European Financial Reporting Advisory Group

REVENUE RECOGNITION

TOWARDS A EUROPEAN VIEW

DISCUSSION PAPER SUMMARY

A paper prepared for discussion by the
EFRAG Advisory Forum on Revenue Recognition
being held in Brussels on 18 October 2006

Introduction

1 It is currently expected that within the next month or so EFRAG, the German standard-setter (the Deutsches Rechnungslegungs Standards Committee or DRSC), and other European national standard-setters will together issue a discussion paper, entitled 'Revenue Recognition: Towards a European View'. This paper will be issued as part of Europe's Proactive Accounting Activities in Europe initiative.[1]

2 The discussion paper seeks to stimulate debate within Europe—and thereby to encourage the development of European views—on a very important subject for the future of accounting: when should revenue (by which the paper means turnover)[2] be recognised. This might sound like a non-issue—"everyone knows what revenue is and when it arises"—yet, except in the simplest of transactions, it would seem that there is little agreement as to what revenue is and when exactly it arises, and the existing standards do not help very much.

3 This note briefly summarises the key issues raised in the discussion paper.

Background

The importance of revenue

4 Revenue as the top-line of the income statement is usually the largest single item in the financial statements in monetary terms. It is also very significant in terms of its information value for investors. Investment analysts, for example, consistently report that the 'revenue number' is one of the key inputs to their analysis and assessment of an entity's past performance as well as to their forecasts of the entity's future earnings capacity.

5 Revenue has to date been important for another reason: for most businesses, the point at which revenue has been recognised has been the earliest point of profit recognition under historical cost.

6 Revenue recognition is therefore an important subject; one which entities need to address in a consistent manner. Clear, comprehensive, generally accepted revenue recognition principles are needed to ensure that consistency.

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1 EFRAG and the European National Standard Setters have reached an understanding that EFRAG and the National Standard-Setters would pool some of their resources so that together they could consider more of the issues on the IASB's work programme, and do so more deeply and at an earlier stage. In this way, Europe can become more actively involved in the IASB's work from an early stage and, as a result, can participate fully and effectively in the global standard-setting process. This initiative is known as the 'Proactive Accounting Activities in Europe' (or PAAinE) initiative.

The work that the DRSC and EFRAG have been carrying out on revenue recognition has been selected as a PAAinE project. Other PAAinE projects are currently being carried out on the Framework, the classification of instruments between equity and liabilities, pensions and other post-retirement benefits and reporting financial performance.

2 Terminology can be a real problem in discussions about notions such as 'revenue' because the term is used to mean different things. In this note and in the upcoming European discussion paper, the term 'revenue' refers to the top line of the income statement.

Weaknesses in the existing revenue standards

7 Currently, there are two main standards that address revenue: IAS 11 'Construction contracts' and IAS 18 'Revenue'. However, it is widely accepted that the material on revenue in those standards is incomplete—it says little for example about multiple-element arrangements—and is not internally consistent—the principles underlying the two standards are not the same[3] and the examples in IAS 18 are not fully consistent with the main standard. Consequently, although the standards seem to work reasonably well for fairly simple types of transactions, they give either conflicting guidance or no guidance at all for more complex transactions.

8 Some companies have responded to this by looking to US GAAP for help. However, US GAAP on revenue recognition is set out in numerous very narrowly-scoped pronouncements of varying authority that have been issued by several different bodies. The SEC has sought to help by issuing SAB No. 101 'Revenue Recognition in Financial Statements' (which has subsequently been replaced by SAB 104 'Revenue Recognition'). However, although SAB 104 lays down some principles, it also raises further issues.

9 The result is that different entities and industries have adopted different practices, and inconsistencies and uncertainties are arising. It has also become apparent that there are different views of what revenue should represent, and of how financial statements should portray an entity's activities. This has been a particular issue for start-up businesses in some of the newer industries where investors have been focusing on revenue growth as an indicator of a company's profit potential.

The IASB/FASB project

10 Faced with these concerns, the IASB and FASB decided to undertake a project on revenue recognition. In theory there are a number of different ways of tackling the problem. At one extreme standard-setters could attempt to resolve the problems by making a series of ad hoc changes to the existing standards. Although such an approach might seem attractive because the existing revenue recognition and measurement literature seems to work for the vast majority of transactions, it would mean that the standards would still be based on different revenue accounting principles. That in turn would mean that there would still be boundaries between principles that will be problematical and it would still be difficult to extrapolate the existing material to address new types of transactions that will emerge in the years ahead. There would also continue to be different views of what revenue is and of how financial statements should portray an entity's activities. In other words, the approach described above would provide only temporary relief.

11 The IASB and FASB have therefore taken the view that a fundamental rethink is necessary. This does not necessarily imply that there needs to be a fundamental change to existing practice; indeed, if the existing literature on revenue really does work for the vast majority of transactions, it is likely that the changes resulting from the fundamental rethink will not be major. However, by considering why exactly we

[3] Put simply, IAS 18 adopts a contract completion notion of revenue—revenue arises when the supplier has fulfilled its 'side' of the contract—and IAS 11 adopts a contract performance notion—revenue arises as the supplier carries out the activities it is required to perform under the contract.

do the things we do and what are the alternatives, it ought to be possible to develop a comprehensive set of conceptually-based principles for revenue recognition and measurement.

12 The current intention of the IASB and FASB is to issue a Discussion Paper in Q4 of 2007, with an exposure draft of a standard scheduled for 2008.

This discussion paper

13 Over the last few years it has become clear that Europe needs to participate fully in the global standard-setting process in order to ensure that European views and any special European circumstances are understood and taken fully into account in new international standards. This is especially important when fundamental issues like revenue are involved. Furthermore, if Europe is to participate fully in the revenue accounting debate, it needs to start thinking about the issues now. For those reasons, the DRSC and EFRAG decided to work together, with the help of a joint Working Group, to prepare a paper that would encourage Europe to start thinking about the issues.

14 To be useful to the IASB and FASB, the paper needs to discuss revenue accounting within the context of the IASB and FASB Frameworks. Those Frameworks take an asset/liability approach to the income statement.[4] In some ways it sounds strange to start a discussion about revenue by talking about assets and liabilities, because one tends to think that revenue is all about an earnings process.

(a) However, if the European project is to influence the joint IASB/FASB project on revenue accounting, it needs to adopt the same 'ground rules'. The two Boards have made it clear that their objective is to produce principles that are consistent with the Framework.

(b) In any event, adopting the asset/liability approach does not mean that the earnings process has to be ignored. For example, at the centre of the earnings process of a manufacturing entity is the production, then disposal of an asset in exchange for another asset (a receivable). IAS 18 currently determines whether there has been a sale (and therefore whether revenue has arisen) by considering which asset the seller holds.

What is revenue?

What does the Framework tell us about revenue?

15 The Framework defines income as "increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in

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[4] In other words, the Frameworks define the items that are recognised in the balance sheet (assets and liabilities), then define the items that are recognised in the income statement (referred to in our paper as 'revenue', 'other income statement credit items', and 'expenses') in terms of changes in assets and liabilities. The only items that are recognised on the balance sheet are assets, liabilities and equity (the difference between assets and liabilities).

liabilities that result in increases in equity, other than those relating to contributions from equity participants." [5]

16 It also makes clear that revenue is a type of income. It then explains that "the procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

17 The above seems to suggest that:

(a) revenue is a particular type of increase in economic benefits that results in an increase in equity;[6] and

(b) revenue should be recognised as soon as:

(i) it has arisen, and

(ii) it can be measured reliably.

18 Some argue that, as we need to focus on assets and liabilities, we *must* focus on enforceable rights and enforceable obligations. However, not all assets and liabilities are based on enforceable contractual rights or obligations. For example, liabilities that are based on constructive obligations might not be enforceable. Similarly, inventory and fixed assets do not involve enforceable rights.

What other attributes should revenue have?

19 In the absence of any further clues from the Framework, we appear to have a choice as to which types of income we would like revenue to represent. It therefore seems reasonable to ask what information the top-line of the income statement should provide.

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5 To simplify our discussion, hereafter we will omit the words "other than those relating to contributions from equity participants" and assume that we are *always* talking about increases in assets or decreases in liabilities that do not arise from contributions from equity participants.

6 One could look at this explanation and conclude that it means that no revenue arises from a sale of goods at cost (ie a sale on which no profit is earned). However, that is not how the statement should be read: the sales 'leg of the transaction —in other words, the part that is not the costs—involves an increase in economic benefits.

<u>Revenue is some sort of measure of activity undertaken pursuant to a contract with a customer</u>

20 For many businesses, the revenue figure is currently seen as a key measure of the level of economic activity undertaken by the entity. That is because it reflects the extent to which the entity has been supplying goods and services to customers. This is important because ultimately it is the transactions with third parties that enable the value that the entity adds to be realised. An entity that works hard but has no customers is a very different entity to one that works hard for its customers. Users compare the entity's current level of activity with past activity levels and with that of its competitors as part of their assessment of the entity's performance. Such market share information, coupled with the users' own assessments about the sector's prospects and the entity's competitiveness also provide the basis for their forecasts about the entity's future performance.

21 In other words, revenue is currently some sort of measure of the level of activity undertaken pursuant to a contract with a customer.[7]

22 There are though other possibilities. Revenue could be some sort of measure of the level of *all* economic activity undertaken including, for example, manufacturing for inventory and constructing an asset for own use. This might seem a rather odd idea but consider the following example:

The Boat Builder

Assume a company makes boats. The boats are large and complex to make and the shipbuilding company makes only a few boats each year. Usually it makes the boats to order (ie under the terms of a customer contract) and, because its boats are very attractive, it generally has a very full order book. However, occasionally it is short of orders and in those circumstances it makes the most popular designs of boat for inventory.

In 2004 it did not need to make any boats for inventory; it worked at full capacity making boats to order.

In 2005 those of its customers that buy the most popular designs decided to delay placing their orders, comfortable in the knowledge that the shipbuilder would build the boats they want anyway, meaning they could buy the boats from stock instead. However, because that meant much of the company's time was spent building for inventory, revenue fell significantly.

In 2006, the boats built for stock were sold and customers went back to placing orders in advance for boats, so revenue increased very significantly.

In this example, if we say that revenue is a measure of the level of economic activity undertaken pursuant to a contract with a customer, the shipbuilder's revenue will have fluctuated significantly even though its shipbuilding activity has been constant.

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[7] The term 'contract' is used throughout this paper to refer to an agreement between two parties. It does not need to be a written agreement in order to be a contract. Even when one party goes into a sweet shop and buys a sweet, there is a contract between the buyer and supplier.

Expressed more generally, in industries (and at times) in which the placing of an advance order seems not to be particularly significant, basing revenue only on the activities undertaken pursuant to a contract can produce revenue figures that are difficult to interpret.

23 Nevertheless, under existing accounting practice, revenue is about activities undertaken pursuant to a contract and the paper takes the view that this should remain the case.

24 Thus, no revenue will arise from manufacturing for inventory or for own-use. Furthermore, no revenue will arise solely from the act of entering into a contract, because that does not involve any “activity undertaken pursuant to” the contract. And all the revenue arising on a transaction will be recognised by the time the contract has been completed.

<u>Revenue is some sort of gross number</u>

25 Under existing practice, when an item is sold for a profit, it is the sale proceeds—not the profit—that are recognised as revenue. In other words, revenue is currently a 'gross' notion.

26 This is particularly important as regards the prediction of future cash flows. Selling prices and buying prices do not always move together—the entry of a new competitor, for example, may reduce selling prices but have no effect on costs. It is therefore reasonable to suppose that sophisticated users will attempt to predict future activity levels and future selling prices (to forecast future revenue) and, separately, the cost of obtaining those revenues (or, equivalently, the margin that will be achieved on those revenues). Users’ predictions are likely to be more reliable if they are based on separate information on sales (ie revenue) and costs of sales than if they are based only on a net number such as gross profit. For that reason, the paper proposes that revenue should continue to be some sort of gross number.

<u>Core activities versus incidental activities</u>

27 Assume for a moment that an entity that hardly ever sells any of its fixed assets sells some of its land and buildings for a large amount of money. Are the proceeds from that sale revenue?

28 It is probably fair to say that, if an activity occurs frequently and is expected to continue to occur frequently, users will want to use information about the activity on the past to make assessments about how the activity might develop in the future. However, if an activity does not occur frequently, users will usually want a different sort of information—information about timing and likely cash flow impact—if they are to make assessments about the future. For these reasons, the predictive value of revenue as regards the entity’s ability to generate cash flows in the future is probably enhanced if the revenue number takes no account of incidental activities.

29 To operationalise this, we would need a robust definition of an entity’s ‘incidental activities’. However, it is difficult to generalise about what is an incidental activity. For example, although for many entities fixed asset disposals may be an incidental activity, for a car rental company one could well imagine that selling the cars it rents is an essential part of its business model.

30 Although for some entities this can be a very significant issue in monetary terms, the paper does not attempt to reach a conclusion on it because the objective of the paper is to develop some revenue recognition and measurement principles and there appears to be no reason to believe that the recognition and measurement principles involved will vary depending on whether the focus is on just core activities or on both core and incidental activities.

When does revenue arise?

31 As mentioned earlier, there is currently no agreement on exactly what revenue should represent—should it, for example, represent completed transactions with customers or should it represent activity carried out by the supplier[8] in the process of completing transactions with customers. Different commentators also have different views as to whether revenue can arise before a right to consideration has arisen, and when rights to consideration arise. This all means that there are different views as to when exactly revenue arises.

32 The paper describes, explores, compares and contrasts four different views of when revenue arises—Approaches A to D. And it does so using the following example transactions:

The Chair
A customer buys an already-made chair from the supplier, and takes it home in his car.

The Washing Machine
A customer with a washing machine enters into a contract with a separate supplier (the plumber) that requires the supplier to connect the washing machine, to the customer's existing plumbing and do all that is necessary to make the washing machine work.

The Cleaner
A customer enters into a contract that requires the supplier (the cleaner) to visit his office every work day evening for a year and carry out on each of those visits an identical set of cleaning tasks.

The Bridge
A customer enters into a contract with the supplier (a construction company) that requires the supplier to build a bridge to the customer's design and specification. The contract envisages that the bridge will take three years to complete.

8 To simplify our discussion, we will refer throughout simply to 'the supplier' and 'the customer'.

The Computer

A customer orders from the supplier a particular specification of computer along with a specified package of off-the-shelf software. The supplier is required to supply and deliver the computer with the software already loaded, connect up all the wires and make sure everything works, and provide the customer with ten hours of tuition on how best to use the computer and its software.

NB. Earlier, we referred briefly to multiple-element arrangements ("transactions that appear to involve more than one component"). It is assumed that it is generally accepted that this transaction has at least two components.[9]

Approach A—The complete contract fulfilment approach

The approach explained

A33 The paper starts by suggesting that "everyone knows what revenue is and when it arises". What it meant was that many would say that revenue is something an entity gets for doing what it has promised to do for a customer. For example, consider a simple transaction in which that the supplier agrees to carry out a single, relatively simple act of performance for the customer that will not take long to do (the performance obligation) and the customer agrees to pay the supplier an amount of money when the supplier has met its performance obligation. If revenue is "something an entity gets for doing what it has promised to do for a customer", no revenue will arise until the supplier has met the performance obligation and at that point all the revenue relating to the transaction arises.

A34 In terms of assets and liabilities, what is happening in this transaction is that, when—and because—the supplier has met its performance obligation, it acquires a right to consideration. That right to consideration is a new asset, so the supplier's performance under the contract (ie the activity it has undertaken pursuant to a contract with a customer) has given rise to an increase in assets—and therefore to revenue.

A35 This suggests a draft revenue recognition principle along the following lines:

> Revenue arises when the supplier fulfils the performance obligations arising under a contract with a customer.

The approach applied to our five examples

A36 This approach (Approach A) can be illustrated by considering the five example transactions summarised in paragraph 32 above.

(a) *The Chair*—In this example, the supplier hands the chair to the customer and by doing so, fulfils all its performance obligations. Therefore, as soon as it has

[9] The authors have not so far in this paper defined what they mean by a 'multiple-element arrangement', nor have they attempted to develop a methodology for identifying the elements in a multiple-element arrangement. There are, furthermore, differing views on both issues. However, few would disagree that there are, at the very least, two elements in the transaction described: the tuition and the rest of the contract.

handed over the chair, the supplier gets a right to consideration and revenue arises.[10]

(b) *The Washing Machine*—In this example, the supplier (ie the plumber) fulfils all its performance obligations only when it has connected the washing machine and ensured that it is working. At that point, it gets a right to consideration for the work done and revenue arises.[11]

(c) *The Cleaner*—Although the cleaning contract could be described as involving 365 identical daily contracts, the fact is that it is actually a single contract and that is what matters under Approach A. The supplier (ie the cleaner) fulfils all its performance obligations only when it has carried out its cleaning duties on each and every day of the year. Until then, no revenue arises and at that point, the supplier gets a right to consideration for the work done and revenue arises.

(d) *The Bridge*— In this example, the supplier (ie the construction company) will not fulfil all its obligations under the contract until the bridge has been completed. Therefore, under Approach A no revenue at all would arise until the supplier has completed the bridge—then a right to consideration (and revenue) for the whole amount of the consideration would arise.

(e) *The Computer*—The fact that this transaction is a multiple-element arrangement is irrelevant under Approach A—all that matters is when the supplier has done everything it is contracted to do (in other words, when the computer with software loaded has been supplied, connected and made to work and all the tuition has been provided). Until that happens, there is no revenue and, when it does happen, a right to consideration (and revenue) for the whole amount of the consideration will arise.

Discussion

A37 Approach A was selected by the paper for discussion because it reflects what many people instinctively feel about revenue—it is something you get when you have done what you promised to do. However, our five examples have highlighted some of the problems that arise from the approach. For example:

(a) Under Approach A, the Chair and Washing Machine transactions would be accounted for in the way they would be accounted for under IAS 18 and, probably, in the way that most people would expect them to be accounted for. On the other hand, some commentators would find the treatment of the Cleaner and the Bridge transactions troublesome, probably not least because under Approach A revenue would arise much later than it currently does under IASs 11 and 18.

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10 This is a very simple transaction. In many cases, for example, there would be a customer acceptance stage. Customer acceptance is discussed later in the paper. Furthermore, again for simplicity warranty terms and periods are not discussed here although they may impact on when revenue arises. Finally, IAS 18 uses the phrase 'the transfer of all significant risks and rewards of ownership' rather than 'hands the chair to the customer'. This can be important in some transactions, but is not in the examples discussed in this summary.

11 Again, there is no mention of 'customer acceptance' here. It will be discussed later.

(b) Another way of looking at this is to say that, as Approach A focuses on complete contract fulfilment, its application results in revenue being a measure of complete contract fulfilment. That is fine when contract completion is almost instantaneous, but some commentators find it less satisfactory when the contract takes a longer period of time to complete (as is certainly the case with the Cleaner and Bridge examples and may well be the case with the Computer example too).

A38 The remainder of the paper therefore explores approaches that do not focus on *contract* completion.

Approach B—A variation of Approach A

The approach explained

B39 Depending on how one looks at it, Approach A is based on the view that

(a) revenue arises only on complete contract fulfilment, or

(b) revenue arises when the supplier acquires a right to consideration and that occurs only when the supplier has fulfilled all its performance obligations in full.

B40 However, there seems little doubt that, in most legal jurisdictions at least, a right to consideration can arise prior to complete contract fulfilment. Approach B takes the view that, if revenue is something the supplier receives for doing what it has promised to do, revenue will arise when a right to consideration arises.

B41 Thus, Approach B accepts that it might be necessary to disaggregate (or divide up or unbundle) the contract with the customer into part-contracts. For example, if a right to consideration arises two-thirds of the way through the contract and a further right to consideration arises at the end, Approach B would disaggregate the contract into two part-contracts—the first part-contract covering the first two-thirds of the whole contract and the second part-contract the last third. Revenue would then be accounted for separately for each part-contract.

B42 The key issue is therefore when might a right to consideration arise other than at the end of the contract? Approach B is based on the premise that a right to consideration arises prior to complete contract completion only if the contractual terms state that to be the case. (Approach C involves a relaxation of this assumption.)

B43 Under Approach B, the revenue recognition principle would be as follows:

> Revenue arises when the entity fulfils all the performance obligations arising under a part-contract with a customer.
>
> (A part-contract comprises one or more (and maybe all) of the performance obligations required by the whole contract that, when fulfilled, will result in a right to consideration arising.)

The approach applied to our five examples

B44 In our five examples as described in paragraph 32 above, there was no mention of any contractual terms that would cause rights to consideration to arise prior to complete contract completion. It is furthermore unlikely that there would be such a contractual term in the case of the Chair and Washing Machine examples, primarily because they are relatively short duration contracts. On the other hand, it is possible that such contractual terms exist for the other three examples.

(a) *The Cleaner*—It is quite conceivable that the cleaning contract might stipulate that a right to consideration would arise in respect of each month's work successfully completed (or maybe even each week or each day). Assuming that this is the case, it would mean that under Approach B the contract would be disaggregated into twelve (month long) part-contracts and, as the performance obligations under each part-contract are fulfilled in their entirety, a right to consideration (and therefore revenue) would arise.

(b) *The Bridge*— In the case of the bridge, it would be common for the contract to stipulate that the construction of the bridge is in effect undertaken in three stages and that, on completion of each stage, a right to consideration will arise. If the contract contains such a clause, under Approach B the revenue relating to each stage of the contract[12] would be recognised on fulfilment of the performance obligations relating to that stage.

However, it is also common practice in the construction industry for the customer to be required to accept each stage of work done only *conditionally*; only at the end of the contract is the customer required to accept the supplier's work unconditionally. As explained more fully in the next section, some commentators believe that conditional acceptances do not give rise to rights to consideration. Under that view, typically Approach B will not result in revenue arising from a construction contract any earlier than Approach A.

(c) *The Computer*—It is possible that the contract underlying the Computer transaction (ie the multiple element arrangement) might, for example, specify that a right to consideration will arise for the supply, connection and testing of the computer and software, and that another right to consideration will arise when the required tuition has been provided. If that were the case, under Approach B an appropriate amount of revenue would arise as soon as the supplier has supplied, connected and successfully tested the computer and software, with the balance of the revenue arising when the tuition has been provided.

Discussion

B45 Some commentators criticise Approach B for focusing too much on the contractual terms underlying the transaction. They argue that two entities undertaking contracts that are in substance exactly the same could recognise very different patterns of revenue simply because their contracts with customers include or exclude the contractual terms described in paragraph 41. Others would argue however that whether those terms are included in a contract is not simply a matter of 'form'; they

[12] Determining the amount involved is a measurement issue and is therefore discussed in the next chapter.

alter the substance of the transaction as well, because the supplier has a right to consideration that it would not otherwise have had.

B46 Some commentators criticise Approach B for assuming that rights to consideration arise only when the contract says they do. In their view, it is not only the contractual terms that can give rise to such rights. This is explored further under Approach C.

B47 There are of course other grounds on which the approach can be criticised as well. For example, paragraph 37 explains that some commentators criticise Approach A for in effect not being a measure of the level of economic activity towards contract completion. (For example, by not recognising any revenue on the Bridge example until the contract is complete.) Approach B could be criticised on similar grounds—that the resulting revenue figures will not always be a good measure of the entity's economic activity because, if the contractual terms do not envisage rights to consideration arising before the end of the contract, no revenue would arise even though the entity has been busy carrying out activities that need to be carried out to enable it to fulfil its performance obligations in due course.

B48 The paper then goes on to consider in detail two additional approaches—Approaches C and D—that are better than Approaches A and B at measuring the level of economic activity towards contract completion. However, before doing that it reflects on some of the key notions underlying the discussion so far.

A pause for reflection

The critical event approach

49 Approaches A and B are examples of the so-called 'critical event approach'.

(a) 'Critical event approach' is a term used to describe an approach to revenue recognition that involves recognising no revenue under a contract until a particular event or threshold in the contract (the critical event) has been reached; then all the revenue is recognised either on the critical event occurring or between that point and the end of the contract.

(b) There are a number of different types of critical event approach, depending on the event selected as the critical event and on how revenue is recognised when the critical event has occurred.

(c) Approach A is a critical event approach in which the critical event is the point at which the performance obligations are met in full and, therefore, a right to consideration arises. In Approach B, the critical event is still when a right to consideration arises—it is just that it is not assumed that such rights arise only on contract completion.

(d) The next approach to be discussed (Approach C) is also a critical event approach, but the final approach discussed (Approach D) is not—it is a so-called 'continuous approach'.

Perspectives

50 An issue arising from the draft revenue recognition principles developed so far is from whose perspective or point of view (ie through whose eyes) should performance be assessed? From the perspective of the supplier or the customer? For example, to date the discussion has focused on the point at which a right to consideration arises and has taken the view that such a right arises only when the related performance obligations have been met in full[13]: under such an approach, should we be focusing on when the supplier thinks it has fulfilled the relevant performance obligation or on when the customer thinks that obligation has been fulfilled?

51 The paper takes the view that one particular perspective is not necessarily better than the other; it is simply that one perspective may be better suited to one particular approach and another perspective might be more appropriate to another approach. For example, if the revenue recognition approach focuses, as some of the approaches discussed later in the paper do, on the costs incurred on the activities undertaken pursuant to the contract (ie inputs), a supplier perspective will generally be more appropriate.

Customer acceptance

52 For revenue to arise under a revenue recognition approach that is based on fulfilment of performance obligations, one needs evidence that the supplier has performed. And, if a contract requires the supplier to supply a particular item of goods to a customer, it is not enough for the supplier to then deliver something else to the customer; it must deliver to the right location at the right time the right item of goods in the right condition. Similarly, in the case of a contract for services, the supplier would need to deliver the right quality of service at the right time.

53 In the case of many contracts, the simplest way of determining whether the supplier has fully performed is to look for some evidence of customer acceptance.

(a) The fact that the customer has paid the contract amount is usually evidence of customer acceptance. However, payment generally takes place some time after the supplier has fully performed, so using that as evidence of customer acceptance is not ideal because our objective is to determine the exact moment at which performance has been completed (because that is the point at which the right to consideration arises).

(b) Sometimes a contract can be so complex that it is difficult to know whether the supplier has performed fully unless and until there has been customer acceptance. In such circumstances, the contract will usually stipulate that there needs to be explicit customer acceptance of the supplier's work.

As has already been mentioned, contracts that involve work carried out over a long period of time, such as a construction contracts, typically ask for explicit customer acceptance at each stage in the contract. Such acceptance tends to

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13 The paper explores briefly a 'substantive fulfilment' approach. Under that approach, it would not be necessary for all the related performance obligations to be met in full; instead all but the non-substantive performance obligations are to be met in full. However, the paper does not pursue that approach and the discussion of it is not reproduced in this summary.

be only conditional acceptance. Does customer acceptance have to be unconditional for revenue to arise or will conditional customer acceptance suffice? Or, to put it another way, does a right to consideration arise if the customer has only conditionally accepted the supplier's work? Different commentators have different views on this issue, depending at least in part on their view as to exactly what a right to consideration entails.

54 However, it is important to remind ourselves that our objective is to determine whether or not the supplier has performed. The absence of explicit unconditional customer acceptance at the end of each stage does not necessarily mean that the supplier has not performed, merely that we need to use some other method of determining whether performance has occurred. For example, in some cases there may be evidence of implicit acceptance by the customer. However, it may be that, even without any evidence of customer acceptance, it will be possible to reach reasonable conclusions about whether the supplier has performed.

The notion of 'an exchange'

55 Some commentators argue that the notion of ´exchange´ should play an important role in the approach to revenue recognition. However, there is little agreement as to what the notion actually means. For example, some argue that, as long as there is a contract with a customer there will always be an exchange because a contract is an exchange of promises. Some others argue that, for there to be an exchange, the supplier needs to have given up an asset and received a new asset in return. Some others believe that what we mean by an exchange is that the supplier carries out some act of performance for another party and as a result acquires a right to consideration.

56 If we took the view that an exchange is important and that, by exchange, we mean that the supplier needs to have given up an asset and received a new asset in return, it would mean that revenue probably would not arise unless and until the supplier has some sort of receivable for the work performed. Approaches A and B involve such an exchange.

Approach C—Part-output that has value to the customer

The approach explained

C57 There are different ways to characterise the next approach discussed in the paper:

(a) Approaches A and B focus on rights to consideration and assume that revenue arises only when a right to consideration arises. Some commentators are firmly of the view that revenue can never arise unless a right to consideration arises. However, the definition of revenue does not limit itself in that way—it talks of increases in assets and decreases in liabilities generally, rather than just those that result from a right to consideration arising. We need therefore to consider revenue recognition approaches that do not focus just on rights to consideration. In the paragraphs that follow we explore an approach that involves disaggregating into part-contracts which, when fulfilled, will result in an asset—and therefore revenue—arising but will not necessarily result in a right to consideration arising.

(b) Approach A is based on the notion that revenue does not arise until the supplier has done everything that it promised to do. Approach B modifies that notion by saying that revenue arises when the supplier gets a right to consideration in exchange for the work it has done or is doing. However, it then stipulates that such rights to consideration arise only when the contractual terms envisage that they should arise. In the paragraphs that follow that stipulation is relaxed.

C58 Business entities do not usually do things for nothing; when a supplier carries out activities pursuant to a contract with a customer, its position relative to the customer improves to reflect the benefit given. At some point that "improved position" will be a right to consideration, but some commentators believe that will not be the case immediately.[14] In their view what arises initially is a claim on the customer, with a flavour of a contingent right to consideration. (Some describe it as right to consideration that is contingent on the supplier finishing the work.)

C59 If the supplier receives something as it carries out work pursuant to a contract with a customer, it seems reasonable to consider whether it might be appropriate to disaggregate the contract in a way that reflects this. An example of such an approach would be to disaggregate the contract by reference to items of part-output that have value to the customer.[15] Revenue would then be treated as arising when each part-contract represented by an item of part-output is fulfilled by the supplier. This can be illustrated by the following example:

The Swimming Pool
Assume a customer enters into a contract that requires the supplier (a builder of swimming pools) to construct a swimming pool of a specified shape, size and depth in a specified location within his garden.

[14] There is no agreement on whether or not a right to consideration arises immediately—that is the reason for the two different ways of characterising Approach C. Furthermore, the authors of the paper have not yet decided what view the paper will take. However, for the purposes of preparing this summary, it has been assumed from paragraph 59 onwards that a right to consideration does not arise immediately.

[15] This notion of an item of part-output having value to the customer is very similar to the notion of standalone value to the customer set out in EITF 00-21. Under EITF 00-21, in an arrangement with multiple deliverables, a delivered item should be considered a separate unit of accounting if all of the following criteria are met:

- The delivered item has a value to the customer on a stand-alone basis;
- There is objective and reliable evidence of the fair value of the undelivered item; and
- If the arrangement includes a general right of return relative to the delivered item, delivery of the performance of the undelivered item is considered probable and substantially in the control of the vendor.

A deliverable has value on a stand-alone basis if any vendor sells it separately or if the customer could resell the delivery item on a standalone basis. EITF 00-21 does not require the existence of an observable market for the deliverable, only the theoretical ability to sell the deliverable. EITF takes the view that, without evidence of the fair value of each element in an arrangement, a company would be unable to determine the amount of the total arrangement fee that should be recognised as revenue upon delivery of each of the elements in the arrangement. EITF 00-21 distinguishes between a general right of return and all other return of refund provisions in an arrangement. The criterion above on a general right to return is there to make sure that delivery or performance of the undelivered item is in control of the vendor so that the vendor can reasonably estimate the right to return. If so, the right to return does not impact the ability of the vendor to separate the arrangement and recognise revenue for the delivered element if all the revenue criteria are satisfied.

> The supplier starts its work by moving various items of equipment into the customer’s garden, and then digs out the hole for the swimming pool. When it has dug a whole of the right shape, size and depth and in the right location, it stops digging. The next stage is to line the hole; then various pumps will be attached to the hole and lining. The issue that Approach C raises is: before the supplier lines the hole, has any revenue arisen?

C60 The paper then attempts to develop the notion of ‘items of part-output that have value to the customer’ into a set of working principles. In doing so it suggests:

(a) Under certain circumstances it may be possible to assess directly whether the part-output discussed above has a value to the customer. In other circumstances it may be possible to assess only indirectly whether there is value to the customer. It is suggested that this could be done by saying an item of part-output has value to the customer if it can be sold or used by that customer.

(b) It is sometimes argued that anything can be sold as long as one is not too fussy about the price one receives. Similarly, it is often possible to use a partly-finished item for some other purpose—for example, a half finished computer screen could perhaps be used as fruit bowl. That is not what is intended; the part-output should be something that is usable for its intended purpose and/or capable of being sold at a price that reflects its worth when used for that intended purpose.

(c) By ‘usable for its intended purpose’ we mean:

(i) It could be used without further work on a standalone basis for its intended purpose. This would directly demonstrate a value to the customer, as the part-output is ready for its intended use as it stands.

(ii) It could be used for its intended purpose if it is made operational (for example, a dishwasher that needs to be connected to be able to work), and there are a number of market participants other than the supplier who could make it operational.

(iii) It could be used for its intended purpose if it is connected to other freely available components (for example, a screen that is connected to a computer).

(d) And, by ‘can be sold’ we mean that:

(i) the supplier habitually sells that part-output separately, which clearly and directly makes a reference to a market place as discussed above,

(ii) the customer habitually buys or sells that part-output separately, which also clearly and directly refers to a marketplace, or

(iii) although neither the supplier not the customer habitually buys or sells that part-output separately, a market exists for items that are in substance the same as the part-output and there is no reason why the customer could not access it.

(e) Thus, an item that is being constructed but is half-finished will not represent part-output that is of value to the customer because it is neither usable for its intended purpose nor sellable at a price that would reflect its worth when used for that intended purpose.

C61 Under Approach C, the revenue recognition principle would probably be the same as for Approach B, but there would be a different definition of a part-contract:

> Revenue arises when the entity fulfils all the performance obligations arising under a part-contract with a customer.
>
> Each part-contract comprises the work necessary to produce an item of output that the customer can either use for its intended purpose or can be sold at an amount that reflects its worth when used for that intended purpose.

The approach applied to our five examples

C62 This approach (Approach C) can be illustrated by considering the five example transactions summarised in paragraph 32 above.

(a) *The Chair*— Under Approaches A and B, revenue would arise at the point at which the supplier hands over the chair. That would also be the case under Approach C as well, because there is no part-output.

(b) *The Washing Machine*— Under Approaches A and B, revenue would arise at the point at which the supplier connects up the washing machine and ensures it works. Under Approach C, we would need to consider whether the supplier’s performance obligations should be broken down into part-contracts. For example, depending on precisely what the work involves, it might be appropriate to disaggregate the work needed to extend the existing water pipes to the place where the machine is to be located (‘the piping work’) from the work needed to connect the extended piping to the machine (‘the connection work’).

Typically, if the work (in this case the piping work and connection work) is not particularly specialised, each of the outputs would be usable for its intended purpose (as defined) so Approach C would require disaggregation—subject to materiality considerations. On the other hand, if for example the connection work is highly specialised and could not be done by a number of other market participants, it would not be appropriate to treat it as a part-contract separate from the other work.

(c) *The Cleaner*—Under Approach C, each day’s cleaning activity would be viewed as a separate part-contract because it is usable (in this case consumable) for its intended purpose. Therefore, revenue would be recognised on a daily basis as long as the supplier is fulfilling its daily performance obligations.

(d) *The Bridge*—A partly finished item will not represent an item of part-output that has value to the customer in the way that that notion is described in this paper. Therefore, the construction phase part of the construction contract in our example will not be disaggregated under Approach C and no revenue will arise on that construction phase until construction is complete. However, if the contract as a whole has, say, a planning stage and a design stage as well as a construction phase, it may well be appropriate to disaggregate the contract by reference to those phases and recognise revenue separately on each.

Some commentators believe that this conclusion is inappropriate and the half-finished bridge should be treated as an item of part-output that has value to the customer because, unless it is a highly specialised piece of work, the customer could employ another bridge constructor to finish the work should the supplier not be able to (or not be willing to). If this is a valid argument, the principles in paragraph C60 would need to be amended to accommodate it.[16]

(e) *The computer*—It would appear that there are several part-outputs in this transaction that would have value to the customer: delivery of the computer, delivery and installation of the off-the-shelf software, the connection service, and the tuition. Therefore, under Approach C, the contract would be disaggregated into part-contracts on the basis of those part-outputs and revenue would be recognised on each of these part-contracts separately as the work involved is completed.

In our example, the computer does not need specialised software in order to be operational. However, had the example been slightly different and, as a result, software specially tailored to the system and the customer is needed to make the computer operational, it is unlikely that the supplier would be able to account for the revenue on supplying the computer separately from supplying and installing the software. In other words, the computer hardware might not be deemed to be an item of part-output that has value to the customer because it is useless without the software and the software might not be available from other market participants. If that is the case, revenue will not arise on supplying the hardware until the software has also been supplied and installed—not even if the computer hardware represents the vast majority of the value of the contract.

Discussion

C63 This approach seems particularly suited to multiple-element arrangements, because it seems to enable them to be disaggregated into their elements. Some would argue, as already mentioned, that it is less suited to construction contracts. However, there is no doubt that it is the most complicated of the approaches discussed so far in this paper and probably involves more judgment that Approaches A and B. Furthermore, the description above seems rather rules-based. Further thought and refinement may ease all of those problems.

C64 There is however another issue. In our Swimming Pool example above we asked whether any revenue would have arisen after completing the whole and before lining the whole. The subsequent discussion suggests that some revenue will have arisen. However, why does revenue only arise when the hole has been completed? Or does revenue also arise when all that has been dug is a part-hole? This question leads the discussion in the paper onto the continuous approach (ie Approach D).

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16 This is an issue on which the authors have not yet reached a conclusion.

Approach D—The continuous approach

The approach explained

D65 As already mentioned, a critical event approach to revenue recognition involves recognising no revenue under a contract until a particular event or threshold in the contract (the critical event) has been reached; then recognising all the revenue either on the critical event occurring or between that point and the end of the contract. IAS 18 is based on a critical event approach.

D66 IAS 11, on the other hand, is based on an alternative revenue recognition approach—the so-called continuous approach. Under the continuous approach, revenue is recognised continuously over the course of the contract as the contract progresses and the entity performs. There is no need to ask oneself whether there has been complete performance, nor (or at least not to the same extent) to develop complex ways of disaggregating customer contracts.

D67 Under the continuous approach revenue is a measure of performance towards completion rather than result of completion itself. Thus, the continuous approach takes a different perspective from the critical events approaches discussed earlier: whilst they all ask, “what is the claim the entity has against the customer?", the continuous approach asks, “what has the entity done in order to fulfil the contractual performance obligation?” For that reason some refer to it as ‘the performance approach’.

D68 As with the critical event approach, the term ‘continuous approach’ is a generic term used to describe a number of slightly different approaches. The main difference relates to the method used to measure the progress of the contract. Possible ways of doing this include:

(a) the supplier incurring the costs inherent in the contract;

(b) increases in value of the goods created under the contract: and

(c) the supplier reducing or eliminating the risks inherent in the transaction.

In paragraph C64 we asked, in the context of the Swimming Pool example, whether revenue might arise as soon as a part-hole has been dug. Applying a continuous approach based on (a) or (b) (and probably (c) as well) would usually mean that revenue would be deemed to arise as the hole is being dug.

<u>The asset/liability model</u>

D69 One of the big issues concerning some or all continuous approaches is whether they are compatible with the asset/liability approach. Although some commentators believe they are compatible, others believe some or all of them are not and that therefore they need to be abandoned.

D70 Under the continuous approach, revenue will be deemed to have arisen even though the item being built (in our case, the bridge) is only half finished, the supplier might not have produced items of part-output that have value to the customer, and there might not be a right to consideration (under some commentator’s definition of the term).

The argument is therefore that, by half-finishing the bridge, the company has moved towards fulfilment and has improved its position relative to its position at contract initiation. In order to explore this further we will focus on the Bridge and Cleaner examples.

(a) In the Bridge example, basic book-keeping tells us that, as work on the bridge progresses, so either the supplier's work-in-progress increases or some other asset will increase (or liability will decrease). (The only alternative is for the costs involved to be written off, and when the work is carried out pursuant to a contract with a customer that would probably only be appropriate if something has gone wrong.) Thus, there is definitely an increase in assets or decrease in liabilities. The issue, argue those who believe it is not compatible with the asset/liability approach, is whether it is work-in-progress or a new asset, because they argue that if it is work-in-progress then the amount of revenue that will be recognised under Approach D will be the profit not the 'sales value'.[17] However, those commentators that believe it is compatible with the asset/liability approach believe a new asset *is* created, although they do not agree on precisely what that new asset is:

  (i) Some commentators argue that the related asset, reflecting the results of ongoing work, does not need be a right to consideration or some other sort of receivable; it is more like work in progress. It meets the definition of an asset because it reflects the result of past events and of performance under the contract. It is something from which future economic benefits are expected to flow to the supplier, and it is a resource that is controlled by the supplier.

  (ii) Some other commentators argue that, although the asset is not a right to consideration, it is still more akin to a receivable. Although some disagree, arguing that there is no current claim (or right to consideration) against the customer. To those that argue that the position is no different from Approach C they say that, whilst the position might be the same if the continuous approach is based on the value of the output, that would not be the case if the approach is based on the costs incurred. Going back to our Swimming Pool example, is there really a receivable if all the supplier has done is move its hole-digging and lining equipment into the customer's garden?

(b) It might be that things become clearer in service contracts examples where there is no possibility of inventory. Consider our Cleaner transaction for example. If Approach D is being adopted, unless some sort of asset arises as the cleaning work progresses, it would be necessary to write off the costs incurred and then recognise the whole of the revenue both as revenue and profit on contract completion. However, those who believe that the continuous approaches are compatible with the asset/liability approach argue that a new asset akin to a receivable arises as the contract progresses.

[17] This is a matter of simple-booking: Debit Inventory for the added value created, Credit Revenue.

D71 Under Approach D, the revenue recognition principle would be:

> Revenue should be recognised when activity undertaken pursuant to a contract with a customer gives rise to an asset that reflects performance towards completion.

<u>Reliability</u>

D72 In order to achieve a sufficient level of reliability, IAS 11 requires that the percentage-of-completion method can be used only when the outcome of the construction contract can be estimated reliably. In a similar vein, one might wish to insist that, if a continuous approach is to be used, the supplier must expect the contract to be fully completed. In other words, although a claim against the customer does not need to exist at the balance sheet date, the entity must have valid expectations regarding complete fulfilment.

<u>Disaggregating a contract when applying the continuous approach</u>

D73 At first sight, disaggregation does not appear to be necessary under the continuous approach since revenue is recognised according to the progress of contract fulfilment anyway. However, there may still be a need for disaggregation to account appropriately for the separate parts of the contract. For example, consider the example first mentioned in paragraph C62(d):

> **The Bridge—A modified example**
>
> In the Bridge example we have been using to date, the contract deals only with the construction of the bridge. Assume now that the contract is for the <u>planning</u>, <u>design</u> and construction of a bridge.

In this example, even if Approach D is being adopted it would still seem appropriate to disaggregate the contract into—at least—three part-contracts: planning, designing and constructing. Revenue can then be accounted for separately on each part-contract.

The approach applied to our five examples

D74 The continuous approach can be illustrated by considering the example transactions we have been using throughout this chapter.

(a) *The Chair*— Under Approaches A and B, revenue will arise at the point at which the supplier hands over the chair. That would also be the case under Approach C as well, because there is no part-output. That would also be the case under the continuous approach because the contract progresses from commencement to completion in one step, so there are no intermediate steps at which to recognise some of the revenue.

(b) *The Washing Machine*— Under Approaches A and B, revenue would arise at the point at which the supplier connects up the washing machine and ensures it works. Under Approach C, if the work is not particularly specialised in nature the contract would probably be disaggregated and revenue accounted for differently on each part-contract—although materiality considerations might make that unnecessary. Under Approach D revenue would in theory arise as work under the contract progresses, although again materiality considerations might make that unnecessary.

(c) *The Cleaner*—Approach D would have the same effect as Approach C in the case of this transaction: revenue would be recognised on a daily basis.

(d) *The Bridge*—Under Approach A, no revenue would have arisen until the bridge has been completed. Under Approach B, that would also probably have been the case (unless the contract was unusual in requiring there to be, at certain specified stages in the contract, unconditional customer acceptance of the work carried out to date). Under Approach C, again no revenue would have arisen until the bridge has been completed. In contrast to these various critical events approaches, under Approach D revenue would be recognised over the course of the performance (assuming, as explained in paragraph 72, that there are valid expectations regarding final fulfilment). This leads to a significant difference from the recognition pattern under the critical events approach. Many claim this as the major advantage of the continuous approach because it reflects the economic activity the supplier has carried out pursuant to contracts with customers.

(e) *The computer*— Under Approach A, no revenue would arise until the contract has been fully completed. Under Approach B it would depend on whether the contract required the customer to unconditionally accept the supplier's work at various stages prior to contract completion but under the typical contract (which would not require unconditional acceptance until the end) the effect would be the same as Approach A. Under Approach C the contract would be disaggregated. Under Approach D (and assuming that, even though the contract clearly has several components there will be no disaggregation) revenue would be recognised as performance proceeds—assuming there is a valid expectation regarding finalisation.

Discussion

D75 The continuous approach enables revenue to be a measure of the level of economic activity undertaken pursuant to contracts with customers, which some commentators find an appealing attribute.

D76 On the other hand, some commentators do not believe the approach is consistent with the asset/liability approach.

Some final comments on this chapter's discussion

77 The discussion in this chapter started by focusing on a basic critical event approach (Approach A), modified that approach to correct an over-simplification (Approach B) and then explored several modifications relating to the disaggregation of the contract (principally Approach C) before finally exploring a critical event approach that involves a very extreme form of disaggregation—also known as the continuous approach—in Approach D.

78 We have as a result several alternative revenue recognition principles:

(a) Approach A—Revenue arises when the supplier fulfils the performance obligations arising under a contract with a customer.

(b) Approach B—Revenue arises when the entity fulfils all the performance obligations arising under a part-contract with a customer. Each part-contract comprises one or more (and maybe all) of the performance obligations required by the whole contract that, when fulfilled, will result in a right to consideration arising.

(c) Approach C—Revenue arises when the entity fulfils all the performance obligations arising under a part-contract with a customer. Each part-contract comprises the work necessary to produce an item of output that the customer can either use for its intended purpose or can be sold at an amount that reflects its worth when used for that intended purpose.

(d) Approach D—Revenue should be recognised when activity undertaken pursuant to a contract with a customer gives rise to an asset that reflects performance towards completion.

79 The intention when work started on the paper was to develop a single revenue recognition principle that would be appropriate to apply to all transactions. The authors still believe that, whichever principle is selected, it should be applied to all transactions. In their view it would be inappropriate to apply one principle to some transactions and a different principle to another set of transactions. Indeed, that is the position at the moment with IAS 11 adopting one principle and IAS 18 another.

80 However, the authors have come to realise that there is probably not one indisputably correct principle. A choice needs to be made, and how one exercises that choice depends on how one views the key issues raised in the paper. The conclusion might also be influenced by measurement.