property, plant and equipment; and intangible assets), although some of those costs may be incurred as part of the process of obtaining a contract (for example, engineering and design costs). However, the asset resulting from the costs of obtaining a contract is primarily the contract asset (unless those costs also relate to assets separate from the contract).
- BC157 As explained in paragraph BC28, a contract asset is the asset arising from the combination of the remaining rights and performance obligations in a contract. In concept, a contract asset can arise as a result of obtaining a contract if the measure of the remaining rights exceeds the measure of the remaining obligations. If a contract asset is recognised as a result of obtaining a contract, its measure at contract inception generally would depend on the amount the entity is able to include in the pricing of the

contract for the level of effort and resources required to obtain that type of contract. Hence, the value of the asset at contract inception would be greater in industries in which obtaining a contract with a customer is costly.

- BC158 Consistently with their reasons for rejecting the measurement of performance obligations at exit price (as noted in paragraph BC77), the boards concluded that an entity should recognise a contract asset and revenue only as a result of satisfying a performance obligation in the contract. Therefore, the proposed requirements specify that the contract asset is measured at nil at contract inception. Consequently, any costs of obtaining a contract are recognised as expenses when incurred, even if those costs are direct and incremental (for example, incremental costs of securing an investment management contract). That is different from some current practice, in which specified costs of obtaining a contract are recognised as an asset and amortised as the related revenue is recognised.

### **Presentation (paragraphs 64–68)**

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- BC159 The boards considered whether to require a gross presentation or a net presentation of the rights and performance obligations in a contract with a customer.
- BC160 In the discussion paper, the boards proposed that the remaining rights and performance obligations in a contract would form a single unit of account and would be accounted for, and presented, on a net basis as either a contract asset or a contract liability. The boards noted that the rights and obligations in a contract with a customer are interdependent—the right to receive consideration from a customer is dependent on the entity’s performance and, similarly, the entity will perform only as long as the customer continues to pay. They concluded that these interdependencies are best reflected by presenting the remaining rights and obligations net in the statement of financial position.
- BC161 Most respondents to the discussion paper agreed with a net presentation. Subsequently, in developing the proposed requirements, the boards considered whether the rights and performance obligations in any contracts should be presented on a gross basis, ie as separate assets and liabilities. In particular, the boards considered contracts that are subject to the legal remedy of specific performance. The boards observed that in the event of a breach, such contracts require the entity and the customer to perform as specified in the contract. Therefore, unlike most contracts that can be settled net, specific performance contracts generally would

result in a two-way flow of resources between the customer and the entity. The contracts are akin to those financial contracts that are settled by physical delivery rather than by a net cash payment and for which the units of account are the individual assets and liabilities arising from the contractual rights and obligations.

- BC162 The boards decided against making any exception for specific performance contracts. That is because the remedy of specific performance is relatively rare and is not available in all jurisdictions. In addition, it is only one of a number of possible remedies that could be awarded by a court if legal action were taken for breach of contract. Therefore, basing the accounting on a determination of what would happen in that event would both be counter-intuitive (because entities do not enter into contracts with the expectation that they will be breached) and difficult (because an entity would need to determine at contract inception what remedy would be awarded by the court if litigation were to take place in the future).

### **Relationship between contract assets and receivables**

- BC163 When an entity performs first by satisfying a performance obligation before the customer performs by paying the consideration, the entity has a contract asset—a right to consideration from a customer in exchange for goods or services transferred to the customer.
- BC164 In many cases, that contract asset is an unconditional right to consideration—a receivable—because nothing other than the passage of time makes payment of the consideration due. The boards decided that there was no need for the revenue recognition standard to address the accounting for receivables in addition to revenue recognition. Issues such as the subsequent measurement (or impairment) of receivables and disclosures relating to those assets are already addressed in IFRSs and US GAAP.
- BC165 Therefore the boards decided that once an entity has an unconditional right to consideration, the entity should present that right as a receivable separately from the contract asset and account for it in accordance with existing requirements. Consequently, contract assets are recognised in accordance with the proposed requirements when an entity has satisfied a performance obligation but does not yet have an unconditional right to consideration, for example because it first needs to satisfy another performance obligation in the contract.



BC166 In many cases, an unconditional right to consideration arises when the entity performs and issues an invoice for payment to the customer. For example, payment for goods or services is often due and an invoice is often issued when the entity has transferred the goods or services to the customer. However, the act of invoicing the customer for payment does not indicate whether the entity has an unconditional right to consideration. For instance, the entity may have an unconditional right to consideration before it invoices (unbilled receivable), if there is nothing but the passage of time before it is able to issue an invoice. In addition, in some cases an entity can have an unconditional right to consideration before it has satisfied a performance obligation. For example, an entity may enter into a non-cancellable contract that requires the customer to pay the consideration a month before the entity provides goods or services. On the date when payment is due, the entity has an unconditional right to consideration.

### **Disclosure (paragraphs 69–83)**

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BC167 Some of the main criticisms by regulators and users of existing revenue disclosures are that the disclosures are inadequate and lack cohesion with the disclosure of other items in the financial statements. For example, many users complain that entities present revenue in isolation so that users cannot relate revenue to the entity's financial position.

BC168 In the light of those deficiencies, the boards decided to propose a comprehensive and coherent set of disclosures to help users of financial statements understand and analyse how contracts with customers affect an entity's financial statements. In identifying the types of disclosures that might meet that objective, the boards initially considered:

- (a) the proposals from the Investors Technical Advisory Committee (ITAC) of the FASB for a 'principle-based' disclosure framework; and
- (b) the approaches adopted for disclosure in recent standards, including IFRS 7 *Financial Instruments: Disclosures*, and disclosures that were developed by the EITF for ASU 2009-13 (now ASC Section 605-25-50).

BC169 To be consistent with recent standards, the boards concluded that a comprehensive and coherent set of revenue disclosures should include:

- (a) an explanation of the composition of revenue recognised in a reporting period;

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- (b) a reconciliation of changes in contract asset and liability balances from period to period;
- (c) information about performance obligations and onerous performance obligations that the entity has with customers; and
- (d) an explanation of the judgements used in recognising revenue.

BC170 The boards' conclusions on the disclosure of this type of information are explained in paragraphs BC172–BC185.

### **Disclosure objective**

BC171 Many recent standards specify a disclosure objective. The boards decided that the proposed requirements also should specify an objective for the revenue disclosures. The boards think that interpretation and implementation of the disclosure requirements improve if the overarching objective for the disclosures is clearly stated. That is because preparers can assess whether the overall quality and informational value of their revenue disclosures are sufficient to meet users' needs. The boards also observed that specifying a disclosure objective would avoid the need for detailed and prescriptive disclosure requirements to meet the specific information needs for the many and varied types of contracts with customers that are within the scope of the proposed requirements. The boards noted that developing principle-based disclosure requirements is necessary because it would not be possible or appropriate, given the objective of a single revenue standard, to develop specific requirements for specific transactions or industries.

### **Disaggregation of reported revenue**

BC172 Revenue recognised in the statement of comprehensive income is a composite amount arising from many contracts with customers. The revenue could arise from the transfer of different goods or services or from contracts involving different types of customers or markets. The disclosure of disaggregated revenue information helps users to understand the composition of the revenue that has been recognised in a reporting period. The level of disaggregation is important—information is obscured if the disclosure of that information is either too aggregated or too granular.

BC173 The boards observed that existing standards require revenue to be disaggregated and that those standards specify the basis for the disaggregation. For example:

- (a) IAS 18 requires disclosure of the amount of each significant category of revenue recognised during the period, including revenue arising from the sale of goods, the rendering of services, interest, royalties and dividends.
- (b) IFRS 8 *Operating Segments* and ASC Topic 280 on segment reporting require an entity to disclose revenue for each operating segment (reconciled to total revenue) and to disaggregate its total revenue by products or services (or by groups of similar products or services) and by geography to the extent that the entity's operating segments are not based on different products or services or different jurisdictions. Related disclosure is required on the entity's types of products and services and its major customers. However, the amounts disclosed can be measured on a basis that is used internally and might not accord with the other measurements used for other purposes in IFRSs or US GAAP.

BC174 Feedback from users consulted on revenue disclosures indicated that the basis for meaningfully disaggregating revenue will not be uniform. Depending on the circumstances, the most useful disaggregation could be by type of good or service, by geography, by market or type of customer, or by type of contract. The boards were persuaded by this view and concluded that the proposed requirements should not prescribe a specific characteristic of revenue to be used as the basis for disaggregation. Instead, the boards propose that an entity should disaggregate revenue into categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors.

BC175 The Financial Statement Presentation project is considering a presentation approach whereby an entity would disaggregate income and expense by nature and by function. That approach is similar to the disaggregation requirement in paragraph 74 of these proposed requirements. The boards will consider whether separate disaggregation requirements are necessary for revenue when they review feedback on the Financial Statement Presentation project.

### **Reconciliation of contract balances**

BC176 For users to assess the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers, they need to understand the relationship between the revenue recognised in a reporting period and the contract asset and liability balances. Among other things, this includes identifying whether the entity typically

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receives payment before or after transferring goods or services to the customer and quantifying the relationship between revenue recognised and cash flows. Although entities currently recognise working capital balances at each reporting date, such as trade receivables and deferred revenue, users have indicated that the relationship between those balances and the revenue recognised in the period is unclear. Therefore, to clarify that relationship, the boards decided that an entity should disclose a reconciliation of the contract asset and liability balances. The entity could present the reconciliation gross or net.

- BC177 A gross reconciliation would show the remaining contractual rights and performance obligations in separate columns with a total net amount that links to the statement of financial position. In doing so, the reconciliation would highlight the amount of new contracts obtained and the amount of unsatisfied performance obligations and, hence, indicate the amount of revenue expected to be recognised in the future as a result of contracts that already exist. The boards acknowledged that this information would be useful to users of financial statements. However, they also noted:
- (a) the high cost of preparing and auditing the reconciliation because an entity would be required to measure all unperformed contracts, including executory contracts;
  - (b) the high level of judgement inherent in executory contracts, including determining when a contract comes into existence; and
  - (c) the information provided may not be useful for many types of contracts, such as those with a short duration.
- BC178 Hence, the boards decided that an entity should disclose a reconciliation from the opening to the closing aggregate balance of the (net) contract assets and (net) contract liabilities. However, the boards understand that users are mainly interested in a gross reconciliation because it would result in the disclosure of performance obligations on a gross basis. Therefore, they decided that an entity should also disclose a maturity analysis that shows the amount of its remaining performance obligations and the expected timing of their satisfaction.
- BC179 The boards think that the separate disclosure of remaining performance obligations would enable users:
- (a) to assess the risks associated with future revenues. In general, users see the outcome as more uncertain the further out is the satisfaction of the performance obligation because it will be

subject to a greater number of factors and uncertainties than will a more immediately satisfied performance obligation.

- (b) to understand the timing and amount of revenue to be recognised from existing contracts.
- (c) to analyse trends in the amount and timing of revenue.
- (d) to obtain consistency in the reporting of 'backlog', which is often disclosed by entities in management commentary but calculated on a variety of bases.
- (e) to understand how changes in judgements or circumstances might affect the pattern of revenue recognition.

BC180 The boards acknowledge that the relevance of a maturity analysis diminishes if those performance obligations arise from contracts that are satisfied shortly after contract inception. Feedback from users indicated that this information is mainly useful for longer-term contracts, such as construction contracts and service arrangements. For that reason, the proposed requirements limit the disclosure of the maturity analysis to contracts with an original duration of more than one year.

### **Description of performance obligations**

BC181 Existing standards require entities to disclose their accounting policies for recognising revenue (see paragraph 10(e) of IAS 1 *Presentation of Financial Statements* or the guidance on notes to financial statements—disclosures in ASC Section 235-10-50). However, users have suggested that, in many cases, entities provide a 'boilerplate' description of the accounting policy adopted without explaining how the accounting policy relates to the contracts that the entity enters into with customers.

BC182 The boards' proposals would not change those requirements. However, in response to the concerns raised by users, paragraph 77 would require an entity to provide more descriptive information about its performance obligations.

### **Onerous performance obligations**

BC183 The boards decided that the disclosures relating to onerous performance obligations should be consistent with the existing onerous contract disclosures in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

### **Assumptions and uncertainties**

- BC184 IFRSs and US GAAP have general requirements for the disclosure of significant accounting estimates and judgements made by an entity. Because of the importance placed on revenue by users of financial statements, the boards decided that the proposed requirements should include specific disclosures on the estimates used and judgements made in determining the amount and timing of revenue recognition.
- BC185 The EITF reached a similar conclusion when developing the requirements in ASC Section 605-25-50 for the disclosure of multiple-element arrangements. The EITF consulted extensively to develop disclosures to communicate the judgements used and their effect on the recognition of revenue from multiple-element arrangements. After considering whether those disclosures could apply appropriately to all contracts with customers, the boards decided that the proposed requirements should include disclosures on significant judgements that are similar to those required by ASC Section 605-25-50.

### **Application guidance (paragraphs B1–B96)**

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- BC186 The boards decided to include application guidance to clarify how the principles in the proposed requirements would apply to features found in various typical contracts with customers. Some of that application guidance is based on existing guidance in IFRSs or US GAAP. Consistently with the objective of developing a single revenue recognition model (as discussed in paragraphs BC3 and BC4), the boards do not intend to provide guidance that would apply only to specific industries.

### **Sale of a product with a right of return (paragraphs B5–B12)**

- BC187 In the discussion paper, the boards identified two approaches for accounting for goods sold with a right of return:
- (a) a performance obligation approach, whereby the promise to provide a return right is a performance obligation. Under this approach, an entity would allocate some of the transaction price in the contract to that performance obligation and recognise it as revenue when the entity provides return services.
  - (b) a failed sale approach, whereby revenue (and costs of sales) is recognised only for goods transferred to customers that are

expected to result in successful sales (ie sales that will not fail). Under this approach, the promise to accept returns would not be a performance obligation.

- BC188 The boards did not express a preliminary view in the discussion paper but invited comment on the issue. The views from respondents were mixed. Some respondents disagreed with the performance obligation approach because it would result in the entity recognising revenue as goods are returned, which they thought was inappropriate because the entity does not retain consideration from customers who return their goods. Furthermore, they observed that the performance obligation approach seems to result in recognition of more revenue than the amount of consideration ultimately retained by the entity. Other respondents disagreed with the failed sale approach because the entity would continue to recognise as inventory the goods expected to be returned even though customers have obtained control of those goods.
- BC189 In the light of the feedback from respondents and the boards' subsequent decisions on variable consideration, the boards refined their analysis of rights of return. The boards concluded that contracts with a right of return typically include at least two performance obligations—a performance obligation to provide the good to the customer and a performance obligation for the return right service, which is a stand-ready obligation to accept the goods returned by the customer during the return period.
- BC190 In relation to performance obligations to provide goods to customers, the boards concluded that an entity has made an uncertain number of sales when it provides goods with a return right. That is because it is only after the return right expires that the entity will know with certainty how many sales it has made (ie how many sales did not fail). Therefore, the boards decided that an entity should not recognise revenue for sales that are expected to fail because the customer will exercise their return rights.
- BC191 Measuring revenue from contracts with return rights can also be viewed as analogous to measuring variable consideration. The return right means that the transaction price—and therefore the amount of revenue—is uncertain at the point of sale. Consistently with their decisions on variable consideration, the boards decided that revenue should be measured at the expected (probability-weighted) amount of consideration that the entity will retain. Therefore, the entity recognises

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a liability for its obligation to refund amounts to customers for those sales that are expected to fail. That refund liability would be measured at the expected (probability-weighted) amount of refunds and credits (for example, a store credit) provided to customers.

- BC192 The boards also considered whether to account for the return right service as a performance obligation separate from the refund liability, by allocating the transaction price between the performance obligation to provide the good and the performance obligation for the return right service. The boards expect that a return right would generally result in a separate performance obligation because it is functionally distinct from the underlying goods provided under the contract and has a distinct profit margin. Moreover, if an entity does not recognise a performance obligation for the return right service, it will have recognised all of the revenue and margin in the contract once the customer obtains control of the good. Such an outcome might not faithfully depict the entity's performance under the contract.
- BC193 However, the boards also observed that accounting for the return right as a performance obligation would typically require the entity to estimate the stand-alone selling price of that service. In many cases, the number of returns is expected to be a small percentage of the total sales and the return period is often short (such as 30 days). Therefore, the boards concluded that the incremental information provided to users by accounting for the return right service as a performance obligation would not justify the complexities and costs of doing so. Accordingly, the boards decided that an entity should not account for a return right service as a separate performance obligation.
- BC194 The boards also considered how to account for goods that are returned to the entity in saleable condition. The boards concluded that an entity should not recognise as inventory the products expected to be returned by customers. That is because a right of return does not preclude customers from directing the use of, and receiving the benefit from, goods they have purchased with a right of return. However, the entity would have a contractual right to recover the good from the customer if the customer exercises its option to return the good and obtain a refund. The boards concluded that the right to recover the inventory asset should be recognised separately from the refund liability because that provides greater transparency and ensures that the asset is considered for impairment testing.



### **Product warranties and product liabilities (paragraphs B13–B19)**

- BC195 In the discussion paper, the boards proposed that all product warranties (whether described as a manufacturer’s warranty, a standard warranty or an extended warranty) give rise to a separate performance obligation for an entity—the promised service being warranty coverage. Those warranties require an entity to stand ready to replace or repair the product over the term of the warranty. Consequently, in any contract for the sale of a product that includes a warranty, an entity would allocate some of the transaction price to the warranty on a relative selling price basis and recognise that amount as revenue only when the promised warranty services transfer to the customer.
- BC196 Most respondents did not support the boards’ proposals. They either:
- (a) disagreed that all warranties give rise to separate performance obligations; or
  - (b) questioned whether identifying a separate performance obligation would provide sufficiently useful information to justify the cost and effort, especially if the warranty period is relatively short.
- BC197 In the light of the feedback from respondents, the boards decided to draw a distinction between warranties that provide the customer with coverage for:
- (a) defects that exist when the product is transferred to the customer (a ‘quality assurance warranty’); and
  - (b) faults that arise after the product is transferred to the customer (an ‘insurance warranty’).

#### **Quality assurance warranty**

- BC198 A quality assurance warranty is a promise that the product is free from defects at the time of sale. The boards concluded that this promise does not provide any additional service to the customer—the entity and the customer entered into a contract for the transfer of a product that was not defective. Consequently, a quality assurance warranty in a contract with a customer is not a performance obligation.
- BC199 The boards considered viewing a quality assurance warranty as either:
- (a) a liability to replace or repair a defective product; or

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- (b) an unsatisfied performance obligation because the entity has not provided the customer with a product that is free from defects at the time of sale.
- BC200 If an entity is viewed as having a liability to replace or repair a defective product, it would recognise revenue once it transfers the product to the customer. The entity would then judge, using all the available evidence, whether the product was defective and, if so, recognise a separate liability for its obligation to replace or repair that product in accordance with IAS 37 or ASC Topic 460 on guarantees. That approach would be similar to current practice for warranties that are neither separately priced nor for an extended term (under US GAAP) or a separately identifiable component of the sales contract (under IFRSs).
- BC201 If an entity is viewed as having an unsatisfied performance obligation, the uncertainty about whether the product was defective when transferred to the customer means that it is uncertain whether the entity satisfied its performance obligation. The entity would judge, on the basis of all the available evidence, whether the product was defective and, if so, continue to recognise the performance obligation for that product.
- BC202 To be consistent with the accounting for rights of return, the boards concluded that an entity has an unsatisfied performance obligation if it transfers to a customer a defective product that is subject to a quality assurance warranty. In other words, the sale has failed.
- BC203 The boards rejected the alternative of recognising the warranty as a separate liability because, if that liability is measured at cost (as it would be at present under ASC Topic 460), the entity would recognise all of the revenue and all of the margin in the contract when the product transfers to the customer. The boards concluded that an entity should not recognise all of the margin in a contract before it has satisfied all its performance obligations under the contract.

### **Insurance warranty**

- BC204 An entity providing an insurance warranty is providing a service in addition to the promise to provide a product that was not defective at the time of sale. The entity is promising to repair or replace the product if it breaks down within a specified period (normally subject to some conditions). This additional service to the customer is a performance obligation and meets the definition of an insurance contract. (Although, in the Insurance Contracts project, the boards have tentatively decided that warranties issued directly by a manufacturer, dealer or retailer would be within the scope of these proposed requirements.)

BC205 In some jurisdictions, the law requires an entity to provide warranties with the sale of its products. The law might state that an entity is required to repair or replace products that develop faults within a specified period from the time of sale. Consequently, these statutory warranties may appear to be insurance warranties because they would cover faults arising after the time of sale, not just defects existing at the time of sale. However, in many such cases, the boards concluded that the law can be viewed as simply operationalising a quality assurance warranty. In other words, the objective of these statutory warranties is to protect the customer against the risk of purchasing a defective product. But rather than having to determine whether the product was defective at the time of sale, the law presumes that if a fault arises within a specified period (which can vary depending on the nature of the product), the product was defective at the time of sale. Therefore, these statutory warranties should be accounted for as quality assurance warranties.

#### **Product liability laws**

BC206 Some respondents to the discussion paper questioned whether product liability laws give rise to performance obligations. These laws typically require an entity to pay compensation if one of its products causes harm or damage. The boards concluded that an entity should not recognise a performance obligation arising from these laws because the performance obligation in a contract with a customer is to provide a product that is not defective. The entity would satisfy that obligation by supplying a product that is not defective.

BC207 Any obligation of the entity to pay compensation for the damage or harm that its product causes is separate from the performance obligation. The boards noted that an entity would account for this obligation separately from the contract with the customer and in accordance with IAS 37 or the guidance on loss contingencies in ASC Subtopic 450-20.

#### **Principal versus agent considerations (paragraphs B20–B23)**

BC208 Existing standards require an entity to assess whether it is acting as a principal or an agent when goods or services are transferred to end customers. That assessment determines whether an entity recognises revenue for the gross amount of customer consideration (if the entity is a principal) or for a net amount after the principal is compensated for its goods or services (if the entity is an agent). Under the proposed requirements, principals and agents would have different performance

obligations. A principal controls the goods or services before they are transferred to customers. Consequently, the principal's performance obligation is to transfer those goods or services to the customer. In contrast, an agent does not control the goods or services before they are transferred to customers. The agent facilitates the sale of goods or services between a principal and the customer. Therefore, an agent's performance obligation is to arrange for another party to provide the goods or services to the customer. The transaction price attributable to an agent's performance obligation is the fee or commission that the agent receives for providing those services.

- BC209 It may not always be readily apparent whether an entity has obtained control of goods or services before they are transferred to a customer. Similar issues arise in consignment sales. For that reason, the boards have included in the proposed application guidance some indicators that a performance obligation relates to an agency relationship. They are based on the indicators specified in the guidance on principal agent considerations in ASC Subtopic 605-45 and in the illustrative examples accompanying IAS 18.

## **Customer options for additional goods or services**

### **Identifying the performance obligation (paragraphs B24–B26)**

- BC210 In the discussion paper, the boards highlighted the fact that at least some options for additional goods or services would be performance obligations in a contract with a customer. However, the boards did not decide when an option for additional goods or services is a performance obligation in an existing contract. Respondents to the discussion paper had differing views on whether some or all options for additional goods or services would be performance obligations.
- BC211 In subsequent discussions, the boards observed that it can be difficult to distinguish between:
- (a) an option that the customer pays for (often implicitly) as part of an existing contract—which would be a performance obligation to which part of the transaction price is allocated; and
  - (b) a marketing or promotional offer that the customer did not pay for and, although made at the time of entering into a contract, is not part of the contract—which would not be a performance obligation in that contract.

BC212 Similar difficulties in distinguishing between an option and an offer have arisen in US GAAP for the software industry. In response to those practice issues, ASC Section 985-605-15 indicates that an offer of a discount on future purchases of goods or services would be presumed to be a separate option in the contract if that discount is significant and is incremental both to the range of discounts reflected in the pricing of other elements in that contract and to the range of discounts typically given in comparable transactions. The boards propose similar criteria to differentiate between an option and a marketing or promotional offer. However, to avoid implying that *significant* and *material* are intended to be different recognition thresholds, the boards refer to the materiality of the right to acquire additional goods or services rather than the significance of that right.

#### **Allocating the transaction price (paragraphs B86–B88)**

BC213 In accordance with the proposed requirements, the entity must determine the stand-alone selling price of the option so that part of the transaction price is allocated to the performance obligation. In some cases, the stand-alone selling price of the option may be directly observable or it may be indirectly observable by, for example, comparing the observable prices for the goods or services with and without the option. In many cases, though, the stand-alone selling price of the option would need to be estimated.

BC214 Option pricing models can be used to estimate the stand-alone selling price of an option. The price of an option includes the intrinsic value of the option (ie the value of the option if it were exercised today) and its time value (ie the value of the option that depends on the time until the expiry and the volatility of the price of the underlying goods or services). The boards decided that the benefits to users of allocating some of the transaction price to the price and availability guarantees inherent in the time value component of the option price would not justify the costs and difficulties to do so. However, the boards concluded that an entity should be able to readily obtain the inputs necessary to measure the intrinsic value of the option in accordance with paragraph B87 and those calculations should be relatively straightforward and intuitive. This measurement approach is consistent with the measurement application guidance for customer loyalty points in IFRIC 13 *Customer Loyalty Programmes*.

*Renewal options*

- BC215 A renewal option gives a customer the right to acquire additional goods or services of the same type as those supplied under an existing contract. The option could be described as a renewal option within a relatively short contract (for example, a one-year contract with an option to renew that contract for a further year at the end of the first and second years) or a cancellation option within a longer contract (for example, a three-year contract that allows the customer to discontinue the contract at the end of each year). A renewal option could be viewed similarly to other options to provide additional goods or services. In other words, the renewal option could be a separate performance obligation in the contract if it provides the customer with a material right that the customer could not otherwise obtain without entering into that contract.
- BC216 However, in cases in which a renewal option provides the customer with a material right, there typically is a series of options. In other words, to exercise any option in the contract, the customer must have exercised all the previous options in the contract. The boards concluded that determining the stand-alone selling price of a series of options would be complex. That is because determining the estimated stand-alone selling prices of the options would require an entity to identify various inputs, such as the stand-alone selling prices for the goods or services for each renewal period and the likelihood that customers will renew for the subsequent period. In other words, the entity would have had to consider the entire potential term of the contract in order to determine the amount of the transaction price from the initial period that should be deferred until later periods.
- BC217 For that reason, the boards concluded that it would be simpler for the entity to view a contract with renewal options as a contract for its expected term (ie including the expected renewal periods) determined on a probability-weighted basis, rather than as a contract with a series of options. Under this approach, an entity would include the optional goods or services that it expects to provide (and corresponding expected customer consideration) in the initial measurement of the contract.
- BC218 The boards concluded that it would be preferable to reflect uncertainty about the term of the contract in the measurement of the contract rather than, say, on the basis of its most likely term because that approach better reflects the uncertainty of the entity's contract—ie the existence of the

option. Furthermore, although each individual contract might not run for the expected term, using a probability-weighted approach more appropriately reflects the economics when there is a portfolio of contracts.

- BC219 The boards propose two criteria to distinguish renewal options from other options to acquire additional goods or services. First, the additional goods or services underlying the renewal options must be similar to those provided under the initial contract—ie the entity continues to provide what it was already providing. Therefore, it is more intuitive to view the goods or services underlying such options as part of the initial contract. In contrast, customer loyalty points and many discount vouchers would be considered to be separate deliverables in the contract because the underlying goods or services may be of a different nature.
- BC220 The second criterion is that the additional goods or services in the subsequent contracts must be provided in accordance with the terms of the original contract. Consequently, the entity's position is constrained—it cannot change those terms and conditions and, in particular, it cannot change the pricing of the additional goods or services beyond the parameters specified in the original contract. That is different from examples such as customer loyalty points and discount vouchers. For instance, if an airline frequent flyer programme offers 'free' flights to customers, the airline is not constrained because it can subsequently determine the number of points that are required to be redeemed for any particular 'free' flight. Similarly, when an entity grants discount vouchers, typically it has not constrained itself with respect to the price of the subsequent goods or services against which the discount vouchers will be redeemed.

### **Licensing and rights to use (paragraphs B31–B39)**

- BC221 Many respondents to the discussion paper questioned how an entity would identify performance obligations in a contract in which an entity licenses its intellectual property by granting a customer the right to use that property. Hence, the boards decided to develop application guidance on the issue.
- BC222 The boards noted that some contracts would be accounted for as a sale, rather than a licence, of intellectual property because the customer obtains control of that intellectual property. That would be the case if an entity grants the exclusive right to use intellectual property for substantially all of its remaining economic life.

- BC223 When developing application guidance, the boards observed that licensing arrangements that are not sales of intellectual property often have characteristics similar to those of a lease. In both cases, a customer purchases the right to use an asset of the entity. The boards decided tentatively in the Leases project that a lessor should recognise revenue during the term of the lease as the lessor permits the lessee to use its asset. However, the boards thought that this pattern of revenue recognition would not be appropriate for all licences of intangible assets. Consequently, the boards considered the following potential differences between a licensing arrangement and a lease:
- (a) tangible versus intangible—the boards decided that it would be difficult to justify why the accounting for a promised asset should differ depending on whether the asset is tangible or intangible. Moreover, in the FASB’s Conceptual Framework, the discussion on the nature of assets de-emphasises the physical nature of assets.
  - (b) exclusive versus non-exclusive—leases, by nature, are exclusive because the lessor cannot grant the right to use a leased asset to more than one lessee at the same time. In contrast, an entity can grant similar rights to use some intellectual property to more than one customer under substantially the same terms.
- BC224 Consequently, the boards decided that an entity should account for a promise to grant an exclusive right to use intellectual property (which is not a sale of that intellectual property) consistently with their tentative decisions on how a lessor would account for the promise to grant a right to use a tangible asset. That right to use gives rise to a performance obligation that is satisfied continuously over time as the entity permits the customer to use the property over time. Because the entity cannot grant a similar right to more than one customer at the same time, the entity’s use of the intellectual property during the licence term is constrained for a period of time. In the boards’ view, that constraint over time suggests that the entity has a performance obligation that is not fully satisfied until the end of the licence term. The boards will review their tentative decisions in the light of feedback on the proposed requirements and further discussions in the Leases project.
- BC225 A licence is non-exclusive if the entity continues to retain and control its intellectual property and can use that property to grant similar licences to other customers under substantially the same terms. In other words, the entity’s rights to its intellectual property are not diminished by granting non-exclusive licences. In those cases, the entity is granting the customer an asset that is separate from the entity’s intellectual property.



For example, a payroll processing software product contains intellectual property, but the customer's asset is the use and benefit of payroll processing and not access to the entity's intellectual property (ie the source code). Similarly, when a customer purchases a dress, that dress contains intellectual property for its design, but the customer's asset is the use and benefit of the dress.

- BC226 The boards noted that licensing intellectual property on a non-exclusive basis often is the only way an entity can distribute its product and protect its intellectual property from the unauthorised duplication of its products. They concluded that the asset transferred with a licence is, in principle, similar in nature to the promised asset in a sale of any product. Hence, the legal distinction between a licence and a sale should not cause revenue recognition on non-exclusive licences to differ from the sale of other types of products.

### **Product financing arrangements (paragraph B51)**

- BC227 If an entity enters into a contract with a repurchase agreement and the customer does not obtain control of the asset, the contract is a financing arrangement if the price at which the entity repurchases the asset (after reflecting the time value of money) is equal to or more than the original sales price of the asset.
- BC228 The FASB noted that if a repurchase agreement is a financing arrangement, an entity applying US GAAP could apply the guidance on product financing arrangements in ASC Subtopic 470-40. However, IFRSs do not have an equivalent standard (the illustrative examples accompanying IAS 18 acknowledge the possibility of a financing arrangement but do not specify the accounting).
- BC229 Therefore, to ensure consistent accounting in IFRSs and US GAAP for a financing arrangement that arises from a contract with a customer, the boards decided to provide guidance consistent with ASC Subtopic 470-40.
- BC230 Consequently, the FASB decided to withdraw ASC Subtopic 470-40. It noted that the remaining guidance in ASC Subtopic 470-40 addresses situations in which an entity arranges for another party to purchase products on its behalf and agrees to purchase those products from the other party. In those cases, the entity is required to recognise the products as an asset and to recognise a related liability when the other party purchases the product. The FASB noted that the proposed model would result in similar accounting when the other party acts as an agent of the entity (ie the other party does not obtain control of the products).

**Transition (paragraph 85)**

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- BC231 The boards decided that an entity should apply the proposed requirements retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* or the guidance on accounting changes in ASC Topic 250. Retrospective application would provide users of financial statements with useful trend information because transactions would be recognised and measured consistently both in the current period and in the comparative periods presented. The boards think that it is particularly important for users to be able to understand trends in revenue, given its significance to the financial statements.
- BC232 The boards noted that retrospective application could be burdensome for some entities preparing financial statements, particularly those entities with many long-term contracts. In addition, some entities might find it difficult to estimate stand-alone selling prices at contract inception and variable consideration throughout the contract without using hindsight. However, the boards noted that some of those concerns would be addressed by:
- (a) IAS 8 and ASC Topic 250 limiting the retrospective application of an accounting policy if it is impracticable; and
  - (b) the boards contemplating a long lead time between issuing a standard on revenue from contracts with customers and its effective date, which would reduce the extent of hindsight needed in applying that standard.
- BC233 Nonetheless, on the basis of that assessment of the potential costs associated with retrospective application, the boards also considered whether the proposed requirements should instead apply:
- (a) on a prospective basis, either for all new contracts from a specified date or for all contracts (new and existing) from that date; or
  - (b) on a limited retrospective basis.
- BC234 The boards rejected the alternative of applying the proposed requirements prospectively because the recognition and measurement of revenue arising from new contracts and existing contracts would not be comparable between the current period and the comparative periods. Moreover, if the requirements were applied prospectively only for new contracts, the recognition and measurement of revenue would not be comparable in the current period.

BC235 The boards considered whether limiting the retrospective application of the proposed requirements would address some of those preparer concerns and still provide comparable revenue information to users of financial statements. Various alternatives for limiting the retrospective application of the proposed requirements were considered. Those alternatives were based on applying the proposed requirements retrospectively to all contracts except those contracts that are completed at a specified date. That could be a date in the past or a date after the effective date of the proposed requirements. However, the boards were unable to identify a specific date for limiting the retrospective application of the proposed requirements that, on cost-benefit grounds, would be preferable to full retrospective application.

### **Effective date and early adoption (paragraph 84)**

BC236 The boards will consider collectively the effective dates and transition for the standards—including revenue recognition—that they have targeted to issue in 2011 and, as part of that consideration, will publish a separate consultation paper to seek comments from interested parties. Hence, the boards may modify their previously stated preferences in the case of some individual standards. As part of that consideration, the boards also will address whether early adoption of the standard on revenue from contracts with customers should be permitted.

BC237 Consequently, the proposed requirements do not specify a possible effective date or whether the proposed requirements could be adopted early, but the boards intend to provide enough time to implement the proposed changes.

BC238 The FASB has indicated a preference to prohibit entities adopting the standard early. The IASB considered the related implications for IFRS 1 *First-Time Adoption of International Financial Reporting Standards* and decided that IFRS 1 should not provide any exceptions to, or exemptions from, the proposed requirements for first-time adopters of IFRSs. To avoid requiring two changes in a short period, the IASB proposes that first-time adopters should be permitted to adopt the standard early.

## Costs and benefits

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- BC239 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users in making economic decisions. To attain that objective, the boards try to ensure that a proposed standard will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Present investors primarily bear the costs of implementing a new standard. Although those costs might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital, including credit, and the efficient allocation of resources in the economy.
- BC240 The evaluation of costs and benefits is necessarily subjective. In making their judgement, the boards consider the following:
- (a) the costs incurred by preparers of financial statements;
  - (b) the costs incurred by users of financial statements when information is not available;
  - (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information; and
  - (d) the benefit of better economic decision-making as a result of improved financial reporting.
- BC241 The boards propose a single standard that would recognise revenue on a consistent and comparable basis for a wide range of contracts with customers. By accounting for those contracts consistently, the proposed standard would address many of the weaknesses and inconsistencies inherent in existing revenue requirements, which have contributed to the existence of diverse practices in the recognition of revenue and, as a result, frequent requests for authoritative guidance on applying those existing requirements to specific transactions or other emerging issues.
- BC242 In addition, a single revenue recognition standard would improve comparability in the recognition, measurement and disclosure of revenue across transactions and across entities operating in various industries. Users have indicated that comparable revenue information is useful when assessing the financial performance of an entity and

assessing financial performance across a number of entities. Moreover, a common revenue standard would make the financial reporting of revenue comparable between entities that prepare financial statements in accordance with IFRSs or US GAAP.

- BC243 The boards acknowledge that some preparers and users do not perceive significant weaknesses in some existing revenue standards or in the financial information resulting from applying those standards to some industries. Those preparers and users have therefore questioned whether the benefits from applying a new standard in some industries would be justified by the costs involved in implementing that new standard. However, the boards concluded that the overall benefits to financial reporting that would result from a single revenue standard being applied consistently across different industries, jurisdictions and capital markets outweigh the concerns about cost-benefit assessments in particular industries. In addition, in developing their proposals, the boards have also carried forward some existing requirements where appropriate. That would reduce the amount of change for some entities on implementing a new standard.
- BC244 The proposed requirements would change existing revenue recognition practices and some entities would need to make systems and operational changes to comply with the proposed requirements. For example, some preparers have indicated that systems changes would be necessary to estimate variable consideration and contract options. The boards think that the costs of those changes would be incurred primarily during the transition from existing standards to the proposed standard, whereas the benefits resulting from increased consistency and comparability in the recognition of revenue would be ongoing.
- BC245 The proposed disclosure requirements are more substantial than those required in existing standards. The boards think that the proposed disclosures would provide users with additional information that explains more clearly the relationship between an entity's contracts with customers and the revenue recognised by the entity in a reporting period. Some users have commented that the proposed disclosures would address deficiencies that exist currently in revenue disclosures.
- BC246 As noted in paragraph BC6, since the discussion paper was published, members and staff of the boards have consulted users and preparers across a wide range of industries and jurisdictions. This has allowed the boards to better understand some of the operational issues arising from their proposals. As a result, the boards have modified some of their

preliminary views in the discussion paper to reduce the burden of implementing the proposed revenue recognition model. The boards will continue to consult widely following publication of the proposed requirements.

- BC247 On balance, the boards concluded that the proposed requirements would improve financial reporting under IFRSs and US GAAP at a reasonable cost. In arriving at that conclusion, the boards acknowledged that the assessments of costs versus benefits would be different under IFRSs and US GAAP.

## **Consequential amendments**

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### **Sales of assets that are not an output of an entity's ordinary activities**

- BC248 ASC Subtopic 360-20 on real estate sales provides guidance for recognising profit on all real estate sales, regardless of whether real estate is an output of an entity's ordinary activities.
- BC249 A contract for the sale of real estate that is an output of an entity's ordinary activities meets the definition of a contract with a customer and, therefore, would be within the scope of the proposed requirements. Consequently, the FASB considered the implications of retaining the guidance in ASC Subtopic 360-20 for other contracts. The FASB noted that the recognition of the profit or loss on a real estate sale would differ depending on whether the transaction is a contract with a customer. However, economically there is little difference between the sale of real estate that is an output of the entity's ordinary activities and real estate that is not. Hence, the difference in accounting should relate only to the presentation of the profit or loss in the statement of comprehensive income—revenue and expense, or gain or loss.
- BC250 Therefore, the FASB decided to amend ASC Subtopic 360-20 to require an entity to apply the recognition and measurement principles of the proposed requirements to contracts for the sale of real estate that is not the output of the entity's ordinary activities. However, the entity would not recognise revenue but instead would recognise a gain or a loss.
- BC251 The FASB also decided to specify that an entity should apply the recognition and measurement principles of the proposed requirements to contracts for the sale of other tangible assets within the scope of ASC Topic 360 on property, plant and equipment and intangible assets within

the scope of ASC Topic 350 on goodwill and other intangibles. The primary reason for that decision was the lack of guidance in US GAAP on accounting for the sale of those assets when they are not an output of an entity's ordinary activities and do not constitute a business or non-profit activity.

- BC252 In IFRSs, an entity selling an asset within the scope of IAS 16 *Property, Plant and Equipment*, IAS 38 or IAS 40 *Investment Property* applies the recognition principles of IAS 18 to determine when to derecognise the asset and, in determining the gain or loss on the sale, measures the consideration at fair value. However, the IASB understands that there is diversity in practice when the sale of those assets involves contingent consideration. Accordingly, to improve the accounting in IFRSs and ensure consistency with US GAAP, the IASB decided to amend those standards to require an entity to apply the recognition and measurement principles of the proposed requirements to sales of assets within the scope of those standards. The IASB decided that a *reasonably estimated* constraint on the transaction price should also apply to the sale of assets that are not an output of the entity's ordinary activities because entities face similar if not greater challenges in determining the transaction price when the asset is not an output of the entity's ordinary activities than when the asset is an output of its ordinary activities.