Principles-based revenue recognition
Executory contracts and the asset/liability approach

April 2011
In the accounting literature, a contract is an agreement between two or more parties that creates enforceable rights and obligations. A contract is an executory contract until one or both of the parties have performed all their obligations according to the contract’s terms. For years, accounting standard setters have struggled with a fundamental issue in accounting theory: Should entities recognize executory contracts as assets and liabilities? Financial statement users have generally supported recognizing executory contracts because they believe recognition would provide useful information. Standard setters have resisted recognition because executory contracts normally do not meet the accounting definition of an asset and a liability.

Resolution of this issue may be unavoidable if the FASB and the IASB (collectively, the Boards) are to attain their goal of promulgating conceptually consistent, principles-based standards using an asset/liability approach to financial reporting. Nowhere is that more apparent than in the accounting for revenue recognition. An asset/liability approach, according to the SEC’s Office of the Chief Accountant (OCA), implicitly requires two distinct steps for revenue recognition. The first step is to identify and measure the assets and liabilities arising from the transaction. The second is to recognize revenue based on changes in those assets and liabilities.

Revenue recognition is a major component of the Boards’ current project to converge U.S. GAAP and IFRS. The Boards issued an Exposure Draft, Revenue from Contracts with Customers (the ED), in June 2010 that proposes major changes to how revenue is perceived conceptually, measured and recognized in the financial statements. The objectives of that ED are heroic:

- to remove inconsistencies and weaknesses in existing standards and practices;
- to provide a more robust framework for addressing revenue recognition issues;
- to improve comparability across entities, industries, jurisdictions, and capital markets; and
- to simplify the preparation of financial statements by reducing the number of requirements to which entities must refer.

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### Definitions

**Contract asset:** an entity’s right to consideration from a customer in exchange for goods or services transferred to the customer.

**Performance obligation:** an enforceable promise (whether explicit or implicit) in a contract with a customer to transfer a good or service to the customer.

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1 Although there is not one generally accepted definition of an executory contract in the authoritative accounting guidance, for purposes of EITF Issue 03-17, Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity’s Balance Sheet, the EITF defined an executory contract as “a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract.”

The ED implicitly proposes an asset/liability approach to revenue recognition. It marks a significant departure from current revenue recognition theory described in the FASB’s conceptual framework, which calls for revenue to be recognized when it is realized or realizable and earned — a revenue/expense approach. The ED would change the underlying conceptual basis for revenue recognition to an asset/liability approach by introducing a new type of asset (a contract asset) and a new type of liability (a performance obligation). A vendor would recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer; that is, by derecognizing a liability. A transfer occurs when the customer obtains control of the good or service. The shift to the customer’s view for determining transfer of control effectively changes the model’s focus from derecognition of a liability by the vendor to derecognition of an asset by the vendor and recognition of an asset by the customer.

In this paper, we note that revenue recognition upon satisfaction of a performance obligation is a complete specification of a principles-based asset/liability approach, but that satisfaction of the performance obligation by transferring a promised good or service to a customer changes the model to a hybrid of the asset/liability approach and the revenue/expense approach. Recognition of revenue upon delivery of a good or service to a customer is part of the current revenue/expense approach where revenue is recognized when realized or realizable and earned. However, this is an incomplete description of the revenue/expense approach, which includes other methods of revenue recognition such as percentage of completion or recognition over time. Further, we argue that a customer’s obtaining control describes one of several methods for determining when a vendor has transferred a good or service to a customer, and should not be viewed as the core principle of the proposed model. As we noted in our comment letter3 in response to the ED, although control appears to work well as the basis of derecognition in the sale of goods, it does not apply well to services, nor does it acknowledge temporary transfers of control found in, for example, leases and financing arrangements.

3 Grant Thornton’s comment letters can be found at www.GrantThornton.com at Home>Grant Thornton Thinking>Comment letters.
In addition to arguing that the proposed revenue recognition model contains aspects of a revenue/expense approach, we seek to illustrate in this paper how the Boards have made the model more complex and potentially more difficult to apply and audit by not addressing the issue of accounting for executory contracts. The proposed revenue recognition model stops short of requiring a seller to separately recognize the contract assets and performance obligations that constitute an executory contract. Instead, the seller would acknowledge the existence of the contract asset, identify and measure separate performance obligations, and recognize revenue when the performance obligations are satisfied. In other words, the seller would recognize revenue when it derecognizes a performance obligation that was never formally recognized in the books of account.

The complexity arises because, although the model implicitly relegates the accounting for contract assets and performance obligations into memoranda accounts, the movement in these memoranda account balances is not illustrated in the ED. It is our view that the Boards should address the issue of accounting for executory contracts head-on, and illustrate how an entity would track the balances of unrecognized contract assets and performance obligations as part of the financial reporting process under the proposed revenue recognition model.

Although the gross balances of contract assets and performance obligations are not recognized under the proposed model, the net contract position is recognized on the balance sheet, and therefore it is critical that the proposed guidance address the accounting for the components of that position. It is our opinion that these changes would improve the revenue recognition standard by making it more transparent and understandable. We demonstrate this by comparing an illustrative transaction from the ED with our own interpretation of the substance of the transaction, including effective recognition of the executory contract elements in memoranda accounts.

The remainder of this paper is organized into four sections:

1. Background on accounting for executory contracts
2. A two-step model of revenue recognition
3. Illustration of the two-step model
4. Conclusion

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4 A memorandum account is used to track accounting entries outside the general ledger.
5 Throughout this paper we use the term “effective recognition” to describe the recording of assets and liabilities in “memoranda” entries.
Background

To begin we provide some background on the issues of accounting for executory contracts and the asset/liability approach to standards setting.

**Executory contracts**

According to the SEC in its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (SEC OBS report), there are three views on how an entity could account for unperformed contractual obligations (executory contracts). First, an entity could recognize all contractual rights and obligations as assets and liabilities. Second, an entity could not recognize any contractual rights and obligations as assets and liabilities. Third, an entity could view the contractual rights and obligations within a particular contract as a group, and recognize the group as an asset or liability.

Financial statement users have generally supported the first view that entities should recognize all contractual rights and obligations. The CFA Institute, in its 2007 publication, *A Comprehensive Business Reporting Model: Financial Reporting for Investors* (CBRM), describes changes that it believes will enhance the usefulness of the current reporting model, particularly for the benefit of investors. Among the CFA Institute’s proposed changes is:

> …that all activities that currently are off balance sheet as a result of accounting standards or other conventions must be recognized, including executory contracts. Executory contracts, arrangements for which performance by the various parties is still in progress, represent commitments entered into by the parties. These commitments will affect shareholders’ wealth and should be recognized as any other obligation would be.

The CBRM does not go into detail as to how recognition of executory contracts would be accomplished, but does state that fair value information is the only information relevant for financial decision making.

U.S. standard setters have generally supported the second view, that an entity should not recognize any assets or liabilities for rights and obligations in an executory contract. According to the SEC OBS report:

> Although standard-setters have almost invariably determined that such unperformed contracts (executory contracts) should not result in the recording of assets and liabilities, the basis for these decisions is not always stated.

Two examples, lease contracts and onerous contracts, illustrate this.

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7  CFA Institute is a not-for-profit professional association of investment analysts, portfolio managers, investment advisors, and other investment professionals that, as part of its mission, seeks to ensure that high-quality corporate financial reporting and disclosures are provided to investors and other end users.

Lease contracts

Whether executory contracts should be recognized in the statement of financial position has been an issue at the heart of accounting for leases for many years. In 1964, the Accounting Principles Board (APB) stated, in APB Opinion 5, Reporting of Leases in Financial Statements of Lessee:

*It seems clear that leases covering merely the right to use property in exchange for future rental payments do not create an equity in the property and are thus nothing more than executory contracts requiring continuing performance on the part of both the lessor and the lessee for the full period covered by the leases. The question of whether assets and liabilities should be recorded in connection with leases of this type is, therefore, part of the larger issue of whether the rights and obligations that exist under executory contracts in general (e.g., purchase commitments and employment contracts) give rise to assets and liabilities which should be recorded.*

In a separate Exposure Draft, Leases, issued in August 2010, the Boards proposed that executory contracts associated with lease arrangements would be recognized in the financial statements as right-of-use assets and lease obligations. However, like the revenue recognition ED, the leasing ED left the “larger issue” of accounting for executory contracts unaddressed. Many of the difficult issues identified in the lease accounting project, including distinguishing lease elements from service elements, the timing of revenue and expense recognition, and determination of the lease term may have as much to do with the accounting for executory contracts as they do with the accounting for leases.

Onerous contracts

In 2001 the EITF deliberated Issue 00-26, “Recognition by a Seller of Losses on Firmly Committed Executory Contracts.” In this Issue the Task Force sought to determine

*When a seller, or service provider, under a firmly committed executory contract that requires the seller to deliver goods or services to the counterparty in the future for specified consideration should recognize a loss under the contract and*

*If a loss should be recorded, how the loss should be measured.*

The Task Force did not reach a conclusion on this Issue, but it did make the following observation:

*… the accounting for executory contracts is an extremely broad topic with significant and pervasive implications on financial reporting. However, due to the lack of authoritative guidance on this subject, the Task Force requested the FASB staff to explore with the Board the possibility of a Board project to address executory contract accounting.*

The Boards have addressed the specific issue raised in Issue 00-26 in the revenue recognition ED. The ED proposes that entities recognize a liability and corresponding expense for “onerous” performance obligations. The Boards, however, made this decision without addressing the broader issue of executory contract accounting.
The third view, that an entity should recognize an asset or liability representing contractual rights and obligations within a particular contract as a group, is, as we will show later, the approach the Boards have taken in their joint revenue recognition project. This view establishes the contract as the unit of account, rather than the individual assets and liabilities. Therefore, if the assets and liabilities within the contract offset each other, there would be no explicit recognition of the executory contract in the financial statements.

Although the Boards have not explicitly addressed executory contracts in their proposed revenue recognition model, we suggest that there is implicit accounting for executory contracts within the ED. This accounting draws its conceptual basis from the asset/liability approach to revenue recognition.

**Asset/liability approach**

In its *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System* (SEC report), the SEC’s Office of the Chief Accountant describes the asset/liability approach as follows:

*In the asset/liability view, the standard setter, in establishing the accounting standard for a class of transactions would, first, attempt to define and specify the measurement for the assets and liabilities that arise from a class of transactions. The determination of income would then be based on changes in the assets and liabilities so defined. Thus, in this view, the accounting for transactions and events involves identifying assets and liabilities, and changes in those assets and liabilities, associated with the underlying transactions and events.*

The SEC report describes the revenue/expense approach, on the other hand, as an approach that

*… would call upon the standard setter to establish standards that give primacy to the direct measurement and recognition of the revenues and expenses related to the class of transactions. Under this approach, the balance sheet becomes residual to the income statement, and contains assets, liabilities, and other accruals/deferrals needed to maintain a “balance sheet.”*
U.S. GAAP currently supports a revenue/expense approach to revenue recognition. According to Statement of Financial Accounting Concepts 5, Recognition and Measurement in Financial Statements of Business Enterprises, revenue recognition depends on two factors: (1) whether it is realized or realizable, and (2) whether it is earned. Revenue is realized when goods or services are exchanged for cash or claims to cash, and revenue is realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash. Revenue is earned when the vendor has substantially accomplished what it must do to be entitled to the benefits represented by that revenue. FASB Concepts Statement 5 goes on to describe several indicators that revenue is realized or realizable and earned, and appropriate recognition methods based on those indicators.

The revenue recognition model described in FASB Concepts Statement 5 represents a revenue/expense model because it focuses on the direct measurement of revenue as opposed to the direct measurement of assets and liabilities for which changes in carrying amounts would give rise to revenue. Although FASB Concepts Statement 5 describes situations in which revenue would be recognized upon delivery of an asset to a customer, this does not indicate an asset/liability approach because it is not derecognition of an asset (for example, inventory) that is driving revenue recognition. Inventory is measured at cost and gives rise to cost of goods sold when it is derecognized. Rather, revenue is measured directly based on the amount of customer consideration that has been or will be received and its recognition may or may not coincide with a change in an existing asset or liability.

The SEC report states that the asset/liability foundation is crucial, not only to the FASB’s efforts to establish when identified assets and liabilities should be recognized and how they should be measured, but also what transactions or events should be addressed by a standard. That is, the asset/liability approach allows standard setters to identify the “optimal scope” for accounting standards, reducing the need for scope exceptions that tend toward a rules-based, rather than a principles-based, approach to standard setting.
The asset/liability approach and revenue recognition

The Boards’ revenue recognition ED states that:

An entity shall recognize revenue when it satisfies a performance obligation … by transferring a promised good or service to a customer. A good or service is transferred when a customer obtains control of that good or service.

To analyze this section of the proposed guidance in terms of the asset/liability approach, it is helpful to break it down into three components:

• What is the principle?
• How is a performance obligation satisfied?
• When is a performance obligation satisfied?

What is the principle?

The fundamental principle of the asset/liability approach is fully described in the phrase “[a]n entity shall recognize revenue when it satisfies a performance obligation.” Under that principle, revenue is recognized in conjunction with derecognition of a liability (performance obligation). The Boards expressed this principle precisely in their Discussion Paper, Preliminary Views on Revenue Recognition in Contracts with Customers:

In the proposed model, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.
How is a performance obligation satisfied?
The second phrase “…by transferring a promised good or service to a customer” describes one method of implementing the asset/liability approach. This phrase describes how a performance obligation is satisfied: by transfer of goods or services to the customer. It is here that our view diverges from that described in the ED, because we believe that this is an incomplete description of how an entity could satisfy and, therefore, derecognize the performance obligation.

Consider that U.S. GAAP currently describes several ways that an entity can extinguish a liability. *FASB Accounting Standards Codification™* (ASC) 405-20-40-1, *Liabilities: Extinguishments of Liabilities*, states that a liability has been extinguished if either:

(a) the debtor pays the creditor and is relieved of its obligation for the liability, or
(b) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Under (a), payment to the creditor could include the following:9

1. delivery of goods or services
2. delivery of cash or other financial assets

Under (b), the debtor might extinguish a liability by transferring it to a third party such that the debtor is no longer the primary obligor.

As illustrated by ASC 405-20-40-1, there are multiple ways to extinguish, and therefore derecognize, a liability. One way — delivery of goods or services — appears to be consistent with the derecognition method described in the ED. The other ways, including delivery of cash and transferring the liability to another party, are not addressed under the proposed guidance. In our view, the proposed guidance should address these other methods of satisfying a performance obligation because they could be part of revenue-generating transactions. For example, a vendor might satisfy a net performance obligation by transferring cash to the customer in an amount less than the carrying amount of the net performance obligation. Likewise, a vendor could satisfy a net performance obligation by transferring the net position to a third party. In both cases the vendor might recognize revenue in conjunction with derecognizing its performance obligation, although we acknowledge that, in some cases, a vendor might recognize a gain rather than revenue under such circumstances.

Regardless whether the proposed guidance is ultimately consistent with the guidance in ASC 405–20, we believe that the proposed guidance should at least acknowledge the existing guidance that deals with derecognition of liabilities and, if applicable, the rationale for divergence from existing guidance.

We believe the ED’s specification that a performance obligation is satisfied when a customer obtains control of a good or service changes the nature of the proposed model from an asset/liability approach to a hybrid that incorporates elements of a revenue/expense approach. This is because the focus of the model shifts from satisfaction of a performance obligation, which is what gives rise to revenue under the proposed model, to the transfer of a good or service, which is the usual criteria under the current revenue/expense approach for determining when revenue is realized or realizable and earned. Conceptually, derecognition of the performance obligation is no longer the driver of revenue recognition but, rather, a consequence.

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9 For purposes of this paper, we have abbreviated the items constituting payment to a creditor. For a full list refer to ASC 405-20-40-1.
To illustrate, consider the proposed model as a series of equations:

1. Revenue recognition = satisfaction of a performance obligation
2. Satisfaction of a performance obligation = transfer of a good or service to a customer
3. Revenue recognition = transfer of a good or service to a customer

Satisfaction of the performance obligation is not a necessary component of the model. This equation does not reflect an asset/liability approach to revenue recognition, whereby revenue is recognized as a performance obligation is satisfied.

When is a performance obligation satisfied?
The third element, “… when the customer obtains control of a good or service” describes when a transfer is complete. Many comment letters in response to the ED noted that application of a control concept to non-goods categories will be, to say the least, challenging.

It is our view that defining revenue recognition as occurring when a customer obtains control of a good or service transforms the fundamental principle of revenue recognition from a principle based on an asset/liability approach to one based on an incomplete representation of the current revenue/expense approach. Although control may be an appropriate criterion for derecognition of performance obligations relating to nontemporary transfers of goods, it would not apply to performance of services or temporary transfers of goods. Services can be performed, but do not constitute assets for which control can be transferred, making the determination of when revenue should be recognized in a service arrangement problematic. Temporary transfers, despite the customer’s obtaining control, may not meet the criteria for derecognition of the performance obligation because the transaction might be in substance a lease or financing arrangement. We are concerned that these limitations of the control criterion could lead to rules-based guidance for determining when control of a service has been transferred, as well as scope exceptions, diluting the principle of recognizing revenue when a performance obligation is satisfied. Also, as we describe in more detail below, the proposed model’s focus on control introduces an aspect of a revenue/expense approach to what was otherwise intended to be an asset/liability approach to revenue recognition. The reliance on the customer’s obtaining control instead of satisfaction of the performance obligation to designate when revenue is recognized may create significant implementation difficulties, diversity in practice, and demand for additional implementation guidance.
Continuing our series of equations, we can state that under the proposed model:

4. Transfer of a good or service to a customer = customer obtains control

Using the transitive property for equations (3) and (4), the revenue recognition principle becomes:

5. Revenue recognition = customer obtains control

Financial statement preparers will focus on determining when the customer has obtained control instead of determining when the vendor has satisfied the performance obligation. The focus on the customer’s obtaining control is more consistent with a revenue/expense approach to revenue recognition than an asset/liability approach.

It may appear to some that a model that focuses on the customer’s obtaining control of an asset, such as inventory, is representative of an asset/liability approach because derecognition of an asset is driving revenue recognition.

We believe there are three significant problems with this view. First, it does not acknowledge derecognition of the net contract asset, which is not transferred, but rather some other asset, such as inventory. Second, the measurement basis for goods or services transferred under a contract is cost, not customer consideration, which is the measurement basis for revenue. Third, in contracts to provide services, there is no pre-existing asset for the vendor to derecognize and often no recognized asset for the customer to control.

An asset/liability approach must focus on when the performance obligation is satisfied and, therefore, derecognized. However, this focus is difficult to visualize under the current proposal because the performance obligation arising from an executory contract is not acknowledged as effectively recognized. We believe that the ED could be improved by better illustrating the increases and decreases in the amounts of contract assets and performance obligations from contract inception to derecognition. These changes determine the net contract position to be presented in the financial statements, as we will illustrate later.

Redefining the terms changes the approach

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\} An asset/liability approach...

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The asset/liability approach and remeasurement

The ED also requires vendors to recognize a loss for onerous performance obligations where the vendor expects to recognize a loss. In the Basis for Conclusions, the Boards describe the accounting for an onerous performance obligation as a remeasurement. The remeasurement amount would be recognized as a separate liability on the statement of financial position so that the amount, and its impact on the entity’s profit or loss, can be tracked separately. As a result, vendors would recognize the loss portion of onerous executory contracts but not the original performance obligation.

The SEC OBS report mentions this inconsistency in relation to current accounting guidance on loss contracts:

...losses on certain contractual commitments, such as inventory purchases and construction contracts, are required to be recognized before performance occurs. Conceptually, the loss in these contracts might be viewed as akin to an asset impairment loss, even though the rights in these contracts have not previously been reported as assets.

...vendors would recognize the loss portion of onerous executory contracts but not the original performance obligation.

The proposed onerous contract provisions also affect the overall measurement principle in the ED. The Boards have proposed a measurement principle whereby entities would recognize revenue in an amount that reflects the consideration the entity receives, or expects to receive, in exchange for goods or services.

However, the proposed guidance for onerous performance obligations implies a different measurement standard: performance obligations would be measured at the greater of the transaction price or the cost to satisfy the performance obligation. The cost to satisfy the performance obligation would be the lower of the cost to satisfy or the cost to cancel the performance obligation.

This measurement principle is obviously more complicated than the basic principle, and introduces both remeasurement and elements of fair value accounting into revenue recognition.
Financial executives weigh in on criteria for revenue recognition in contracts

For preparers’ views on revenue recognition, Grant Thornton LLP recently asked participants in its semi-annual Survey of Financial Executives what they felt was the best criterion for recognizing revenue on contracts with customers.

Only 19 percent of respondents indicated that control of the underlying asset is the best criterion. Approximately 37 percent of respondents indicated that they believe satisfaction of a performance obligation coupled with an unconditional right to consideration is a better criterion, while approximately 36 percent prefer a proportional method as goods are delivered or services are performed.

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A two-step model of revenue recognition

According to the SEC report’s description, the asset/liability approach to revenue recognition requires identification and measurement of the assets and liabilities arising from a transaction with a customer and then recognition of revenue upon changes in those assets and liabilities. We describe this as a two-step process that starts with effective recognition of the contract assets and performance obligations arising from an executory contract and ends with derecognition of the performance obligation.

Step one: Recognize contract assets and performance obligations
In the ED, the Boards are silent on the issue of whether executory contracts should give rise to assets and liabilities, although they propose a model that implies effective recognition of assets and liabilities upon a vendor entering into an executory contract. The proposed model uses the terms “contract asset” and “performance obligation” to describe those assets and liabilities, respectively. According to the ED, at contract inception, an entity would have a net contract position that consists of a contract asset and a performance obligation. The net amount will usually be zero, but could be positive (a net contract asset) from including contract costs in the measure of the contract asset.

As to the nature of the contract, the ED is careful to never describe the contract as recognized, but provides criteria for when it would exist:

A contract exists for the purpose of applying the proposed revenue requirements only if:
(a) the contract has commercial substance (that is, the entity’s future cash flows are expected to change as a result of the contract)
(b) the parties to the contract have approved the contract and are committed to satisfying their respective obligations
(c) the entity can identify each party’s enforceable rights regarding the goods or services to be transferred
(d) the entity can identify the terms and manner of payment for those goods or services

A contract does not exist for the purpose of applying the proposed guidance if either party can terminate a wholly unperformed contract without penalty.

The ED does not discuss the measurement or recognition of the net contract position at contract inception, but it does refer to the proposed guidance from the Discussion Paper in its Basis for Conclusions:

… the Boards proposed in the Discussion Paper that performance obligations should be measured at the same amount as the rights in the contract, thereby precluding the recognition of a contract asset and revenue at contract inception.
More specifically, the Discussion Paper noted the following:

When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract.

In other words, at contract inception, the performance obligation and the rights in the contract are measured at the same amount. The key question is: Would the net contract position be recognized? According to the Discussion Paper:

If the measurement of the rights is equal to the measurement of the obligations, the entity would recognize a net contract position at nil. In other words, the entity would, in effect, not recognize the contract. (our emphasis)

The Boards state that the net contract position would effectively not be recognized, but acknowledge that the position is actually recognized at nil. The ED, on the other hand, makes no mention of whether the net contract position is recognized or not. The Boards did not directly address the issue of whether executory contracts give rise to recognized assets and liabilities.

The recognition of contract assets and performance obligations on a net basis is a key feature of the proposed guidance that allows it to function as an asset/liability model. Net recognition is based on the theory that the rights and obligations in a contract with a customer are interdependent — the right to receive consideration from a customer is dependent on the entity’s performance, and the entity will perform only as long as the customer continues to pay. When an entity satisfies a performance obligation before the customer performs by paying the consideration, the entity has a net contract asset representing a right to consideration from the customer. The contract asset would be an account receivable when the vendor has an unconditional right to receive consideration.

In order to recognize net contract assets and liabilities, it is necessary to identify and measure the gross amounts of the contract asset and performance obligation. The ED avoids the issue of identifying the contract asset and performance obligation, and changes the model to one where the contract asset and performance obligation are not created at contract inception. Net recognition of executory contracts is a critical component of the asset/liability approach, the first step in a two-step process of revenue recognition.
It is our view that the ED’s focus on the customer’s obtaining control makes the proposed model difficult to implement because it is at odds with the asset/liability approach the Boards are pursuing. The focus is on when the customer has obtained control of an asset rather than when a vendor has satisfied a performance obligation. A customer’s obtaining control is only appropriate as a criterion for revenue recognition when that is the action that satisfies the liability. A model that does not provide for other means of satisfying a performance obligation is incomplete. A model that focuses on the customer’s obtaining control may be more similar to a revenue/expense model of recognition, where revenue is recognized when it is earned and realized or realizable, than to an asset/liability model.

When obtaining control is viewed as part of the core principle of the revenue recognition model, as it is in the ED, instead of as one of several methods for determining when a performance obligation is satisfied, the result is a hybrid of the asset/liability and revenue/expense models.

**Step two: Recognize revenue**

The second step is the recognition of revenue. In the proposed model, an entity recognizes revenue when it satisfies a performance obligation. The performance obligation is satisfied by transferring a promised good or service to a customer. The Boards further qualified the model by adding that a good or service is transferred when the customer obtains control of that good or service.

The Boards received many comment letters expressing concern about the description of this second step, particularly with how one would determine whether a vendor has transferred control of a service to the customer. In our view, the Boards could begin to address this concern by acknowledging that the performance obligation is a recognized element and that revenue recognition occurs when the performance obligation is derecognized. This would shift the focus from determining when control is obtained by the customer to determining when a performance obligation is satisfied. We believe that such a shift in focus is appropriate because, under an asset/liability approach, revenue recognition occurs upon derecognition of a liability.
Implementation of this hybrid model could lead to a rules-based standard-setting approach, which the Boards have attempted to avoid. According to the Boards’ September 2008 progress report on their convergence efforts, “[t]he Boards … agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process.” The proposed model’s incorporation of elements from a revenue/expense approach makes it prone to rules-based standard setting. According to the SEC report:

We believe that the revenue/expense view is inappropriate for use in standard setting — particularly in an objectives-oriented regime. In establishing an accounting standard, the standard setter is attempting to define and establish the accounting principles for the underlying economic substance of the class of transactions under consideration … Historical experience suggests that without this conceptual anchor [identifying the assets and liabilities related to the class of transactions] the revenue/expense approach can become ad hoc and incoherent.

To illustrate, the Boards tentatively agreed during redeliberations that the customer would obtain control of services if the transaction meets one of the following conditions:

- The vendor’s performance creates or enhances an asset that the customer controls as the asset is created and enhanced.
- The vendor’s performance does not create an asset with alternative use to the vendor, and at least one of the following conditions is met:
  a. The customer receives a benefit as the vendor performs each task.
  b. Another vendor would not need to reperform the tasks in order to fulfill the remaining performance obligation.
  c. The vendor has a right to receive payment for its performance to date, even if the customer cancels the contract for convenience.

We believe that these tentative decisions are moving toward a rules-based approach and are a direct result of incorporating a revenue/expense approach element in the proposed model’s core principle.
Illustration of the two-step model

Perhaps the most effective way to illustrate revenue recognition as derecognition using the two-step model described above is through an example. As we show here, the journal entry illustrations in the ED do not correspond with the effective recognition of a contract asset and performance obligation at contract inception that, in our view, is necessary for implementation of an asset/liability approach to revenue recognition.

**Simple scenario**
To illustrate, we use Scenario 1 in Example 29 of the ED. The following timeline describes the key dates in this scenario:

- **January 1**: The vendor enters into a contract with the customer.
- **March 31**: The vendor transfers the product to the customer, and the customer obtains control of the product.
- **April 30**: The customer pays the vendor.

**Approach outlined in the ED**
The journal entries presented in the ED are:

- **January 1**, contract inception:
  No entry

- **March 31**, customer obtains control of the asset:
  - Dr. Receivable $1,000
  - Cr. Revenue $1,000

- **April 30**, payment received:
  - Dr. Cash $1,000
  - Cr. Receivable $1,000

These journal entries are identical to what would be recorded today under the revenue/expense approach to revenue recognition. From the journal entries provided in the ED, it is not observable how the performance obligation was either created or satisfied and therefore, how revenue was generated. Rather, the entries illustrate recognition of a receivable in conjunction with the vendor’s recognition of revenue — simultaneous creation of an asset and revenue, consistent with the revenue/expense approach.

According to this illustration, neither contract assets nor performance obligations are recognized at any time, although the components exist at some point during the transaction. In our view, it is necessary to track the components of the net contract position in a memorandum account. As described in the Boards’ Discussion Paper, the net balance in the memorandum account (the difference between the contract asset and the performance obligation) represents a contract asset or a contract liability and is recognized in the statement of financial position.
Alternative approach
The following journal entries are, in our view, a better way to illustrate the asset/liability approach using the fact pattern in Scenario 1 of Example 29:

**January 1**, contract inception
Dr. Contract asset (memo) $1,000
Cr. Performance obligation (memo) $1,000

To further illustrate the impact of these memoranda entries in the proposed model, we present the memorandum account balances after each set of journal entries, along with the net contract position that is presented in the financial statements, unless its balance is nil.

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<thead>
<tr>
<th>Memorandum account balances</th>
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<tbody>
<tr>
<td>Contract asset</td>
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<tr>
<td>Performance obligation</td>
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<tr>
<td>Net contract position</td>
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<tr>
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At inception, the net contract position represented by the balance in the memorandum account is nil.

**March 31**, control transferred:
Dr. Receivable $1,000
Cr. Contract asset (memo) $1,000
Dr. Performance obligation (memo) $1,000
Cr. Revenue $1,000

In this example, the net contract position remains nil from inception to satisfaction of the performance obligation, but the gross amounts may be required to meet some of the disclosure requirements in the ED.

As we have presented the entries here, the event that triggers revenue is now satisfaction of the effectively recognized performance obligation, an explicit representation of the underlying principle and the text of the ED.

The final entry to record the cash receipt is unchanged.

**April 30**, payment received:
Dr. Cash $1,000
Cr. Receivable $1,000
Complex scenario
Next, we consider a more complex scenario with multiple separate performance obligations. The following timeline describes the key dates in this scenario, which is based on Scenario 3 in Example 29 of the ED:

January 1  The vendor enters into a contract with the customer.
March 31  The vendor delivers the product to the customer.
April 15  The vendor completes installation.
April 16  The vendor submits its invoice to the customer.
April 30  The customer pays the vendor.

In this example we assume that the total consideration of $1,000 is allocated 40 percent to the product and 60 percent to installation services.

Approach outlined in the ED
The journal entries under the model proposed in the ED are:

January 1, contract inception:
No entry

March 31, goods are delivered (customer obtains control of the goods):
Dr. Net contract asset $400
Cr. Revenue $400

The net contract asset is recognized because the contract asset now exceeds the performance obligation by $400. The triggering event is derecognition of the performance obligation, but that is not apparent from the journal entry.

April 15, installation completed (customer obtains control of services):
Dr. Accounts receivable $1,000
Cr. Revenue $600
Cr. Net contract asset $400

Completion of installation creates an unconditional right to receive payment; therefore, the net contract asset is credited, and an account receivable is recognized.

April 30, payment received:
Dr. Cash $1,000
Cr. Accounts receivable $1,000

Note that until delivery occurs, neither a contract asset nor a performance obligation is recognized on the balance sheet. On delivery, a net contract asset, rather than an account receivable, is recognized because there is a remaining performance obligation. We argue that this is a confusing presentation because:

a. There is no reference to recognition or derecognition of a performance obligation, the latter being the event that triggers revenue recognition.

b. The net contract asset recognized on March 31 represents implicit derecognition of a performance obligation to deliver goods. Technically, the contract asset is a net of the original contract asset and the remaining performance obligation. This is not clear from the accounting method illustrated in the ED.

c. Key elements of the revenue recognition process are not illustrated, making it harder to understand, control and audit the underlying events.
Alternative approach
We propose the following alternative journal entries as a better way to illustrate the asset/liability approach:

**January 1, contract inception:**
Dr. Contract asset (memo) $1,000  
Cr. Performance obligation one (delivery — memo) $400  
Cr. Performance obligation two (installation — memo) $600

As in the first example, the net contract position, represented by the net balance of the memorandum accounts, is zero at inception and does not appear in the statement of financial position.

**March 31, control transferred (delivery)**
Dr. Performance obligation one (memo) $400  
Cr. Revenue $400

Note that a net contract asset is automatically created by derecognition of performance obligation one and will now appear in the financial statements.

As illustrated by the the memorandum account balances, the net contract position after satisfaction of the first performance obligation is $400. This amount is recognized in the statement of financial position, although the components of that balance (the contract asset and performance obligations) are only effectively recognized in the memorandum accounts.

**April 15, installation completed and invoice submitted:**
Dr. Performance obligation two (memo) $600  
Cr. Revenue $600  
Dr. Accounts receivable $1,000  
Cr. Contract asset (memo) $1,000

Memorandum account balances
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</tr>
<tr>
<td>Net contract position</td>
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</tbody>
</table>

Note that a net contract asset is automatically created by derecognition of performance obligation one and will now appear in the financial statements.
The performance obligations and contract asset have now been completely accounted for, as revenue and a receivable are recognized.

April 30, payment received:

Dr. Cash $1,000
Cr. Accounts receivable $1,000

It is our view that by not explicitly recognizing the contract asset and the performance obligation at contract inception, even though they are the drivers of revenue recognition, the ED adds to the complexity of the accounting and decreases the understandability of the process.

Even more important, perhaps, is that by not addressing the issue of executory contracts, the Boards move important aspects of revenue recognition, including the identification and measurement of contract assets and performance obligations, outside double-entry bookkeeping without properly describing the mechanics of the revenue recognition process. That will affect everyone involved in the financial reporting process from educators and preparers to auditors and readers of the financial statements. Future teachers of intermediate accounting will face the daunting task of explaining how revenue is recognized upon satisfaction of an unrecorded performance obligation and how the concepts in the ED relate to the illustrations.
The FASB and the IASB have proposed a new model for revenue recognition. The ED states that an entity will recognize revenue when it satisfies a performance obligation by transferring a promised good or service to a customer, which in turn occurs when the customer obtains control of the good or service.

We argue that the ED contains a complete specification of a revenue recognition principle based on an asset/liability approach: that revenue is recognized on satisfaction/derecognition of a performance obligation. However, with the addition of a provision that defines satisfaction of the performance obligation as occurring when a customer obtains control of a good or service, the principle is transformed into one that is more consistent with the revenue/expense approach. Recognition of revenue when the customer obtains control of a good or service is an incomplete description of when or how a performance obligation could be satisfied, whether under an asset/liability approach or a revenue/expense approach. Therefore, as we noted in our comment letter on the ED, a control-based model for services may be challenging to apply.

A model that focuses on derecognition of the performance obligation may prove to be more understandable to both preparers and readers of the financial statements. We suggest that the specification of derecognition needs to consider temporary transfers of control and other means of satisfying a performance obligation besides transferring a good or an implied service asset. The final guidance should be consistent with other GAAP, such as the criteria in ASC 405-20 and the guidance on lease accounting.

Further, we argue that the understandability of the ED could be improved by explicit consideration of executory contracts. A model based on an asset/liability approach to revenue recognition that does not effectively recognize the related assets and liabilities will be harder to understand because significant accounting events, including the identification and measurement of contract assets and performance obligations, are occurring outside the boundaries of the double-entry bookkeeping system. We believe that explicit consideration and illustrations of the executory contract assets and liabilities would make the model more understandable and should be considered.

The issue of executory contracts extends beyond revenue recognition. Certainly the accounting for purchases could ultimately be informed by the same model. Examination of the underlying issues may also help resolve some of the complicated aspects of lease accounting and the accounting for insurance contracts. We support an objective of developing a consistent, understandable principles-based approach to executory contracts that provides readers of financial statements with relevant information.
About the authors

**John Hepp**
John Hepp is a partner in the National Professional Standards Group. Hepp started his professional career in the National Office at Grant Thornton LLP focusing on accounting and auditing issues, including computer-assisted auditing and statistical sampling applications. Hepp spent several years working overseas in Europe, Asia and Africa on accounting and auditing policy matters and professional regulation, including curriculum development and continuing education design. His current role includes monitoring of accounting developments under both U.S. GAAP and IFRS. He provides consultative services to Grant Thornton LLP and its clients on U.S. GAAP and IFRS-related issues. He is based in Chicago.

Hepp is a CPA (Illinois) and a CMA and has a Ph.D. from the University of Wisconsin—Madison. He is a member of the AICPA, Institute of Management Accountants, American Association of Accountants (AAA), International Association for Accounting Education and Research and the Illinois CPA Society. Hepp serves as a director of the Illinois CPA Society and is a member of the Professional Standards Committee (chair from 2007 through 2009). He also serves on the Pre-certification Education Committee of the AICPA. Hepp is a member of the Financial Accounting and Reporting Section and the International Accounting Sections of AAA.

Hepp was previously a project manager at the FASB and an assistant professor at Suffolk University in Boston. He is currently an adjunct professor at DePaul University in Chicago.

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