

SPECIFIC ITEMS

SECTION 3400

revenue

Basis for Conclusions

Revenue, Section 3400 (May 2024)

Revenue, Section 3400 (November 2022)

Revenue, Section 3400 (December 2019)

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PURPOSE AND SCOPE

- .01 This Section establishes standards for the timing of recognition of revenue in the financial statements of enterprises. It is concerned with the recognition of revenue arising in the course of the ordinary activities of an enterprise from the sale of goods, the rendering of services and the use by others of enterprise resources yielding interest, royalties and dividends. Except as specified in paragraphs 3400.A8-A34, it does not deal with the measurement of revenue, which is usually determined by agreement between the parties involved. However, when uncertainties exist regarding the determination of the amount of revenue, these uncertainties may influence the timing of revenue recognition.
- .02 The timing of recognition of the following types of revenue is dealt with elsewhere in other Sections:
- revenue arising from investments accounted for under the equity method (see INVESTMENTS, Section 3051);
 - revenue arising from lease agreements (see LEASES, Section 3065); and
 - revenue arising from government grants and other similar subsidies (see GOVERNMENT ASSISTANCE, Section 3800).

DEFINITIONS

- .03 The following terms are used in this Section with the meanings specified:
- Revenue** is the inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise, normally from the sale of goods, the rendering of services and the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is net of items such as trade or volume discounts, returns and allowances, claims for damaged goods and certain excise and sales taxes. Excise and sales taxes to be netted against revenue would normally include those imposed at the time of sale and would normally exclude those imposed prior to the time of sale on either the goods or their constituents.
 - Completed contract method** is a method of accounting that recognizes revenue only when the sale of goods or the rendering of services under a contract is completed or substantially completed.
 - Percentage of completion method** is a method of accounting that recognizes revenue proportionately with the degree of completion of goods or services under a contract.

RECOGNITION

- .04 *Revenue from sales and service transactions shall be recognized when the requirements as to performance set out in paragraphs 3400.05-.06 are satisfied, provided that at the time of performance ultimate collection is reasonably assured.*
- .05 *In a transaction involving the sale of goods, performance shall be regarded as having been achieved when the following conditions have been fulfilled:*
- (a) *the seller of the goods has transferred to the buyer the significant risks and rewards of ownership, in that all significant acts have been completed and the seller retains no continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership; and*
 - (b) *reasonable assurance exists regarding the measurement of the consideration that will be derived from the sale of goods, and the extent to which goods may be returned.*
- .06 *In the case of rendering of services and long-term contracts, performance shall be determined using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance shall be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.*
- .07 Performance would be regarded as being achieved under paragraphs 3400.05-.06 when all of the following criteria have been met:
- (a) persuasive evidence of an arrangement exists;
 - (b) delivery has occurred or services have been rendered; and
 - (c) the sellers' price to the buyer is fixed or determinable.
- .08 Some of the items an enterprise would consider in determining if persuasive evidence of an arrangement exists are as follows:
- (a) customary business practices;
 - (b) side arrangements;
 - (c) consignment arrangements;
 - (d) rights to return the product; and
 - (e) requirements to repurchase the product.
- Other characteristics may exist. Accordingly, judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing or other arrangement for which revenue recognition is not appropriate.
- .09 Generally, delivery is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. Some of the aspects of the revenue arrangement an enterprise would consider in determining if delivery has occurred or services have been rendered are as follows:
- (a) bill and hold arrangements (paragraphs 3400.A40-.A44 provide related application guidance);
 - (b) customer acceptance of product;
 - (c) layaway sales arrangements;
 - (d) non-refundable fee arrangements (paragraphs 3400.A45-.A48 provide related application guidance); and
 - (e) licensing and similar fee arrangements.
- .10 In determining if the seller's price to the buyer is fixed or determinable, an enterprise would consider the impact of the following factors:
- (a) cancellable sales arrangements;
 - (b) right of return arrangements;
 - (c) price protections and/or inventory credit arrangements; and
 - (d) refundable fee for service arrangements.
- .11 The recognition criteria in this Section are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. A single sales transaction may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In some cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an enterprise may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction. In such a case, the two transactions are dealt with together. (Paragraphs 3400.A8-.A12 provide related application guidance.)

- .12 Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends shall be recognized when reasonable assurance exists regarding measurement and collectability. These revenues shall be recognized on the following bases:
- (a) interest: on a time proportion basis;
 - (b) royalties: as they accrue, in accordance with the terms of the relevant agreement; and
 - (c) dividends: when the shareholder's right to receive payment is established.
- .13 Revenue from a transaction involving the sale of goods would be recognized when the seller has transferred to the buyer the significant risks and rewards of ownership of the goods sold. When the seller retains significant risks of ownership, it is normally inappropriate to recognize the transaction as a sale. Examples of a significant risk of ownership being retained by a seller are: when there is a liability for unsatisfactory performance not covered by normal warranty provisions; when the purchaser has the right to rescind the transaction; and when the goods are shipped on consignment.
- .14 Assessing when the risks and rewards of ownership are transferred to the buyer with sufficient certainty requires an examination of the circumstances of the transaction. In most cases, revenue is recognized on passing of possession of the goods. In retail sales, this is usually coincident with the passing of legal title. In other cases, the passing of legal title may occur at a different time from the passing of possession or of the risks and rewards of ownership.
- .15 The following considerations are relevant in deciding whether significant risks and rewards of ownership have been transferred to the buyer:
- (a) whether any significant acts of performance remain to be completed; and
 - (b) whether the seller retains any continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership.
- .16 Revenue from service transactions and long-term contracts is usually recognized as the service or contract activity is performed, using either the percentage of completion method or the completed contract method.
- .17 The percentage of completion method is used when performance consists of the execution of more than one act, and revenue would be recognized proportionately by reference to the performance of each act. Revenue recognized under this method would be determined on a rational and consistent basis such as on the basis of sales value, associated costs, extent of progress, or number of acts. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue would be recognized on a straight line basis over the period unless there is evidence that some other method better reflects the pattern of performance. The amount of work accomplished would be assessed by reference to measures of performance that are reasonably determinable and relate as directly as possible to the activities critical to the completion of the contract. (Measures of performance include output measures, such as units produced and project milestones, or input measures, such as labour hours or machine use.) Amounts billed are not an appropriate basis of measurement. (Paragraphs 3400.A13-.A34 provide related application guidance.)
- .18 The completed contract method would only be appropriate when performance consists of the execution of a single act or when the enterprise cannot reasonably estimate the extent of progress toward completion.

Effect of uncertainties

- .19 Recognition of revenue requires that the revenue is measurable and that ultimate collection is reasonably assured. When there is reasonable assurance of ultimate collection, revenue is recognized even though cash receipts are deferred. When there is uncertainty as to ultimate collection, it may be appropriate to recognize revenue only as cash is received.
- .20 When the uncertainty relates to collectability and arises subsequent to the time revenue was recognized, a separate provision to reflect the uncertainty would be made. The amount of revenue originally recorded would not be adjusted.
- .21 Uncertainties relating to the measurement of revenue may result from one or both of the following issues:
- (a) Consideration
When consideration is not determinable within reasonable limits; for example, when payment relating to goods sold depends on the resale of the goods by the buyer, revenue would not be recognized.
 - (b) Returns
Revenue would not be recognized when an enterprise is subject to significant and unpredictable amounts of goods being returned; for example, when the market for a returnable good is untested. If an enterprise is exposed to significant and predictable amounts of goods being returned, it may be sufficient to provide therefor.
- .22 Consideration may include a note or other financial instrument issued by the purchaser to be settled in cash and under the terms of the note the seller has recourse effectively only against the assets sold. The transaction is considered to be a sale because the total amount of the consideration received is determinable within reasonable limits (see paragraph 3400.21). However, income from the sale is only recognized when:
- (a) there is a substantial commitment by the purchaser demonstrating its intent to honour its obligations under the note; and
 - (b) the seller has reasonable assurance of collecting the note.
- A commitment would include, for example, non-refundable cash consideration from resources other than those transferred from the seller, or the assumption of an obligation of the seller to a third party when the third party thereby releases the seller from that obligation.

Reporting revenue gross or net

- .23 Revenue includes only the gross inflows of economic benefits received and receivable by the enterprise on its own account. Amounts collected on behalf of third parties such as sales taxes and goods and services taxes are not economic benefits that flow to the enterprise and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal that do not result in increases in equity for the enterprise. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission. (Paragraphs 3400.A35-.A39 provide related application guidance.)
- .24 An enterprise is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an enterprise is acting as a principal include, but are not limited to:
- the enterprise has the primary responsibility for providing the goods or services to the customer or for fulfilling the order (for example, by being responsible for the acceptability of the products or services ordered or purchased by the customer);
 - the enterprise has inventory risk before or after the customer order, during shipping or on return;
 - the enterprise has latitude in establishing prices, either directly or indirectly (for example, by providing additional goods or services); and
 - the enterprise bears the customer's credit risk for the amount receivable from the customer.

One feature indicating that an enterprise is acting as an agent is that the amount the enterprise earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

Additional features indicating that an enterprise is acting as a principal or as an agent are provided in paragraphs 3400.A38-.A39, respectively.

Payments by a vendor to a customer

- .25 Cash consideration received by a customer from a vendor is presumed to be a reduction of the prices of the vendor's products or services and, therefore, is not normally recognized as revenue by the customer. However, if the consideration is a payment for assets or services delivered to the vendor, the customer recognizes the consideration as revenue and if the consideration is a reimbursement of costs incurred by the customer to sell the vendor's products, the customer recognizes the consideration as a reduction of that cost.
- .26 Cash consideration represents a payment for assets or services delivered to the vendor if the vendor receives, or will receive, an identifiable benefit in exchange for the consideration. In order to meet this condition, the identified benefit must be sufficiently separable from the customer's purchase of the vendor's products such that the customer would have entered into an exchange transaction with a party other than the vendor in order to provide that benefit, and the customer can reasonably estimate the fair value of the benefit provided. If the amount of cash consideration paid by the vendor exceeds the estimated fair value of the benefit received, that excess amount is recognized as a reduction of cost of sales and related inventory.
- .27 Cash consideration represents a reimbursement of costs incurred by the customer to sell the vendor's products if the cash consideration represents a reimbursement of a specific, incremental, identifiable cost incurred by the customer in selling the vendor's products or services. If the amount of cash consideration paid by the vendor exceeds the cost being reimbursed, that excess amount is recognized in the customer's income statement as a reduction of cost of sales.
- .28 Cash consideration given by a vendor to a customer is presumed to be a reduction of the selling prices of the vendor's products or services and, therefore, is normally recognized by the vendor as a reduction of revenue. However, the vendor recognizes the consideration paid as a cost incurred if, and to the extent that, both of the following conditions are met:
- The vendor receives, or will receive, an identifiable benefit (products or services) in exchange for the consideration. The identified benefit must be sufficiently separable from the recipient's purchase of the vendor's products that the vendor could have entered into an exchange transaction with a party other than the purchaser of its products or services in order to receive this benefit.
 - The vendor can reasonably estimate the fair value of the benefit identified under condition (a). (If the amount of consideration paid by the vendor exceeds the estimated fair value of the benefit received, that excess amount is recognized as a reduction in revenue.)

PRESENTATION

- .29 *The amount of revenue recognized during the period shall be presented separately in the income statement.*
- .30 The amount of revenue generated by an enterprise during the period is an important indicator of the level of the enterprise's activity. This information assists the users of financial statements in assessing the enterprise's performance.

DISCLOSURE

- .31 *An enterprise shall disclose its revenue recognition policy. If an enterprise has different policies for different types of revenue transactions, including non-monetary (barter) sales, the policy for each material type of transaction shall be disclosed. If sales transactions have multiple elements, such as a product and service, the enterprise shall clearly state the accounting policy for each element as well as how multiple elements are determined and valued.*

- .32 If sales transactions have multiple elements, the policy may contain items such as a description and nature of such an arrangement, including performance, cancellation, termination or refund-type provisions.
- .32A *An enterprise shall disclose each of the following for contracts in progress at the end of the reporting period accounted for using the percentage of completion method:*
 - (a) *the method or methods of measuring the degree of completion;*
 - (b) *the aggregate amount of costs incurred and recognized profits (less recognized losses) to date;*
 - (c) *the aggregate amount of advances received, as defined in paragraph 3400.32B;*
 - (d) *the aggregate amount of holdbacks withheld, as defined in paragraph 3400.32B; and*
 - (e) *uncertainties affecting the measurement of the degree of completion, in accordance with MEASUREMENT UNCERTAINTY, Section 1508.*
- .32B Holdbacks are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.
- .33 *An enterprise shall disclose separately, either on the face of the income statement or in the notes to the financial statements, the major categories of revenue recognized during the period.*
- .34 The objective of this disclosure is to assist the reader in understanding the sources of revenue and their effect on the financial statements.
- .35 Judgment is necessary to determine the categories that an enterprise uses. An enterprise may separate out sources based on life expectancy (for example, initial and ongoing franchise fees), and significantly differing profit margins or sources that differ from the standard operation of the business (for example, a manufacturing business that has material investment income).
- .35A *An enterprise shall disclose the nature and amount of upfront non-refundable fees or payments recognized in revenue when the enterprise recognizes the fee or payment in revenue upon entering into the arrangement.*

EFFECTIVE DATE AND TRANSITION

- .36 Except as specified in paragraph 3400.37, this Section applies to annual financial statements relating to fiscal years beginning on or after January 1, 2011. Earlier application is permitted.
- .37 Amendments to paragraphs 3400.01, 3400.09(a), 3400.09(d), 3400.11, 3400.17 and 3400.23-24 and new paragraphs 3400.32A-.32B and 3400.A1-.A44, issued in December 2019, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2022. Except as specified in paragraphs 3400.38-.40, an enterprise applies these amendments retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506. Earlier application is permitted.
- .37A Amendments to paragraphs 3400.A45-.A48, issued in December 2019, apply to annual financial statements relating to fiscal years beginning on or after a date to be determined by the AcSB. Earlier application is permitted. An enterprise applies these amendments retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506.
- .37B Amendments to paragraph 3400.35A, issued in May 2024, apply to annual financial statements relating to fiscal years beginning on or after January 1, 2025. An enterprise applies these amendments retrospectively, in accordance with ACCOUNTING CHANGES, Section 1506. Earlier application is permitted.
- .38 An enterprise may choose to apply the amendments specified in paragraphs 3400.32A-.32B and 3400.A1-.A34, either:
 - (a) at the beginning of the earliest period presented, recording the cumulative effect of applying the amendments in opening retained earnings of the earliest period presented; or
 - (b) at the beginning of the fiscal year in which the amendments are first applied, recording the cumulative effect of applying the amendments in opening retained earnings of the fiscal year in which the amendments are first applied.
- .39 When the amendments specified in paragraphs 3400.A13-.A34 are applied, an enterprise is not required to make retrospective adjustments in respect of contracts accounted for using the percentage of completion method that were completed during:
 - (a) the fiscal year immediately preceding the date at which the amendments are first applied; or
 - (b) the fiscal year in which the amendments are first applied.
- .40 When the amendments specified in paragraphs 3400.A8-.A12 are applied, an enterprise is not required to make retrospective adjustments in respect of arrangements with separately identified units of account when all deliverables have been delivered by:
 - (a) the fiscal year immediately preceding the date at which the amendments are first applied; or
 - (b) the fiscal year in which the amendments are first applied.

APPENDIX

APPLICATION SUPPLEMENT

This Appendix is an integral part of this Section.

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IDENTIFYING UNITS OF ACCOUNT

- A1. The recognition criteria in this Section are usually applied separately to each transaction. An enterprise needs to determine whether the transaction consists of a group of contracts or a single contract. It may be necessary to combine a group of contracts to reflect the substance of the transaction. A single contract may include more than one deliverable. In those circumstances, it may be necessary to segment the contract into the separate deliverables (see paragraph 3400.A5).
- A2. A group of contracts may be so closely related that they are, in effect, parts of a single arrangement with an overall profit margin, and accounting for the contracts individually may not reflect the substance of the transaction. For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.
- A3. A group of contracts, whether with a single customer or with several customers, is treated as a single contract when the contracts:
 - (a) are negotiated as a package in the same economic environment with an overall profit margin objective;
 - (b) constitute in essence an agreement to do a single arrangement with a single customer;
 - (c) are so closely interrelated that they are, in effect, part of a single arrangement with an overall profit margin; and
 - (d) are performed concurrently or in a continuous sequence.
- A4. A single contract or a group of contracts that meet the criteria in paragraph 3400.A3 for combining as a single contract, may include several deliverables. An enterprise transfers these deliverables to the customer and performance may occur at different times or over different periods of time, and the customer's payments for these deliverables may be fixed, variable or a combination thereof.
- A5. At the inception of an arrangement, an enterprise evaluates all deliverables in the arrangement to determine whether they represent separate units of account. In an arrangement with multiple deliverables, the deliverables should be considered a separate unit of account, if both the following criteria are met:
 - (a) if the arrangement includes a general right of return relative to the deliverable(s), delivery or performance of the remaining deliverable(s) is considered probable and substantially in the control of the vendor; and
 - (b) the deliverable(s) have value to the customer on a stand-alone basis.
- A6. The deliverable(s) have value on a stand-alone basis if they are sold separately by any vendor or the customer could resell the deliverable(s) on a stand-alone basis. In the context of a customer's ability to resell the deliverable(s), it is not required to have an existing observable market for the deliverable(s).

- A7. Deliverable(s) that do not qualify as a separate unit of account within the arrangement should be combined with the other applicable deliverable(s) within the arrangement. The allocation of arrangement consideration and the recognition of revenue should then be determined for those combined deliverable(s) as a single unit of account.

MULTIPLE-ELEMENT ARRANGEMENTS

Allocation of revenue to multiple elements

- A8. Arrangement consideration is allocated at the inception of the arrangement to all deliverables on a relative stand-alone selling price basis. The objective when allocating the consideration is for an enterprise to allocate the consideration to each deliverable in an amount that depicts the amount of consideration to which the enterprise is expected to be entitled in exchange for the deliverables.
- A9. The stand-alone selling price is the price at which an enterprise would sell a promised good or service separately to a customer. The best evidence of a stand-alone selling price is the observable price of a good or service when the enterprise sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be the stand-alone selling price of that good or service but is not presumed to be.
- A10. If a stand-alone selling price is not directly observable, an enterprise estimates the stand-alone selling price at an amount that would result in the allocation of the transaction price meeting the allocation objective in paragraph 3400.A8. When estimating a stand-alone selling price, an enterprise may consider all information (including market conditions, enterprise-specific factors and information about the customer or class of customer) that is reasonably available to the enterprise. In doing so, an enterprise may use observable inputs and apply estimation methods consistently in similar circumstances.
- A11. Methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:
- (a) Adjusted market assessment approach — An enterprise could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. This approach might also include referring to prices from the enterprise's competitors for similar goods or services and adjusting those prices as necessary to reflect the enterprise's costs and margins.
 - (b) Expected cost plus a margin approach — An enterprise could forecast its expected costs of delivering a good or service in each unit of account, and then add an appropriate margin for that good or service.

- A12. A combination of methods may need to be used to estimate the stand-alone selling prices of the goods or services promised in the arrangement if two or more of those goods or services have highly variable or uncertain stand-alone selling prices. When an enterprise uses a combination of methods to estimate the stand-alone selling price of each promised good or service in the arrangement, the enterprise evaluates whether allocating the transaction price at those estimated stand-alone selling prices would be consistent with the allocation objective in paragraph 3400.A8 and the requirements for estimating stand-alone selling prices in paragraph 3400.A10.

PERCENTAGE OF COMPLETION METHOD

Revenue recognition using percentage of completion method

- A13. Under the percentage of completion method, revenue is recognized in net income as work on a contract progresses. This involves considerable use of estimates in determining revenues, costs and profits and the degree of contract completion. The process is complicated by the need to evaluate continually the uncertainties inherent in the performance of contracts.

Determining the percentage of completion

- A14. Under the percentage of completion method, revenue is recognized based on the amount of work accomplished. The amount of work accomplished may be determined in a variety of ways. The method used to determine the amount of work accomplished depends on the nature of the contract.

Input and output measures

- A15. The approaches to measuring the degree of completion of a good or service under contract can be grouped into input and output measures. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved.
- A16. Input measures are used to measure degree of completion indirectly, based on an established or assumed relationship between a unit of input and productivity. Output measures are used to measure results directly. The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances.
- A17. The efforts-expended method is an input method based on a measure of the work, such as labour hours, labour dollars, machine hours or material quantities. Under the labour-hours method, for example, the degree of completion is measured by the ratio of hours performed to date to estimated total hours at completion. Estimated total labour hours may include the following:
- (a) The estimated labour hours of the enterprise; and
 - (b) The estimated labour hours of subcontractors engaged to perform work for the project, if labour hours of subcontractors are a significant element in the performance of the contract.
- A18. A labour-hours method can measure the degree of completion in terms of efforts expended only if substantial efforts of subcontractors are included in the computation. If the enterprise is unable to obtain reasonably dependable estimates of

subcontractors' labour hours at the beginning of the project and as work progresses, the enterprise should not use the labour-hours method.

- A19. The various forms of the efforts-expended method generally are based on the assumption that profits on contracts are derived from the enterprise's efforts in all phases of operations, such as designing, procurement and management. Profit is not assumed to accrue merely as a result of the acquisition of material or other tangible items used in the performance of the contract or the awarding of subcontracts. A significant drawback of efforts-expended methods is that the efforts included in the measure may not all be productive.
- A20. Measuring the degree of completion based on the ratio of costs incurred to total estimated costs is also an input method. When using this method, only those costs that reflect work performed are included in the costs incurred to date. Some of the costs incurred, particularly in the early stages of the contract, shall be disregarded in applying this method because they do not relate to contract performance. Such costs should be excluded from costs incurred for the purpose of measuring the degree of completion. Examples of such costs are:
- costs that relate to future activity on the contract, such as costs of contract materials purchased at the commencement of a contract that have not yet been used; or
 - payments made to a subcontractor not determined in accordance with the degree of completion of the work accomplished by that subcontractor.
- A21. The cost of uninstalled materials that have been delivered at the job site may be included in the costs used to measure the degree of completion.
- A22. Also, the cost of equipment purchased for use on a contract may be allocated over the period of its expected use unless title to the equipment is transferred to the customer by terms of the contract. For manufacturing contracts, the complement of expensive components (e.g., computers, engines, radars, and complex black boxes) to be installed into the deliverable items may aggregate a significant portion of the total cost of the contract. In some circumstances, the costs incurred for such components, even though the components were specifically purchased for the project, should not be included in the measurement of the degree of completion before the components are installed if inclusion would tend to overstate the percentage of completion otherwise determinable.
- Paragraph 3400.A27 provides guidance on contract costs.
- A23. Output measures include methods based on units produced, units delivered and contract milestones. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed. In other circumstances, the degree of completion may be measured, for example, on the basis of cubic metres of excavation for foundation contracts or on the basis of cubic metres of pavement laid for highway contracts.

Computation of income earned for a period under the percentage of completion method

- A24. Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be determined before the amount earned on the contract for a period can be determined. The portion of total revenue earned or the total amount of gross profit earned to date is determined by the measurement of the degree of completion of the contract. The computation of income earned for a period involves a determination of the portion of total estimated contract revenue that has been earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue).
- A25. Two examples are provided below of approaches that an enterprise may use to determine earned revenue and cost of earned revenue. Other approaches may also be appropriate. An enterprise is to use the selected approach on a consistent basis for all contracts.

Alternative A

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

- Earned revenue to date may be computed by multiplying total estimated contract revenue by the percentage of completion (as determined by one of the acceptable methods of measuring the degree of completion). The excess of the amount over the earned revenue recognized in prior periods is the earned revenue that is recognized in the income statement for the current period.
- Cost of earned revenue for the period may be computed in a similar manner. Cost of earned revenue to date is computed by multiplying total estimated contract cost by the percentage of completion on the contract. The excess of that amount over the cost of earned revenue recognized in prior periods is the cost of earned revenue that is recognized in the income statement for the current period. The difference between total cost incurred to date and cost of earned revenue recognized to date is reported on the balance sheet.
- Gross profit on a contract for a period is the excess of earned revenue over the cost of earned revenue.

Alternative B

Earned revenue, cost of earned revenue, and gross profit are determined as follows:

- Earned revenue is the amount of gross profit earned on a contract for a period plus the cost of earned revenue.
- Cost of earned revenue is the cost incurred during the period, excluding the costs incurred for subcontracted work that is still to be performed.

- Gross profit earned on a contract shall be computed by multiplying the total estimated gross profit on the contract by the percentage of completion (as determined by one of the acceptable methods of measuring extent of degree of completion). The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit that shall be recognized in the income statement for the current period.

Revised estimates

- A26. Adjustments to the original estimates of the total contract revenue, total contract cost, profit estimates or the degree of completion are often required as work progresses under the contract and as experience is gained, even though the scope of the work required under the contract may not change. The nature of accounting for contracts is such that refinements of the estimating process for changing conditions and new developments are continuous and characteristic of the process. Revisions in revenue, cost, and profit estimates or in measurements of the degree of completion are changes in accounting estimates as defined in ACCOUNTING CHANGES, Section 1506.

Contract costs

- A27. Contract costs may include:
- (a) costs that relate directly to the specific contract;
 - (b) costs that are attributable to contract activity in general and can be allocated to the contract; and
 - (c) such other costs as are specifically chargeable to the customer under the terms of the contract.

- A28. Costs that relate directly to a specific contract may include:

- (a) site labour costs, including site supervision;
- (b) costs of materials used;
- (c) amortization of plant and equipment used on the contract;
- (d) costs of moving plant, equipment and materials to and from the contract site;
- (e) costs of leasing plant and equipment;
- (f) costs of design and technical assistance that is directly related to the contract;
- (g) claims from third parties; and
- (h) the estimated costs of rectification and guarantee work, including expected warranty costs.

These costs may be reduced by any incidental income that is not included in contract revenue, for example, income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

- A29. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:
- (a) insurance;
 - (b) costs of design and technical assistance that are not directly related to a specific contract; and
 - (c) overhead costs.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of activity. Overhead costs include costs such as the preparation and processing of personnel payroll for personnel working on the contract.

- A30. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

- A31. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a contract. Such costs include:

- (a) general administration costs for which reimbursement is not specified in the contract;
- (b) selling costs;
- (c) research and development costs for which reimbursement is not specified in the contract; and
- (d) amortization of idle plant and equipment that is not used in a particular contract.

- A32. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognized as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Expected losses

- A33. When it is probable that total contract costs will exceed total contract revenue, the entire expected loss is recognized as an expense immediately.
- A34. The amount of such a loss is determined irrespective of:
- (a) whether work has commenced on the contract;
 - (b) the degree of completion of the contract; or
 - (c) the amount of profits expected to arise on other contracts which are not treated as a single contract in accordance with paragraph 3400.A3.

REPORTING REVENUE GROSS OR NET

- A35. To assess whether revenue should be reported gross or net, an enterprise considers whether it:
- (a) acts as principal in the transaction;
 - (b) takes title to the products;
 - (c) has risks and rewards of ownership, such as the risk of loss for collection, delivery or returns; or
 - (d) acts as an agent or broker, including performing services, in substance, as an agent or broker, with compensation on a commission or fee basis.
- A36. Whether revenue is recognized based on the gross amount billed to a customer or the net amount retained is a matter of judgment that depends on the relevant facts and circumstances. The factors and features set out below may be considered in the evaluation to determine the appropriate revenue recognition. None of the indicators included in paragraphs 3400.A37-A39 should be considered presumptive or determinative; however, the relative strength of each indicator should be considered.
- Indicators of gross revenue reporting**
- A37. When considering the indicators included in paragraphs 3400.24(a)-(d), the following may also be considered:
- (a) The enterprise is the primary obligor in the arrangement — Whether a supplier or an enterprise is responsible for providing the product or service desired by the customer is a strong indicator of the enterprise's role in the transaction. If an enterprise is responsible for fulfillment, including the acceptability of the product(s) or service(s) ordered or purchased by the customer, that fact is a strong indicator that an enterprise has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer. Representations (written or otherwise) made by an enterprise during marketing and the terms of the sales contract generally will provide evidence as to whether the enterprise or the supplier is responsible for fulfilling the ordered product or service. Responsibility for arranging transportation for the product ordered by a customer is not responsibility for fulfillment.
 - (b) The enterprise has general inventory risk (before customer order is placed or upon customer return) — Unmitigated general inventory risk is a strong indicator that an enterprise has risks and rewards as a principal in the transaction. Therefore, it should record revenue gross based on the amount billed to the customer. General inventory risk exists if an enterprise takes title to a product before that product is ordered by a customer (i.e., maintains the product in inventory) or will take title to the product if it is returned by the customer (i.e., back-end inventory risk) and the customer has a right of return. Evaluation of this indicator may include arrangements between an enterprise and a supplier that reduce or mitigate the enterprise's risk level. For example, an enterprise's risk may be reduced significantly or essentially eliminated if the enterprise has the right to return unsold products to the supplier or receives inventory price protection from the supplier. A similar and equally strong indicator of gross reporting exists if a customer arrangement involves services and the enterprise is obligated to compensate the individual service provider(s) for work performed regardless of whether the customer accepts that work.
 - (c) The enterprise has latitude in establishing price — If an enterprise has reasonable latitude, within economic constraints, to establish the exchange price with a customer for the product or service, that fact may indicate that the enterprise has risks and rewards of a principal in the transaction and that it should record revenue gross based on the amount billed to the customer.
 - (d) The enterprise has credit risk — If an enterprise assumes credit risk for the amount billed to the customer, that fact may provide weaker evidence that the enterprise has risks and rewards as a principal in the transaction and, therefore, that it should record revenue gross for that amount. Credit risk exists if an enterprise is responsible for collecting the sales price from a customer but must pay the amount owed to a supplier after the supplier performs, regardless of whether the sales price is fully collected. A requirement that an enterprise return or refund only the net amount it earned in the transaction if the transaction is cancelled or reversed is not evidence of credit risk for the gross transaction. Credit risk is not present if an enterprise fully collects the sales price prior to the delivery of the product or service to the customer (i.e., before the enterprise incurs an obligation to the supplier). Credit risk is mitigated, for example, if a customer pays by credit card and an enterprise obtains authorization for the charge in advance of product shipment or service performance. Credit risk that has been substantially mitigated is not an indicator of gross reporting.
- A38. In addition to the factors listed in paragraphs 3400.24(a)-(d), the following indicators may also be considered to determine if revenue should be recognized based on the gross amount billed to a customer:
- (a) The enterprise changes the product or performs part of the service — If an enterprise physically changes the product (beyond its packaging) or performs part of the service ordered by a customer, that fact may indicate that the enterprise is primarily responsible for fulfillment, including the ultimate acceptability of the product component or portion of the total services furnished by the supplier, and that it should record revenue gross based on the amount billed to the customer. This indicator is evaluated from the perspective of the product or service itself such that the selling price of that product or service is greater as a result of an enterprise's physical

- change of the product or performance of the service and is not evaluated based on other enterprise attributes such as marketing skills, market coverage, distribution system or reputation.
- (b) The enterprise has discretion in supplier selection — If an enterprise has multiple suppliers for a product or service ordered by a customer and discretion to select the supplier that will provide the product(s) or service(s) ordered by a customer, that fact may indicate that the enterprise is primarily responsible for fulfillment and that it should record revenue gross based on the amount billed to the customer.
 - (c) The enterprise is involved in the determination of product or service specifications — If an enterprise must determine the nature, type, characteristics or specifications of the product(s) or service(s) ordered by the customer, that fact may indicate that the enterprise is primarily responsible for fulfillment and that it should record revenue gross based on the amount billed to a customer.
 - (d) The enterprise has physical loss inventory risk (after customer order or during shipping) — Physical loss inventory risk exists if title to the product is transferred to an enterprise at the shipping point (e.g., the supplier's facilities) and is transferred from that enterprise to the customer upon delivery. Physical loss inventory risk also exists if an enterprise takes title to the product after a customer order has been received but before the product has been transferred to a carrier for shipment. This indicator may provide some evidence, albeit less persuasive than general inventory risk, that an enterprise should record revenue gross based on the amount billed to the customer.

Indicators of net revenue reporting

- A39. Indicators that revenue should be recognized based on the net amount retained include:
- (a) The supplier (not the enterprise) is the primary obligor in the arrangement — Whether a supplier or an enterprise is responsible for providing the product or service desired by a customer is a strong indicator of the enterprise's role in the transaction. If a supplier (and not the enterprise) is responsible for fulfillment, including the acceptability of the product(s) or service(s) ordered or purchased by a customer, that fact may indicate that the enterprise does not have risks and rewards as principal in the transaction and that it should record revenue net based on the amount retained (i.e., the amount billed to the customer less the amount paid to a supplier). Representations (written or otherwise) made by an enterprise during marketing and the terms of the sales contract generally will provide evidence as to a customer's understanding of whether the enterprise or the supplier is responsible for fulfilling the ordered product or service.
 - (b) The amount the enterprise earns is fixed — If an enterprise earns a fixed dollar amount per customer transaction regardless of the amount billed to a customer or if it earns a stated percentage of the amount billed to a customer, that fact may indicate that the enterprise is an agent of the supplier and should record revenue net based on the amount retained.
 - (c) The supplier (and not the enterprise) has credit risk — If credit risk exists (i.e., the sales price has not been fully collected prior to delivering the product or service) but that credit risk is assumed by a supplier, that fact may indicate that the enterprise is an agent of the supplier and, therefore, the enterprise should record revenue net based on the amount retained.

BILL AND HOLD ARRANGEMENTS

- A40. Paragraph 3400.07(b) states that the product has to have been delivered before revenue can be recognized, which is amplified by paragraph 3400.14. However, revenue should not be recognized until the vendor has substantially accomplished what it should do pursuant to the terms of the arrangement, which usually occurs upon delivery of the product.
- A41. Delivery has not generally occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. If the customer specifies an intermediate site but a substantial portion of the sales price is not payable until delivery is made to a final site, then revenue should not be recognized until final delivery has occurred.
- A42. In some circumstances, a vendor may retain a form of title to goods delivered to customers until the customer makes payment so that the vendor can recover those goods in the event of customer default on payment. Presuming all other revenue recognition criteria have been met, it is appropriate to recognize revenue at delivery if the only right that a vendor retains with the title are those enabling recovery of the goods in the event of customer default on payment and such rights cannot be maintained by other means.
- A43. The following criteria are required to be met to recognize revenue when delivery has not occurred:
- (a) the risks of ownership must have passed to the buyer;
 - (b) the customer must have made a fixed commitment to purchase the goods;
 - (c) the buyer, not the seller, must request that the transaction be on a bill and hold basis, and the buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
 - (d) there must be a schedule for delivery of the goods that is reasonable and consistent with the buyer's business purpose (e.g. storage periods are customary in the industry);
 - (e) the seller must not have retained any specific performance obligations such that the earning process is not complete;

(f) the ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and

(g) the product must be complete and ready for shipment.

A44. The following factors may also be considered when applying the above criteria to a bill and hold transaction:

- (a) the date by which the seller expects payment, and whether the seller has modified its normal billing and credit terms for this buyer;
- (b) the seller's past experiences with and pattern of bill and hold transactions;
- (c) whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods;
- (d) whether the seller's custodial risks are insurable and insured; and
- (e) whether there are any exceptions to the buyer's commitment to accept and pay for the goods (i.e., the business reasons for the bill and hold have not introduced a contingency to the buyer's commitment).

UPFRONT NON-REFUNDABLE FEES OR PAYMENTS

A45. Enterprises may negotiate arrangements in which they may receive upfront non-refundable fees or payments upon entering into arrangements or on certain specified dates. The fees may be received by the seller for a license or other intangible right or for delivery of products or services, such as joining fees in health-club membership contracts, set-up fees in service contracts and initial fees in supply contracts. In some circumstances, the right, product or service provided in conjunction with the non-refundable fee has no utility to the buyer separate and independent of the seller's performance of the other elements of the arrangement. In the absence of the seller's continuing involvement under the arrangement, the buyer would not have paid the fee.

A46. Revenue is deferred when the upfront fee is in exchange for products delivered or services performed that have no utility to the buyer separate and independent of the enterprise's performance of the other elements of the arrangement.

A47. Supply or service transactions may involve the charge of upfront non-refundable fees with subsequent periodic payments for future products or services. The upfront fees may be wholly or partly an advance payment for future products or services. The ongoing rights or services being provided or products being delivered are essential to the customers receiving the expected benefit of the upfront payment.

A48. In such cases, the upfront fee and the continuing performance obligation related to the services to be provided or products to be delivered are assessed as an integrated package. These upfront fees, even if non-refundable, are earned as the products and/or services are delivered and/or performed and should be deferred and recognized systematically over the periods that the fees are earned.

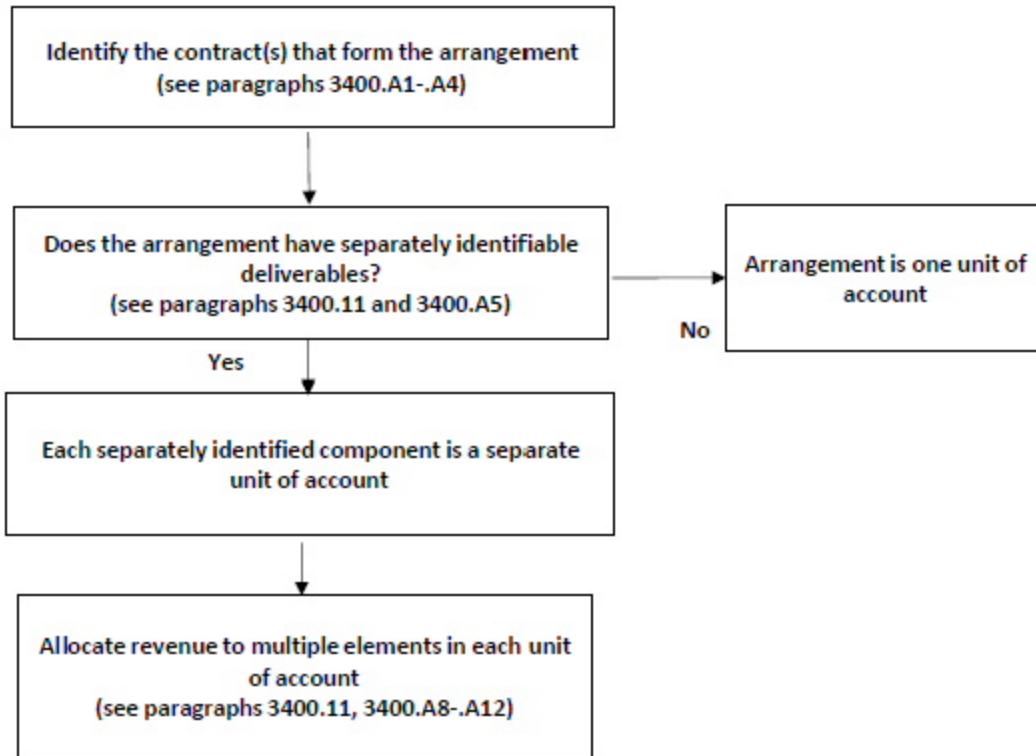
DECISION TREES

These Decision Trees are illustrative only.

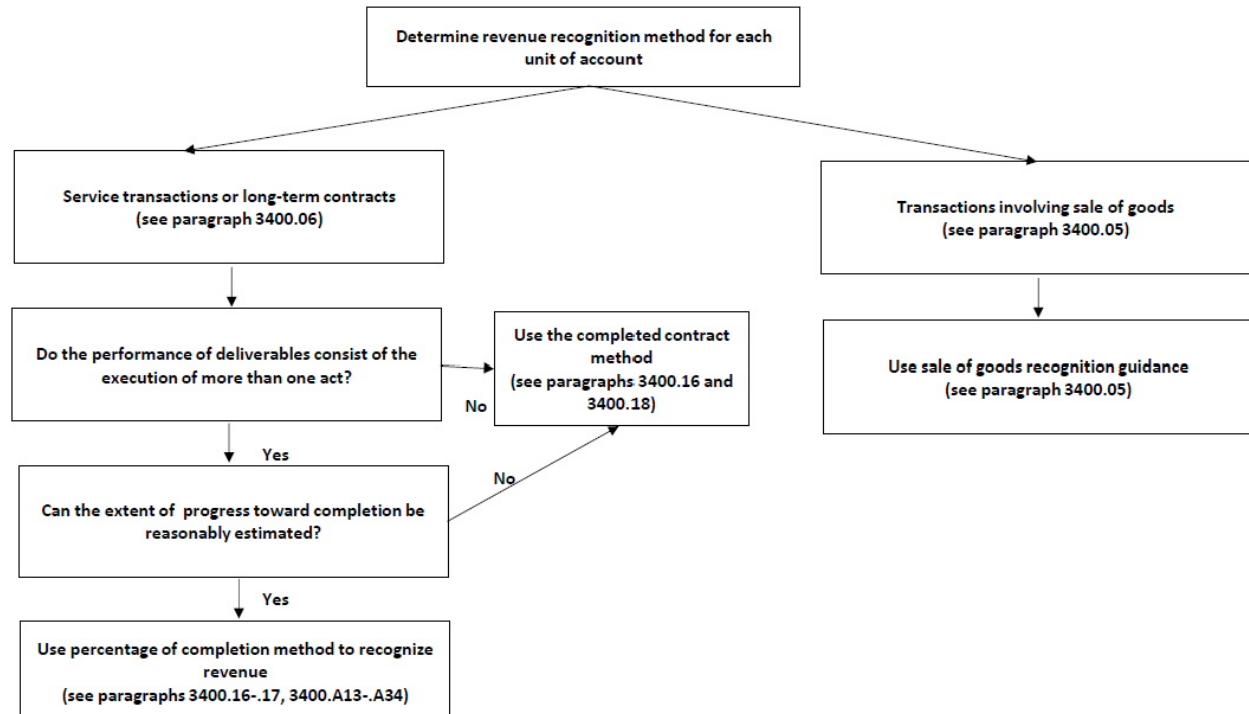
Decision Tree 1 – Identifying units of account for all revenue arrangements and allocation of revenue

Decision Tree 2 – Recognition of revenue for each unit of account

Decision Tree 1 – Identifying units of account for all revenue arrangements and allocation of revenue



Decision Tree 2 – Recognition of revenue for each unit of account



ILLUSTRATIVE EXAMPLES

This material is illustrative only.

These examples illustrate how the accounting treatment specified in this Section might be applied in particular situations. Matters of principle relating to particular situations should be decided in the context of the Section.

Multiple-element arrangements	B1
Percentage of completion method	B2-B4
Reporting revenue gross or net	B5
Bill and hold arrangements	B6
Upfront non-refundable fees or payments	B7

MULTIPLE-ELEMENT ARRANGEMENTS

- B1. The following examples indicate the application of the guidance for multiple-element arrangements.

Service agreements

Example 1

Human resources outsourcing services

Entity HR provides its customers with human resource solutions, such as support and guidance, employee relations, payroll and taxes, health benefits and administration. Customers may choose a prepackaged bundle of services, may customize an existing bundle of services, or may select the individual services they require. Given the many services Entity HR provides and its customers' varying needs, no two arrangements are exactly alike. Entity HR prices its arrangements based on the unique bundle of services to be provided. As a result, the stand-alone selling price for each of the services included in the contract is not directly observable.

Assume that on January 1, 20X1, Entity HR begins providing human resource solution services to Customer Y under a three-year arrangement. Under the arrangement, Entity HR agrees to provide Customer Y with payroll processing, three periodic training events, employee handbook development and an executive compensation assessment. The executive compensation assessment and employee handbook development are expected to be completed by June 30, 20X1 and 20X2, respectively. Entity HR expects to provide one training event annually. Total compensation under the arrangement is \$1,275,000. Entity HR receives compensation under the arrangement as follows: an upfront payment of \$375,000 and monthly payments of \$25,000. There are no general refund rights included in the arrangement.

Entity HR is evaluating whether payroll processing, periodic training, employee handbook development and executive compensation assessment represent separate units of account and how to allocate arrangement consideration to the separate units of account.

Entity HR considers the criteria in paragraph 3400.A5 and determines that each of the deliverables in the arrangement has stand-alone value and should be accounted for as separate units of account. Because Entity HR does not have stand-alone selling prices that are directly observable, Entity HR must use its best estimate of selling price for each deliverable when allocating arrangement consideration under the relative stand-alone selling price method.

In estimating the stand-alone selling price for the deliverables, Entity HR considered its internal costs, its profit objectives, the pricing practices it used to establish the bundled price for its services, and whether any market constraints exist that may limit its selling price; for example, whether competitors could charge a lower price for the same service or whether the price for the service exceeds the cost savings to its customers. Entity HR believes that as the price for its service begins to exceed the customers' internal cost, the customers will be less likely to purchase the service.

When determining the price for its bundled services, Entity HR typically applies a gross profit margin to the cost incurred, primarily labour and other time and expenses, in providing the contracted services. The profit margin varies with the types of services to be provided and generally includes a discount based on the number of services being purchased. For example, Entity HR typically includes a 26 percent gross profit margin on its payroll processing services, 15 percent gross profit margins on its employee handbook development services and executive compensation assessments, and a 22 percent gross profit margin on its training services before considering any discount on the total arrangement. Those gross profit margins have been developed over time by a relevant authorized level of management based on available market data and demand for the services.

Entity HR's analysis also indicates that the price of the individual services calculated using its internal gross profit margins would be in a range in which the service would still be attractive to its customers, that is, the cost of the service would be less than the internal costs for the same service if the customers had to provide the service themselves.

Using its internal gross profit margins, and the total estimated costs it will incur to deliver the remaining units of account and considering market constraints, Entity HR estimates the selling price for the units of account as follows:

Costs to be incurred for payroll processing for 3 years (Payroll processing gross profit margin of 26%)	\$976,250 ÷ .74
Estimated selling price for payroll processing	1,319,257
Cost to be incurred for executive compensation assessment (Executive compensation assessment gross profit margin of 15%)	45,223 ÷ .85

Estimated selling price for executive compensation assessment	53,204
Costs to be incurred for employee handbook development	56,113
(Employee handbook gross profit margin of 15%)	<u>.85</u>
Estimated selling price for employee handbook development	66,015
Costs to be incurred for three training events	40,706
(Training event gross profit margin of 22%)	<u>.78</u>
Estimated selling price for training events	<u>52,187</u>
Total estimated selling price of all deliverables	<u>\$1,490,663</u>

Entity HR allocates the arrangement consideration of \$1,275,000 for January 1, 20X1, as follows:

Payroll processing	$[1,275,000 \times (1,319,257 \div 1,490,663)]$	\$1,128,392
Executive compensation	$[1,275,000 \times (53,204 \div 1,490,663)]$	45,507
Employee handbook	$[1,275,000 \times (66,015 \div 1,490,663)]$	56,464
Three training events	$[1,275,000 \times (52,187 \div 1,490,663)]$	<u>44,637</u>
Total consideration		\$1,275,000

Example 2

Biotech license, research and development

Biotech enters into an agreement with Pharmaceutical Company ("Pharma"). The agreement includes Biotech licensing certain rights to Pharma and Biotech providing research and development services to Pharma. Additional details on each of those aspects of the agreement follow.

Biotech licenses certain rights on an exclusive basis to Pharma for a period of 10 years. The license gives Pharma the exclusive right to market, distribute and manufacture Drug B as developed using Technology A. Biotech retains all ownership rights to Technology A and Drug B. There are no when-and-if-available clauses or other performance obligations associated with the license, except as described below.

Biotech agrees to provide research and development services on a best-efforts basis to Pharma. Biotech agrees to devote four full-time equivalent employees to the research and development activities, and Pharma expects to devote several full-time equivalent employees to the research and development activities as well. The objective of the research and development services is to develop Drug B using Technology A. The ultimate objective is to receive government approval on Drug B.

Compensation under the arrangement is as follows:

- (a) Biotech receives \$5 million upfront upon signing the agreement;
- (b) Biotech receives \$250,000 per year for each full-time equivalent employee who performs research and development activities; and
- (c) None of these payments, once received, is refundable, even if government approval is never received. In addition, Biotech must perform on a best-efforts basis.

Pharma must use Biotech to perform the research and development activities necessary to develop Drug B using Technology A because the know-how and expertise related to Technology A is proprietary to Biotech. In other words, Biotech is the only party capable of performing the level and type of research and development services required by Pharma under the agreement. Biotech has determined that the fees charged for the research and development services, \$250,000 per year for each full-time equivalent employee who performs research and development activities, are competitive with the price other third-party vendors charge for similar services.

The two deliverables in this arrangement that are considered for separation are license and research and development activities. The license deliverable does not meet the second criteria for separation because it does not have stand-alone value to Pharma. Because Drug B has not yet been developed, the license is of no value to Pharma and could not be sold without the accompanying research and development activities using Technology A, which is proprietary to Biotech. Likewise, Pharma could not sell the license on a stand-alone basis to another party, because without Biotech agreeing to provide the research and development activities for that other party, the other party would not purchase the license. Therefore, the license and research and development activities should be considered as a single unit of account in the arrangement.

Example 3

Software contract

Software Co. licenses version 1.0 of its enterprise resource planning (ERP) product to 100 customers for \$300 per copy. Software Co. also agrees to provide the 100 customers with a right to receive ERP version 2.0 at no additional cost when

it becomes available. Software Co. also licenses ERP version 1.0 without the right to the software upgrade to customers for \$250 per copy. Software Co. will provide ERP version 2.0 to existing users of ERP version 1.0 as a specified upgrade for a price of \$100. Software Co. does not provide full or partial refunds for software licenses.

Software Co. is evaluating whether the licensing of ERP version 1.0 and the right to receive an upgrade to ERP version 2.0 represent separate units of account. Software Co. considers the criteria in paragraph 3400.A5 and determines that ERP versions 1.0 and 2.0 are separate units of account because they each have stand-alone value and there is no general right of return in the arrangement.

As Software Co. licenses ERP version 1.0 and sells the right to receive an upgrade to ERP version 2.0 separately to customers, the stand-alone selling price is directly observable. The relative stand-alone selling price is calculated as follows:

Total consideration received (\$300 x 100 copies)	\$30,000
=====	
Stand-alone selling price of ERP version 1.0 (\$250 x 100 copies)	<u>\$25,000</u>
Stand-alone selling price of ERP version 2.0 upgrade (\$100 x 100 copies)	<u>\$10,000</u>
Total stand-alone selling of deliverables	\$35,000
=====	
Software Co. allocates the arrangement consideration of \$30,000 on a relative stand-alone selling price basis as follows:	
ERP version 1.0 [\$30,000 x (\$25,000 ÷ \$35,000)]	\$21,429
ERP version 2.0 upgrade [\$30,000 x (\$10,000 ÷ \$35,000)]	<u>\$8,571</u>
Total consideration received	\$30,000
=====	

To meet the objective of allocating consideration to each deliverable in an amount that depicts the amount to which the enterprise is expected to be entitled in exchange for the deliverables, Software Co. recognizes revenue of \$21,429 on delivery of ERP version 1.0 and does not recognize the revenue of \$8,571 related to the upgrade to ERP version 2.0 until delivery of ERP version 2.0.

PERCENTAGE OF COMPLETION METHOD

- B2. The following example illustrates determining the degree of completion of a contract using an input method and an output method.

A construction contractor has a contract for \$9,000 to build a bridge. The initial contract revenue agreed on is \$9,000. The contractor's initial estimate of contract costs is \$8,000. It will take three years to build the bridge. The bridge will be 500 metres in length. The contractor estimates that it will have constructed 100 metres by the end of Year 1, 300 metres by the end of Year 2 and completed construction by the end of Year 3.

By the end of Year 1, the contractor's estimate of contract costs has increased to \$8,050. In Year 2, the customer approves a variation resulting in an increase in contract revenue of \$200 and estimated additional contract costs of \$150. At the end of Year 2, costs incurred include \$100 for standard materials purchased to be used in Year 3 to complete the project. These costs were included in the initial estimate of contract costs.

The contractor evaluated the deliverables in the contract and determined that the contract represents one unit of account. The contractor is using Alternative A as included in paragraph 3400.A25 to calculate earned income under the contract. A summary of the financial data during the construction period is as follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Initial contract revenue	\$9,000	\$9,000	\$9,000
Variation	<u>\$0</u>	<u>\$200</u>	<u>\$200</u>
Total contract revenue	<u>\$9,000</u>	<u>\$9,200</u>	<u>\$9,200</u>
Contract costs incurred to date	\$2,093	\$6,168	\$8,200
Contract costs to complete	<u>\$5,957</u>	<u>\$2,032</u>	<u>\$0</u>
Total estimated contract costs	<u>\$8,050</u>	<u>\$8,200</u>	<u>\$8,200</u>

Estimated profit	<u>\$950</u>	\$1,000	\$1,000
Progress billings	\$3,000	\$3,100	\$3,100

Determining degree of completion using an input method

The contractor determines the degree of completion of the contract based on the ratio of costs incurred to total estimated contract costs.

Calculating degree of completion:	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Cost incurred to date	\$2,093	\$6,168	\$8,200
Total estimated contract costs	\$8,050	\$8,200	\$8,200
Degree of completion (Cost incurred to date/Total estimated contract costs)	26%	74% *	100%

Calculating degree of completion for Year 2:

Cost incurred to date		\$6,168
Less cost of materials for use in Year 3		<u>\$100</u>
		\$6,068
Total estimated contract costs		\$8,200
Degree of completion (\$6,068/\$8,200)		74%

A summary of the financial statement impact during the construction period is as follows:

Income statement

	Year 2 Only	Year 2 Cumulative	Year 3 Only	Year 3 Cumulative
	<u>Year 1</u>			
Earned revenue (Total estimated revenue x degree of completion)	\$2,340	\$4,468	\$6,808	\$2,392
Cost of earned revenue (Total estimated costs x degree of completion)	<u>\$2,093</u>	<u>\$3,975</u>	<u>\$6,068</u>	<u>\$2,132</u>
Gross profit	\$247	\$493	\$740	\$260
	=====	=====	=====	=====

Balance sheet

	Year 2 Cumulative		Year 3 Cumulative
	<u>Year 1</u>		
Work in progress			
Total costs incurred to date	\$2,093	\$6,168	\$8,200
Cost of earned revenue recognized to date	<u>\$2,093</u>	<u>\$6,068</u>	<u>\$8,200</u>
Contracts receivable	\$0	\$100	\$0

Costs and estimated earnings in excess of billings on uncompleted contracts

Progress billings	\$0	\$6,100	\$9,200
Earned revenue	<u>\$0</u>	<u>\$6,808</u>	<u>\$9,200</u>

Costs and estimated earnings in excess of billings on uncompleted contracts

	\$0	(\$708)	\$0
	=====	=====	=====

Billings in excess of costs and estimated earnings on uncompleted contracts

Progress billings	\$3,000	\$0	\$9,200
Earned revenue	<u>\$2,340</u>	<u>\$0</u>	<u>\$9,200</u>

Billings in excess of costs and estimated earnings on uncompleted contracts

	\$660	\$0	\$0
	=====	=====	=====

Determining degree of completion using an output method

The contractor determines the degree of completion of the contract based on how many metres of the bridge have been constructed.

	Year 1	Year 2	Year 3
Length of bridge constructed (in metres)	100	300	500
Degree of completion	20%	60%	100%

A summary of the financial statement impact during the manufacturing period is as follows:

Income statement

	Year 2 Only	Year 2 Cumulative	Year 3 Only	Year 3 Cumulative
Year 1				
Earned revenue (Total estimated revenue x degree of completion)	\$1,800	\$3,720	\$5,520	\$3,680
Cost of earned revenue (Total estimated costs x degree of completion)	<u>\$1,610</u>	<u>\$3,310</u>	<u>\$4,920</u>	<u>\$3,280</u>
Gross profit	\$190	\$410	\$600	\$400
	=====	=====	=====	=====

Balance sheet

	Year 2 Cumulative	Year 3 Cumulative
Year 1		

Work in progress

Total costs incurred to date	\$2,093	\$6,168	\$8,200
Cost of earned revenue recognized to date	<u>\$1,610</u>	<u>\$4,920</u>	<u>\$8,200</u>
Contracts receivable	\$483	\$1,248	\$0

Billings in excess of costs and estimated earnings on uncompleted contracts

Progress billings	\$3,000	\$6,100	\$9,200
Earned revenue	<u>\$1,800</u>	<u>\$5,520</u>	<u>\$9,200</u>
Billings in excess of costs and estimated earnings on uncompleted contracts			
	\$1,200	\$580	\$0

- B3. The following example illustrates the computation of income earned for a period using Alternative B in paragraph 3400.A25.

An enterprise has a contract to manufacture mining equipment. The terms of the contract are negotiated on a cost plus margin basis. The contract cost agreed on is \$4,000 with a gross profit margin of 25 percent. It will take two years to manufacture the mining equipment.

The enterprise evaluated the deliverables in the contract and determined that the contract represents one unit of account. A summary of the financial data during the construction period is as follows:

	<u>Year 1</u>	<u>Year 2</u>
Estimated contract cost	\$4,000	\$4,000
Estimated gross profit	<u>\$1,000</u>	<u>\$1,000</u>
Estimated contract revenue	\$5,000	\$5,000
Contract costs incurred to date	\$2,600	\$4,000
Contract costs to complete	\$1,400	\$0
Progress billings	\$2,500	\$2,500

The enterprise determines the degree of completion of the contract based on the ratio of costs incurred to total estimate contract costs.

	<u>Year 1</u>	<u>Year 2</u>
Calculating degree of completion:		
Cost incurred to date	\$2,600	\$4,000
Total estimated contract costs	\$4,000	\$4,000

Degree of completion (Cost incurred to date/Total estimated contract costs)	65%	100%
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A summary of the financial statement impact during the manufacturing period is as follows:

Income statement

	<u>Year 2 Only</u>	<u>Year 2 Cumulative</u>
	<u>Year 1</u>	
Gross profit (Total estimated gross profit x degree of completion)	\$650	\$350
Cost of earned revenue (Cost incurred during the period)		\$1,000

	<u>\$2,600</u>	<u>\$1,400</u>	<u>\$4,000</u>
Earned revenue (Gross profit earned plus cost of earned revenue)	\$3,250	\$1,750	\$5,000
Balance sheet			<u>Year 2 Cumulative</u>

Work in progress

Total costs incurred to date	\$2,600	\$4,000
Cost of earned revenue recognized to date	<u>\$2,600</u>	<u>\$4,000</u>
Contracts receivable	\$0	\$0

Costs and estimated earnings in excess of billings on uncompleted contracts

Progress billings	\$2,500	\$5,000
Earned revenue	<u>\$3,250</u>	<u>\$5,000</u>
Costs and estimated earnings in excess of billings on uncompleted contracts	\$750	\$0
	=====	=====

- B4. The following example illustrates the application of the guidance for expected contract losses.

Enterprise A is constructing a building for its customer. The construction is in its second year of the three-year project. Enterprise A originally assessed the contract to be profitable and recognized a profit in year 1 of \$2,000, based on the percentage of the contract that had been completed at that time. Enterprise A now estimates that the contract will incur a loss of \$3,000.

In line with paragraph 3400.A33, Enterprise A should recognize a loss in respect of the contract of \$5,000 in Year 2. This represents a reversal of the \$2,000 profit recognized in Year 1 and the \$3,000 loss expected on the contract as a whole.

The loss has been assessed through a revision of the estimated costs to completion. The appropriate accounting entry is to recognize the adjustment in the current year's results rather than record a prior-period adjustment.

REPORTING REVENUE GROSS OR NET

- B5. The following examples demonstrate the application of the indicators for reporting revenue gross or net.

Product sales

Example 1

Entity A facilitates the sale of home furnishing products. Each product marketed has a unique supplier and that supplier is identified in product catalogues distributed to customers. Entity A maintains no inventories of products in advance of customer orders. Entity A takes title to the products ordered by customers at the point of shipment from suppliers. Title is passed to the customer upon delivery. The gross amount owed by a customer is charged to the customer's credit card prior to shipment and Entity A is the merchant of record. Entity A is responsible for collecting the credit card charges and must remit amounts owed to suppliers regardless of whether that collection occurs. Suppliers set product selling prices. Entity A retains a fixed percentage of the sales price and remits the balance to the supplier. Written information provided to customers during marketing and included in the terms of sales contracts states:

"Entity A manages ordering, shipping and billing processes to help you purchase home furnishing products. Entity A does not buy, sell, manufacture or design the products. When you use Entity A, you are purchasing the products from the Suppliers. Entity A has no control over the quality or safety of the products listed. Orders will not be binding on Entity A or the Suppliers until the applicable Supplier accepts them. Entity A will process your requests for order changes, cancellations, returns and refunds with the applicable Supplier. All order changes, cancellations, returns, or refunds are governed by the Supplier's policies, and you agree to pay additional shipment costs or restocking charges imposed by the Supplier. You agree to deal directly with the Supplier regarding warranty issues. Entity A will not be liable for loss, damage or penalty resulting from delivery delays or delivery failures due to any cause beyond reasonable control."

Certain indicators point toward gross reporting, while other indicators point toward net reporting. Entity A concludes that revenues should be reported net in this example. Although indicators of gross reporting exist for physical loss inventory risk (during shipping) and credit risk (for collecting amounts charged to credit cards), in Entity A's judgment, those indicators are not sufficient to overcome the stronger indicators that revenues should be reported net, including:

- (a) the supplier, not the enterprise, is the primary obligor; and
- (b) the amount earned by the entity is a fixed percentage of the total amount billed to the customer.

Example 2

A major Chain of athletic shoe stores obtains 60 percent of its seasonal shoes from an overseas source. The lead time for the order is four months and the selling season lasts three months. Chain takes title to the products upon delivery and is obligated to pay the Supplier according to typical industry payment terms. Selling prices for the products are determined exclusively by Chain. As long as Chain devotes at least 20 percent of its advertising budget to the Supplier's brands and prices the shoes within 20 percent of the national average price, Chain may return for full credit any unsold shoes and any customer returns within 60 days of the end of the season. Sales to customers are by cash or credit card.

After applying the indicators, Chain concludes that revenue from sales of products from the overseas source should be reported based on the gross amount charged to customers. Indicators of gross reporting are:

- (a) Chain is the primary obligor to the customer, a strong indicator, as Chain is responsible for fulfillment and customer remedies in the event of dissatisfaction;
- (b) Chain has general inventory risk as a result of taking title and maintaining inventory, although that risk is mitigated through the return provisions with the supplier;
- (c) Chain has complete latitude to set the prices for the products (even though product pricing may affect Chain's return rights and expose it to greater inventory risk) and the net amount to be earned varies with that selling price; and
- (d) Chain also has credit risk for credit card transactions (a weaker indicator). No indicators of net reporting are present.

Similar fact patterns: Changes in the fact pattern as to product return provisions for unsold products between the Chain and the Supplier that would not change the result that Chain should report revenue gross include, for example, a vendor-imposed restocking fee or a limit on the number of items that may be returned. Those types of changes would increase the amount of general inventory risk present and increase the strength of that indicator of gross reporting.

In this example, the conclusion to report revenue gross based on the indicators would not be affected if the products Chain sold were in Chain's inventory on a consignment basis. While a consignment arrangement would eliminate the general inventory risk indicator of gross reporting, the primary obligor indicator, a strong indicator of gross reporting, and the pricing latitude and credit risk gross indicators continue to point to gross reporting. Further, there continues to be no indicator of net reporting.

Service transactions

Example 3

Entity C sells access to industrial application software that assists customers in managing their energy usage levels. Billings are on standard 30-day terms. Entity C's software is resident on Entity C's hardware and is accessed through the Cloud. Entity C's software incorporates software from another vendor. In its marketing literature and sales contracts, Entity C clearly states that its software includes the other vendor's software (by name) and that the customer has the right to use that software as a component of Entity C's software. (The other software vendor is not party to the sales contract between Entity C and the customer.) Entity C sells access to its software for \$50,000 per year per user/individual access right and pays the other vendor a fixed fee of \$15,000 per year for each annual access right sold. Currently, Entity C has complete discretion in determining the selling price.

Entity C concludes that it should report its revenue from software access gross at an annual total of \$50,000 per copy. [Note that the timing of recognition of that revenue is not covered in this example.] Entity C is primarily responsible to the customer for providing access to the "total solution" software, a strong indicator of gross reporting. Entity C has complete control over the sales price and has developed or physically changed its software (irrespective of the use of components from others), both indicators of gross reporting. Entity C has discretion to incorporate any other vendor software into its software, irrespective of the fact that changing to another vendor for a component would be difficult or expensive or that Entity C's agreement with its current supplier makes that supplier the exclusive supplier of the component for a stated period of time. Entity C determines software specifications, an indicator of gross reporting. Entity C has full credit risk under its credit policies with customers, a weaker indicator of gross reporting. No indicators of net reporting are present.

Example 4

"Matchmaker" provides the service of matching enterprises needing advertising space for its advertisements with enterprises that have advertising space to sell. Matchmaker arranges for space and marks up the price by its fee (while that fee often is equal to 15 percent of the amount charged by the supplier of advertising space, the actual fee is a result of

negotiations between Matchmaker and its customers). "Advertiser" needs to purchase advertising space. "Newspaper" is a major newspaper with advertising space to sell.

Advertiser and Matchmaker enter into a service agreement for Matchmaker to find appropriate advertising space. The agreement requires Advertiser to accept advertising space located by Matchmaker if certain criteria are met. Matchmaker reserves appropriate space for Advertiser at Newspaper. Matchmaker is obligated to purchase the space even if Advertiser cancels the advertisement; however, since Advertiser has engaged Matchmaker to find the advertising space, cancellation is unlikely. Advertiser pays Matchmaker 115 percent of Newspaper's rate and Matchmaker pays Newspaper the net amount. Matchmaker provides Advertiser's advertising copy to Newspaper to print and issue. The contract between Matchmaker and Advertiser requires Advertiser to seek remedies from Newspaper for defects in advertisements (e.g., improper placement or poor-quality print).

Certain of the indicators point to gross reporting, while others point to net reporting. Matchmaker concludes that revenues should be reported net based on the net indicator that Newspaper is the primary obligor. Two indicators of gross reporting were identified; however, Matchmaker did not consider them sufficiently strong to overcome the net indicators. Those gross indicators are:

- (a) Matchmaker has a low-level general inventory risk because Matchmaker is obligated to pay Newspaper for the advertising space even if Advertiser cancels the advertisement (however, this risk is mitigated because Advertiser specifically engaged Matchmaker to obtain the advertising space); and
- (b) Matchmaker has credit risk for collecting the amount billed to Advertiser.

BILL AND HOLD ARRANGEMENTS

- B6. The following example indicates the application of the guidance for a bill and hold arrangement.

Customer A bought goods from Enterprise B and has requested Enterprise B to provide custodial services. Customer A requested the custodial services as its warehouse is under construction and currently has no place to store the purchased goods. Customer A and Enterprise B agreed that Customer A will pick up the goods upon completion of the construction of its warehouse.

The goods are not specifically customized for the customer but are stored in a special storage room. The enterprise typically does not provide custodial services unless a customer has ordered goods.

The contract does not state a price relating to the custodial services and the total transaction price does not change regardless of how long the goods are stored at the enterprise's premise. The storage room is locked and equipped with cameras and alarms and only certain designated employees have access to the room. The enterprise's policy is that once goods are placed in the storage room, they are "reserved" for the specific customer and, therefore, cannot be used or directed to another customer. However, the goods in the storage room are not specifically identified as belonging to a specific customer. There are controls in place to ensure compliance with the enterprise's "reservation" policy.

When the goods are picked up at the scheduled time, a designated employee tracks the customer purchase order in the system and identifies the specific items pertaining to the customer's order by the product description. The employee then enters the storage room, locates the described goods and provides them to the customer. Although the items are not specifically identified for the customer who has requested the custodial service, the total inventory count of a specific item would agree to the total quantity in the system.

Generally, this arrangement fulfills the bill and hold considerations for the goods in paragraph 3400.A43:

- Ownership has passed to Customer A as the Customer A acknowledges the deferred delivery and the payment terms;
- Delivery has been delayed at Customer A's request and receives economic benefit in the form of cost saving for storage space;
- Delivery will be made as per the agreed upon schedule; and
- The inventory on-hand is identified and "reserved" for the customer at the time that the sale is recognized, the customer acknowledges the deferred delivery and the payment terms.

While not illustrated in this example, the custodial services should be assessed using the criteria in paragraph 3400.A5 to determine if they represent a separate unit of account.

UPFRONT NON-REFUNDABLE FEES OR PAYMENTS

- B7. The following examples indicate the application of the guidance for non-refundable fee or payment arrangement.

Example 1

An enterprise sells a lifetime membership in a health club. After paying a non-refundable "initiation fee," the customer is permitted to use the health club indefinitely, so long as the customer also pays an additional usage fee each month. The monthly usage fees collected from all customers are adequate to cover the operating costs of the health club.

The upfront fee is not received in exchange for services provided to the customer that meet the criteria for recognizing revenue in paragraphs 3400.05-.06 and the upfront fee does not have a stand-alone value to the customer because ongoing use of the health club is dependent on payment of an additional usage fee each month. Therefore, the upfront fee and the continuing services to be provided or products to be delivered are assessed as an integrated package.

The upfront fees, even if non-refundable, are earned as the products and/or services are delivered and/or performed over the term of the arrangement or the expected period of performance and generally should be deferred and recognized systematically over the periods that the fees are earned.

Example 2

An enterprise requires a customer to pay a non-refundable "activation fee" when entering into an arrangement to provide telecommunications services. The terms of the arrangement require the customer to pay a monthly usage fee that is adequate to recover the enterprise's operating costs. In order to provide basic local telephone service to a customer, a telephone company must activate the customer's service at the central office.

The company charges \$50 to activate basic local service. Ongoing fees related to basic local service consist of a flat monthly fee and usage-related charges. There is no contract between the customer and the company. The costs associated with activation are \$40 and consist primarily of the technician's salary and related benefits.

The revenue from the fee should be deferred and recognized over the expected term of the customer relationship. The customer can be expected to view activation as a necessary and inseparable part of buying ongoing telephone service, and not as a separate service with a stand-alone value that meets the criteria for recognizing revenue in paragraphs 3400.05-.06.

In this situation, the activation costs are nominal. The question arises as to whether the incurrence of more than nominal costs for activation would permit revenue recognition when activation was performed. This example cited nominal costs solely to make it clear that there was not a separate earnings event in the situation described. However, incurrence of substantive costs does not necessarily indicate that there is a separate earnings event. Whether there is a separate earnings event should be evaluated on a case-by-case basis.

The question also arises as to whether revenue may be recognized in these transactions to the extent of the incremental direct costs incurred in the activation. Because there is no separable element or earnings event, the recognition of revenue to the extent of the incremental direct costs incurred in the activation would not be appropriate. However, capitalization of certain contract acquisition or origination costs may be appropriate in these circumstances when assessed against the criteria in GOODWILL AND INTANGIBLE ASSETS, Section 3064.

Example 3

Cloud Co. enters into a contract with a customer for a license of its software and a non-cancellable one-year subscription to access the licensed application (the cloud services). The contract amount for the software license is an upfront, non-refundable fee of \$1 million. The fee for the cloud services is \$500,000 for one year. The customer has the right to renew the cloud services each year for \$500,000.

Assume that Cloud Co. determines the software license and cloud services are a single unit of account. There are no other promised goods and services in the contract. Therefore, the upfront fee is not associated with the transfer of any other good or service to the customer. However, Cloud Co. determines there is an implied performance obligation. That is, the right to renew the cloud services each year for \$500,000 is a material right to the customer because that renewal rate is significantly below the rate the customer paid for the first year of service (\$1.5 million in total).

Based on its experience, Cloud Co. determines that its average customer relationship is three years. As a result, Cloud Co. determines that the performance obligations in the contract include the right to a discounted annual contract renewal and that the customer is likely to exercise twice.

Cloud Co. should recognize the non-refundable fee of \$1 million systematically over the period the licensing fees are expected to be earned.

Footnotes

* The degree of completion for Year 2 (74 percent) is determined by excluding the \$100 of standard material purchased in Year 2 for use in Year 3, from costs incurred to date.

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