CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

ASPE Briefing: Additional Guidance Added to Section 3400, *Revenue*

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Introduction

In 2015, the Accounting Standards Board (AcSB) consulted with its stakeholders about its relative priorities for Part II of the *CPA Canada Handbook – Accounting* (*Handbook*) (Accounting Standards for Private Enterprises (ASPE)). Stakeholders applying Section 3400, *Revenue* of ASPE identified revenue as an area of concern. Specifically, they noted a lack of guidance pertaining to certain complex revenue topics resulting in the need to refer to guidance in the superseded pre-changeover standards in Part V of the *Handbook*, such as the Emerging Issues Committee (EIC) abstracts; and guidance in other jurisdictions, such as the revenue guidance in International Financial Reporting Standards (IFRS®) or United States Generally Accepted Accounting Principles (U.S. GAAP). With the revenue standards changing in IFRS and U.S. GAAP to include principles inconsistent with ASPE, stakeholders would no longer be able to refer to those standards in applying Section 3400.

In order to better understand stakeholders' concerns, the AcSB conducted a survey targeting stakeholders applying Section 3400. In May 2019, an Exposure Draft was issued proposing an appendix be added to Section 3400 containing additional guidance on the complex revenue topics for which the majority of respondents expressed concern; in December 2019, Section 3400 was amended to include this guidance.

The amendments to Section 3400 provide criteria clarifying how to identify the unit of account in a revenue transaction and additional guidance on the following revenue topics:

- percentage of completion method
- multiple-element arrangements
- reporting revenue gross or net
- bill and hold arrangements
- up-front non-refundable fees or payments (Additional Guidance)

The amendments seek to clarify the principles that were, and still are, contained in Section 3400, since the amendments were largely made through the addition of an appendix (rather than changes to the body of the standard).

This *CPA Canada Briefing* (*Briefing*) summarizes the Additional Guidance and provides illustrative examples of its application. The *Briefing* first covers the Additional Guidance on identifying the unit of account in a revenue transaction because this applies to all types of revenue arrangements. The *Briefing* then discusses the Additional Guidance dealing with the five aforementioned complex revenue topics. Finally, the *Briefing* goes through several illustrative examples to demonstrate how the Additional Guidance might be applied in practice and provides sample accounting policy notes and financial statement note disclosures.

This *Briefing* does not summarize the accounting in Section 3400 which was not amended or clarified as a result of the Additional Guidance. Users should refer to Section 3400 in its entirety for such guidance.

The amendments to Section 3400 are effective for fiscal years beginning on or after January 1, 2022, with earlier application permitted.

Identifying the Unit of Account

Identifying the unit of account for a revenue transaction involves determining whether to segment or combine revenue contracts, as well as determining whether a single contract or a group of combined contracts contains one or more deliverables. **Decision Tree 1** in this *Briefing* can be used to identify the unit of account for all revenue arrangements. In addition, **Decision Tree 2** in this *Briefing* can be used to help determine the revenue recognition guidance to be applied to each unit of account within a revenue arrangement.

Why is it important to determine the unit of account for a revenue arrangement?

An important first step in applying the recognition criteria in Section 3400 is to determine the unit of account for a revenue transaction. Although the recognition criteria in Section 3400 are usually applied separately to each revenue transaction, 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. In other circumstances, 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. In addition, a single contract or group of contracts may include more than one deliverable. In those circumstances, it may be necessary to segment the contract into the separate deliverables.

KEY CONCEPT

It is important to determine whether a revenue transaction consists of a group of contracts or a single contract, and whether such contracts include more than one deliverable, in order to ensure the recognition criteria in Section 3400 are applied appropriately to the revenue transaction. It is the substance of the revenue transaction, not its form, that determines the appropriate revenue recognition criteria to be applied in the circumstances.

When should a group of contracts be treated as a single contract for the purpose of revenue recognition?

As described above, it may be necessary to combine a group of contracts to reflect the substance of the transaction and apply the revenue recognition criteria appropriately. 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.

ILLUSTRATIVE EXAMPLE 1

MNM Limited (the Company) is based in Ontario, Canada and installs heating, ventilation and air conditioning (HVAC) systems in various types of buildings. The Company has entered into contracts with two general contractors to install HVAC systems in two office towers in Manitoba, the first time it will install HVAC systems outside of Ontario. Each general contractor is controlled by the same parent company. Since installation of the HVAC systems will require the Company's labour force to travel to Manitoba and also require certain equipment owned by the Company and used in the installation process to be shipped to Manitoba, the Company has decided to install the HVAC systems in the second building immediately after the first to minimize the time its labour force and equipment are outside of Ontario.

The Company normally prices each contract to earn a 10% gross profit margin. It estimates it will cost approximately $6 million to install the HVAC system in the first building and $4.5 million for the second. Bidding for the first building was quite competitive; to secure the contract, the Company quoted a price of $6.1 million. However, because the bidding for the second building was less competitive, the Company quoted a price of $5.5 million to achieve an overall profit margin of approximately 10% on the two projects.

In determining how to recognize revenue, the Company must first determine whether the two contracts should be treated separately or be combined and treated as a single contract (i.e., the Company must determine the unit of account for the revenue arrangements).

Despite the contracts being with two different customers, it appears they were negotiated as a package in the same economic environment and with an overall profit margin objective. The combined pricing was meant to achieve an overall profit margin of approximately 10%. Both general contractors are controlled by the same parent company so therefore the contracts constitute in essence an agreement to do a single arrangement with a single customer.[1] As this is the first time the Company will install HVAC systems outside Ontario and will need to transport a portion of its labour force and equipment to Manitoba, the contracts are likely so closely interrelated they are, in effect, part of a single arrangement. Finally, the installation of the HVAC systems in each building will be performed in a continuous sequence. Based on this analysis, these two contracts likely meet the criteria to be treated as a single contract for the purpose of revenue recognition to reflect the substance of the transaction.

Combining the two contracts will result in an overall gross profit margin of approximately 10% over the combined term. If the gross profit of the contracts were not combined, a gross profit of 1.64%[2] would be recognized from the first contract and 18.18%[3] from the second contract. This illustrates how accounting for the contracts separately does not reflect the substance of the transaction, which is to install two HVAC systems in Manitoba and earn an overall gross profit of 10%. If the two contracts are combined for the purpose of revenue recognition, the Company will need to determine whether each HVAC system represents a separate deliverable in the combined contract and, if so, how to allocate the arrangement consideration to each of the deliverables (as described later in this *Briefing*).

When do deliverables in a revenue contract represent separate units of account?

A single contract or group of contracts that meet the criteria for combining into a single contract (as described above) may include several deliverables. As an enterprise transfers these deliverables to the customer, performance may occur at different times or over different periods, and the customer's payments for such deliverables may be fixed, variable or a combination thereof.

1 Although both customers are related parties in this example, the customers in each of the contracts need not be related parties in order for this criterion to be met.

2 The gross profit percentage is calculated as ($6,100,000 – $6,000,000) ÷ $6,100,000.

3 The gross profit percentage is calculated as ($5,500,000 – $4,500,000) ÷ $5,500,000.

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 deliverable(s) should be considered a separate unit of account if both of 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.[4]

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 (described later in this *Briefing*) and the recognition of revenue should then be determined for those combined deliverable(s) as a single unit of account.

KEY CONCEPT

An enterprise evaluates all deliverables in a revenue arrangement at its inception to determine whether they represent separate units of account. The revenue recognition criteria in Section 3400 are then applied separately to each unit of account determined to exist in the arrangement.

Multiple-Element Arrangements

In addition to providing criteria to enable an enterprise to determine whether a single revenue contract or a group of revenue contracts contains multiple deliverables, the Additional Guidance also provides two potential methods for allocating the arrangement consideration to each deliverable in an arrangement.

When is the arrangement consideration allocated to the deliverables in a revenue arrangement?

Arrangement consideration is allocated to all deliverables in a revenue arrangement only at inception of the arrangement. This allocation is not reassessed as each item in the arrangement is delivered.

4 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).

ILLUSTRATIVE EXAMPLE 2

Alberta Telecommunications (the Company) is a provider of cell phones and wireless services in Calgary, Alberta. Customers enter into three-year contracts to receive wireless services and a new cell phone with no general right of return. The Company also allows a customer to use a pre-existing cell phone for which it will provide wireless services at a lower monthly rate. A customer may also purchase a cell phone without entering into a contract for wireless services. At the inception of each contract, the Company must determine whether the revenue arrangement contains multiple deliverables. If so, the contract consideration must be allocated to the deliverables in the arrangement so that the revenue recognition criteria in Section 3400 can be applied to each deliverable separately.

In this case, the cell phone (i.e., the hardware component) and the wireless services (i.e., the service component) are likely separate deliverables. The contract does not contain a general right of return for the deliverables. The deliverables have value to the customer on a stand-alone basis in that each deliverable (i.e., the cell phone and the wireless services) is sold separately. Therefore, the Company must allocate the contract consideration to each deliverable in the arrangement (as described later in this *Briefing*).

ILLUSTRATIVE EXAMPLE 3

General Information Technology Services Inc. (the Company) is an information technology (IT) company in Victoria, British Columbia. The Company offers a wide range of IT services including transaction processing, development and implementation of system software, IT support, system training, warranty and upgrade services and various hardware components. The Company frequently enters into contracts that contain many of these services and products in a single contract. For each contract, the Company must therefore determine whether the revenue arrangement contains one or more deliverables so that the revenue recognition guidance in Section 3400 can be appropriately applied to each deliverable.

Whether delivery or performance of the remaining deliverable(s) is considered probable and substantially in the control of the vendor when the arrangement includes a general right of return is a question of fact depending on the terms of each contract. However, judgment must be applied when determining whether the deliverables have value to the customer on a stand-alone basis.

For example, if a contract includes the development and implementation of a highly customized enterprise resource planning (ERP) system, including post-implementation upgrades and support, each deliverable (i.e., development of the ERP system, implementation of the ERP system, upgrades to the ERP system and support services) likely does not have value to the customer on a stand-alone basis since the ERP system is highly customized. It would thus be difficult to obtain the deliverables from the Company or another vendor without the ERP system itself. Accordingly, the Company may conclude there is only one deliverable. This would result in the revenue recognition criteria in Section 3400 being applied to the arrangement as a whole, likely resulting in revenue being recognized using the percentage of completion method.

This contrasts with a contract for similar goods and services, where the underlying software is off-the-shelf and contains no customization. In this case, the customer may be able to purchase one or more of these services separately from the Company or another vendor, indicating that they do have value to the customer on a stand-alone basis. Therefore, the Company may conclude the contract has multiple deliverables which must be separated for the purpose of applying the revenue recognition criteria in Section 3400.

How is the arrangement consideration allocated to the deliverables in a revenue arrangement?

The arrangement consideration is allocated to all deliverables in a revenue arrangement on a relative stand-alone selling price basis. The objective when allocating the consideration is to allocate it to each deliverable in an amount that reflects the consideration the enterprise expects to be entitled to in exchange for the deliverables.

The stand-alone selling price is the price at which an enterprise would sell a 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.

ILLUSTRATIVE EXAMPLE 4

Continuing from Illustrative Example 2 (above), Alberta Telecommunications (the Company) enters into a contract with a customer to provide a cell phone and wireless services over three years. The customer pays $100 per month and the risks and rewards of ownership of the cell phone transfer to the customer at inception of the non-cancellable contract. The cell phone and wireless services are separate deliverables. Accordingly, the arrangement consideration must be allocated to each deliverable in the contract.

The cell phone included in the contract is normally sold by the Company for $1,200. In addition, the Company offers identical wireless services for $70 per month or $2,520 over the three-year term if a customer uses an existing phone. The total arrangement consideration of $3,600 ($100/month x 36 months) must be allocated to the two deliverables. As stand-alone selling prices for each deliverable exist, the arrangement consideration is allocated on the basis of relative stand-alone selling prices such that $1,161 ($3,600 x ($1,200 ÷ $3,720[5])) is allocated to the cell phone and the remaining $2,439 ($3,600 x ($2,520 ÷ $3,720)) is allocated to the wireless services. Since the risks and rewards of cell phone ownership transfer immediately to the customer, the arrangement consideration allocated to the cell phone would be immediately recognized as revenue while the arrangement consideration allocated to the wireless services would be recognized as revenue over the term of the contract.

ILLUSTRATIVE EXAMPLE 5

Continuing from Illustrative Example 4 (above), assume that in month six of the contract, Alberta Telecommunications (the Company) and the customer agree to reduce the length of the contract to two years with all other terms remaining the same. If this had been the length of the contract at inception, $1,000 of the arrangement consideration ($2,400 x ($1,200 ÷ $2,880[6])) would have been allocated to the cell phone and the remaining $1,400 ($2,400 x ($1,680 ÷ $2,880)) would have been allocated to the wireless services (or $58 per month). However, as noted above, the allocation of the arrangement consideration to the deliverables is not reassessed as each item in the arrangement is delivered. Accordingly, since the

5 This amount is calculated as the stand-alone selling price of the cell phone of $1,200 plus the total price of the wireless services over the 36-month term of the contract of $2,520 ($70/month x 36 months).

6 This amount is calculated as the stand-alone selling price of the cell phone of $1,200 plus the total price of the wireless services over the 24-month term of the contract of $1,680 ($70/month x 24 months).

reduction in revenue associated with the contract modification occurred part way through the contract and after the cell phone was delivered, it would not impact the amount of revenue recognized for the cell phone. Instead, the remaining arrangement consideration under the contract at the time of its modification of $832[7] is allocated over the remaining 18 months of the contract, and revenue of $46 is recognized per month.

What happens if a stand-alone selling price is not directly observable?

If a stand-alone selling price for one or more deliverables in an arrangement is not directly observable, an enterprise estimates the stand-alone selling price at an amount that would result in an allocation of the transaction price that meets the allocation objective (described above). 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. In doing so, an enterprise may use observable inputs and apply estimation methods consistently in similar circumstances.

The Additional Guidance provides two examples of methods that could be used to estimate the stand-alone selling price of a good or service, including the:

(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; and

(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.

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, and the requirements for estimating stand-alone selling prices (described above).

7 This amount is calculated as the total revenue under the revised contract of $2,400 ($100/month x 24 months) less the amount recognized for the cell phone of $1,161 and the amounts recognized in the first six months of the contract for the wireless services of $407 (($2,439 ÷ 36 months) x 6 months).

ILLUSTRATIVE EXAMPLE 6

Continuing from Illustrative Example 3 (above), General Information Technology Services Inc. (the Company) contracts with Customer A to implement an off-the-shelf ERP system and provide IT support for a period of three years after implementation for total consideration of $1,150,000. Since the ERP system is not highly customized, the Company concludes the customer could obtain the IT support services from a different vendor such that the implementation of the ERP system and the post-implementation support are separate deliverables. Because the Company does not offer the specific ERP system and the post-implementation services separately, no company-specific stand-alone selling price exists for each deliverable. As a result, the Company must estimate the stand-alone selling price of each deliverable in order to allocate the arrangement consideration.

If the Company chooses to use the adjusted market approach, it may obtain stand-alone selling prices for similar ERP systems and post-implementation services from its competitors. It may use such stand-alone selling prices, adjusted as necessary to reflect the Company's costs and margins, in estimating the stand-alone selling prices for the purpose of allocating the arrangement consideration. Alternatively, if the Company chooses to use the expected cost plus a margin approach, it needs to determine its cost of providing each deliverable and add an appropriate margin for the good or service based on the margin normally obtained on similar goods and services.

In estimating the stand-alone selling price of the post-implementation support, the Company has determined that the most appropriate estimation method is the adjusted market approach. The Company has obtained the price lists of a few competitors and determined the average selling price of similar post-implementation services is $25,000 per month or $900,000 over the three-year term of the contract. In estimating the stand-alone selling price of the ERP system, the Company has determined the most appropriate estimation method is the expected cost plus a margin approach. If the Company sells a similar off-the-shelf ERP system for $275,000 on a stand-alone basis, and the cost to the Company of the similar ERP system is $247,500, then an appropriate margin to add to the cost of the ERP system in the contract with Customer A might be 10%.[8] If the cost to the Company of the ERP system in the contract with Customer A is $297,000, then the stand-alone

8 The gross profit percentage is calculated as ($275,000 – $247,500) ÷ $275,000.

selling price of the ERP system for the purpose of allocating the arrangement consideration in the contract with Customer A is estimated to be $330,000 ($297,000 ÷ (100% – 10%)).

Based on an estimated stand-alone selling price of the post-implementation services of $900,000 and an estimated stand-alone selling price of the ERP system of $330,000 (above), $841,463 ($1,150,000 x ($900,000 ÷ $1,230,000[9])) of the total arrangement consideration is allocated to the post-implementation services and the remaining $308,537 ($1,150,000 x ($330,000 ÷ $1,230,000)) is allocated to the ERP system.

KEY CONCEPT

In a revenue arrangement with multiple deliverables, the arrangement consideration is allocated to each deliverable on a relative stand-alone selling price basis at the inception of the arrangement. The stand-alone selling price is the price at which the enterprise would sell a promised good or service separately to a customer, which can be determined through actual transactions if the enterprise sells each of the promised goods or services separately, or it can be estimated using observable inputs and estimation techniques.

Percentage of Completion Method

What is the percentage of completion method?

The percentage of completion method of accounting recognizes revenue proportionately with the degree of completion of goods or services under a contract. 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 continually evaluate the uncertainties inherent in the performance of contracts.

When is the percentage of completion method used to recognize revenue versus the completed contract method?

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.

9 This amount is calculated as the sum of the stand-alone selling price of the post-implementation services of $900,000 and the stand-alone selling price of the ERP system of $330,000.

The use of the percentage of completion method versus the completed contract method is not an accounting policy choice. 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. The completed contract method is only appropriate in two circumstances:

1. when performance consists of the execution of a single act or
2. when the enterprise cannot reasonably estimate the extent of progress toward completion

In all other cases, revenue from the rendering of services and long-term contracts is required to be recognized using the percentage of completion method.

The completed contract method excludes the recognition of revenue and expenses before a contract is completed or substantially completed even if work has been done and costs have been incurred. The true performance of the enterprise cannot, therefore, be assessed for any period prior to completion of the contract.

ILLUSTRATIVE EXAMPLE 7

In Year 1, a highly successful construction foreman decides to start his own construction company in order to take advantage of a lucrative long-term building contract currently out for tender. The foreman establishes Big Three Construction Inc. (the Company) to bid on a contract to construct a commercial building in Halifax, Nova Scotia. Before the end of Year 1, the Company wins the contract and begins construction.

The Company has determined the most appropriate measure of progress toward completion of the contract is contract costs. However, due to the urgency with which construction began, the Company was unable to track its progress. Given this is the Company's first year of operations and its first contract, management is unable to reasonably determine an estimate of the total costs to complete the building; measuring the degree of completion based on the ratio of costs incurred to total estimated costs is therefore not possible. Accordingly, because the Company has concluded it cannot reasonably estimate the progress toward completion, recognizing revenue using the completed contract method is appropriate.

In the bidding process, the Company estimated the total cost would be $10 million and quoted a price of $11 million. At the end of Year 1, the Company had incurred $2 million in construction costs and billed $3 million. As the Company is using the completed contract method to recognize revenue, the following journal entries are recognized in Year 1:

Description	Debit	Credit
Construction in progress	$ 2,000,000	
Accounts payable		$ 2,000,000
To recognize the contract costs incurred during the year		
Accounts receivable	$ 3,000,000	
Progress billings		$ 3,000,000
To recognize progress billings during the year		

NOTE

The illustration of the accounting for revenue using the completed contract method is continued in Illustrative Example 10 (below) of this *Briefing*.

KEY CONCEPT

A common misconception is that an enterprise can make an accounting policy choice to use either the percentage of completion method or the completed contract method for the purpose of recognizing revenue from the rendering of services and long-term contracts. However, this is not correct. The percentage of completion method must be used to account for revenue from service transactions and long-term contracts except, in rare circumstances, when performance consists of the execution of a single act or when the enterprise cannot reasonably estimate the extent of progress toward completion. The use of the percentage of completion method versus the completed contract method is not an accounting policy choice.

How does an enterprise determine the percentage of completion?

Under the percentage of completion method, revenue is recognized based on the amount of work completed. The method of measuring the amount of work completed may be determined in a variety of ways and depends on the nature of the contract. These methods can be grouped into input and output measures. The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances.

Input measures include methods based on costs and efforts expended. Input measures indirectly measure the degree of completion based on an established or assumed relationship between a unit of input and productivity. Output measures directly measure results achieved.

KEY CONCEPT

Under the percentage of completion method, the degree of completion is measured based on either input measures, which measure the degree of completion indirectly, or output measures, which measure the degree of completion directly.

Refer to the Comprehensive Example at the end of this *Briefing* for illustrative examples on determining the degree of completion for long-term contracts accounted for using the percentage of completion method employing input measures.

How does an enterprise using input measures determine the percentage of completion to measure the degree of completion?

An enterprise using input measures to determine the percentage of completion would measure the degree of completion based on efforts expended or the ratio of costs incurred to total estimated costs.

The efforts expended method is an input method based on a measure of the work (e.g., labour hours, labour dollars, machine hours or material quantities) directly related to the efforts expended by the enterprise in fulfilling the contract. The various forms of the efforts expended method are generally based on the assumption that profits on contracts are derived from the enterprise's efforts in all phases of operations (e.g., designing, procurement and management). Under such methods, profit is not assumed to accrue merely because of the acquisition of material or other tangible items used in the performance of the contract or the awarding of subcontracts as might be the case if the degree of completion were measured based on the ratio of costs incurred to total estimated costs, for example. Efforts must actually be expended in performing work for revenue to be recognized and profit accrued. A significant drawback of efforts expended methods is that the efforts included in the measure may not all be productive.

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. Costs that do not reflect work performed to date should be excluded from costs incurred for the purpose of measuring the degree of completion. Examples of such costs are:

(a) 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

(b) payments made to a subcontractor not determined in accordance with the degree of completion of the work accomplished by that subcontractor.

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.

As an exception to the general principle that only those costs that reflect the work performed be included in the costs incurred to date, an enterprise may make an accounting policy choice that includes the cost of uninstalled materials delivered at the job site in the costs used to measure the degree of completion. To the extent such an accounting policy is material to the users of the financial statements, it should be disclosed in the enterprise's significant accounting policies. An enterprise's decision whether to include the cost of uninstalled materials that have been delivered at the job site in the costs used to measure the degree of completion should be based on whether their inclusion faithfully represents the enterprise's degree of performance under the contract.

How does an enterprise use output measures to determine the percentage of completion?

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 by units of work completed. In other circumstances, the degree of completion may be measured, for example, by cubic metres of excavation for foundation contracts or by cubic metres of pavement laid for highway contracts.

ILLUSTRATIVE EXAMPLE 8

Champion Bridges Ltd. (the Company) enters into a $140 million contract to build a bridge between the mainland and Manitoulin Island in Ontario to reduce traffic on the Little Current Swing Bridge. The bridge will be 400 metres long and take three years to construct. 100 metres were constructed in Year 1, 150 metres in Year 2 and the remaining 150 metres in Year 3. If the Company decides the most appropriate measure of the degree of completion is based on the ratio of the length of the bridge constructed to date as a proportion of the total length of the bridge, the degree of completion would be calculated as 25% at the end of Year 1 (100 metres ÷ 400 metres), 62.5% at the end of Year 2 (250 metres ÷ 400 metres) and 100% at the end of Year 3 (400 metres ÷ 400 metres). The degree of completion at the end of each year would then be used to determine income for the period computed under the percentage of completion method.

How is income earned for a period computed under the percentage of completion method?

Total estimated gross profit on a contract, the difference between total estimated contract revenue and total estimated contract cost, must be calculated to determine the income earned on the contract. Total gross profit earned to date is determined by the measurement of the degree of completion of the contract. The computation of income earned for the

period involves determination of the portion of total estimated contract revenue earned to date (earned revenue) and the portion of total estimated contract cost related to that revenue (cost of earned revenue).

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

Alternative A calculates earned revenue and cost of earned revenue directly; gross profit is calculated as the difference between these two amounts. 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 this amount over the earned revenue recognized in prior periods is the earned revenue 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 this amount over the cost of earned revenue recognized in prior periods is the cost of earned revenue recognized in the income statement for the current period.
- Gross profit on a contract for a period is the excess of earned revenue over the cost of earned revenue for the period.

Alternative B

Using Alternative B, earned revenue is calculated indirectly by calculating the gross profit earned during the period and adding that amount to the cost of earned revenue to arrive at earned revenue. Earned revenue, cost of earned revenue and gross profit are determined as follows:

- Earned revenue is the amount of gross profit earned for the period plus the cost of earned revenue.
- Cost of earned revenue is the cost incurred during the period, excluding costs incurred for subcontracted work still to be performed.
- Gross profit earned is computed by multiplying total estimated gross profit by the percentage of completion as determined by one of the acceptable methods of measuring the degree of completion. The excess of that amount over the amount of gross profit reported in prior periods is the earned gross profit recognized in the income statement for the current period.

KEY CONCEPT

The first step in determining income earned in the period under the percentage of completion method is to calculate the degree of completion. The degree of completion is then used to compute the amount of earned revenue either:

- directly by multiplying the contract revenue by the percentage of completion and subtracting earned revenue recognized in prior periods or
- indirectly by multiplying the estimated gross profit on the contract by the percentage of completion, subtracting the amount of gross profit recognized in prior periods and adding the cost of earned revenue for the period

If the amount of earned revenue is calculated directly, the cost of revenue earned is calculated by multiplying total estimated costs by the percentage of completion and subtracting the cost of earned revenue recognized in prior periods. If the amount of earned revenue is calculated indirectly, the cost of earned revenue is the actual costs incurred during the period, excluding subcontracted work still to be performed.

Refer to the Comprehensive Example at the end of the *Briefing* for illustrative examples on determining income earned for a period computed under the percentage of completion method.

How are revisions in estimates as work progresses accounted for?

Due to the nature of long-term contracts, adjustments to the original estimates of the total contract revenue, contract cost, profit estimates and/or the percentage of completion are often required as work progresses even though the scope of the work required may not change. The nature of accounting for contracts is such that refinements of the estimates for changing conditions and new developments are continuous and characteristic of the process. Revisions in revenue, cost, and profit estimates and/or revisions in measurements of the percentage of completion are changes in accounting estimates as defined in Section 1506, *Accounting Changes* in Part II of the *Handbook*. Accordingly, such revisions are accounted for prospectively, not retrospectively.

Refer to the Comprehensive Example at the end of the *Briefing* for illustrative examples on the accounting for revisions in estimates as work progresses on a long-term contract accounted for using the percentage of completion method.

ILLUSTRATIVE EXAMPLE 9

Continuing from Illustrative Example 7 (above), during Year 2 in an effort to better understand progress toward completion of its contracts, Big Three Construction Inc. (the Company) implemented a time management system to track labour hours worked on each contract. After implementing the system, management can estimate

that it will take approximately 400,000 labour hours to complete construction of the commercial building in Halifax. Approximately 80,000 labour hours were incurred in Year 1 and 160,000 in Year 2. Accordingly, at the end of Year 2, management can now reasonably estimate the extent of progress toward completion of the contract such that the use of the completed contract method for revenue recognition is no longer appropriate.

The degree of completion at the end of Year 2 based on labour hours incurred is 60% (240,000 labour hours worked ÷ 400,000 total estimated labour hours). Using Alternative A to compute income earned for the period, the amount of cumulative earned revenue as at the end of Year 2 is $6.6 million ($11,000,000 x 60%), and the cumulative cost of earned revenue as at the end of Year 2 is $6 million ($10,000,000 x 60%), resulting in cumulative gross profit of $600,000. In addition, the Company incurred $4 million in construction costs during Year 2 and billed the customer $3 million.

The Company's ability to estimate progress at the end of Year 2 (and the resulting requirement to use the percentage of completion method) is due to new information and developments and represents a change in accounting estimate (not the correction of an error). In accordance with the guidance included in Section 1506, a change in accounting estimate is accounted for prospectively. The following journal entries are recognized by the Company in Year 2:

Description	Debit	Credit
Construction in progress	$ 4,000,000	
Accounts payable		$ 4,000,000
To recognize contract costs incurred during the year		
Accounts receivable	$ 3,000,000	
Progress billings		$ 3,000,000
To recognize progress billings during the year		
Progress billings	$ 6,600,000	
Earned revenue		$ 6,600,000
To recognize earned revenue for the period based on the degree of completion		
Cost of earned revenue	$ 6,000,000	
Construction in progress		$ 6,000,000
To recognize cost of earned revenue for the period based on the degree of completion		

NOTE

Since application of the percentage of completion method to recognize revenue is accounted for as a change in estimate, the cumulative earned revenue and cost of earned revenue at the end of Year 2 is recognized entirely in Year 2 rather than by restating earned revenue and cost of earned revenue recognized in Year 1 ($2.2 million and $2 million respectively based on 20% completion calculated as 80,000 labour hours incurred ÷ 400,000 total labour hours) and then recognizing only the revenue earned based on progress made on the contract in Year 2 (earned revenue of $4.4 million and cost of earned revenue of $4 million based on 60% completion at the end of Year 2 less 20% completion at the end of Year 1).

What costs are included in contract costs?

When measuring the percentage of completion by calculating the ratio of costs incurred to total estimated costs, it is very important to include only appropriate costs in any percentage of completion calculations. Incorrect inclusion or exclusion of costs can result in an inappropriate amount of earned revenue, cost of earned revenue and gross profit being recognized in a particular period.

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.

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 not included in contract revenue (e.g., income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract). An enterprise makes an accounting policy choice as to whether to include such incidental income as a reduction of contract costs or elsewhere in the income statement.

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 payroll for personnel working on the contract.

Costs 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.

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.

Can costs incurred in securing a contract be capitalized prior to the contract being secured?

Costs that relate directly to a contract and incurred to secure the contract can be included as part of the contract costs if they can be separately identified and measured reliably, and it is probable the contract will be obtained. Costs incurred in securing a contract must be costs that would not have been otherwise incurred had the enterprise not secured the contract (e.g., a sales commission). Costs that would have been incurred regardless of whether the contract had been secured or not are not eligible for capitalization (e.g., allocation of fixed overhead costs). When costs incurred in securing a contract are recognized as an expense in the period incurred, they are not included in contract costs if/when the contract is obtained in a subsequent period.

KEY CONCEPT

The Additional Guidance includes specific examples of costs that may be included and costs that should be excluded from contract costs. The overall objective is to include only those incremental costs of fulfilling the contract as contract costs so as to accurately determine the amount of earned revenue, cost of revenue and gross profit using the percentage of completion method.

ILLUSTRATIVE EXAMPLE 10

North Construction Company (the Company), a general contractor in Churchill, Manitoba has entered into a contract with a customer to construct a highway in Churchill. The Company has determined the most appropriate measure of the degree of completion under the contract is the ratio of costs incurred to total estimated costs. At the end of Year 1, the Company has incurred the following costs to construct the highway:

- labour costs of the Company's workforce directly involved in the construction of the highway
- labour costs of supervisors working on the highway and other projects
- labour costs of administrative personnel at the Company's head office
- material costs for materials consumed during the period in construction
- material costs for materials purchased but not consumed during the period in construction, some of which had been delivered to the job site by the end of Year 1 and some not
- amortization of the Company's equipment, some of which is used solely in the construction of the highway and some on other projects
- incidental income from the sale of surplus materials purchased for a portion of the highway
- other general and administration costs for which reimbursement is specified in the contract

In determining costs incurred and estimated costs, the Company must determine which of the above costs should be included in the contract costs. As a general rule, contract costs include only those costs that relate directly to the specific contract, attributable to contract activity in general and can be allocated to the specific contract, and such other costs as are specifically chargeable to the customer under the terms of the contract.

The labour costs of the Company's workforce directly involved in the construction of the highway should be included in contract costs since such costs relate directly to the specific contract. However, the labour costs of supervisors who do not work solely on the construction of the highway must be allocated to each project the supervisors work on by using systematic and rational methods applied consistently to all costs having similar characteristics. The allocation is based on the normal level of activity. In this case, the allocation might be based on the ratio of labour hours spent on a particular project to the total labour hours a supervisor worked in the period. Finally, whether labour costs of administrative personnel at the Company's head office can be included in contract costs depends on the nature of the administrative services performed and whether they are directly attributable to contract activity. If such costs are considered overhead in nature (e.g., the preparation and processing of payroll for personnel working on the contract), an allocation of such costs to contract costs may be appropriate.

The cost of materials consumed during the period in the construction of the highway are included in contract costs as they relate directly to the contract. The cost of materials purchased during the period but not consumed are excluded from contract costs because, although they represent a cost that relates directly to the contract, they relate to future activity and will represent contract activity in the period in which the materials are consumed. The exception to this, however, would be for the cost of materials purchased for the contract that were not consumed during the period, but delivered to the job site. The Company must make an accounting policy choice as to whether to include or exclude such costs from contract costs.

Amortization of equipment used in the construction of the highway is a cost that relates directly to the contract. Similar to the discussion on labour costs (above), if a particular piece of equipment was purchased for, and used solely in, the construction of the highway, the entire amount of amortization recognized in the period on that piece of equipment is recognized in contract costs. If, however, a particular piece of equipment was used on multiple projects during the period, the related amortization recognized in the period is allocated to the highway contract costs using systematic and rational methods applied consistently to all costs having similar characteristics. In this case, an allocation based on machine hours, for example, is a reasonable basis for allocating the amortization charge.

Contract costs may be reduced by any incidental income not included in contract revenue. Therefore, the Company may reduce contract costs by the amount of income earned from the sale of surplus materials purchased for construction of the highway. Alternatively, if the Company chooses not to reduce contract costs by incidental

income, the cost of the surplus materials, along with the income from selling them, are excluded from contract costs and therefore from the determination of the percentage of completion on the highway contract. In the calculation of the degree of completion, both the contract costs incurred in the period and estimated total costs of the contract are revised to exclude the surplus materials.

General and administrative costs not considered to be overhead are excluded from contract costs. However, if the terms of the contract allow the vendor to charge the customer for specific general and administrative expenses, such expenses are included in contract costs.

Refer to the Comprehensive Example at the end of the *Briefing* for illustrative examples on the impact of reducing contract costs by incidental income not included in contract revenue, and the impact of uninstalled materials, on determining the degree of completion for long-term contracts accounted for using the percentage of completion method.

What happens when it is probable that total contract costs will exceed total contract revenue?

When it is probable that total contract costs will exceed total contract revenue, the entire expected loss is recognized as an expense immediately. 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 the guidance described above in the *Briefing*).

KEY CONCEPT

Expected losses on contracts must be recognized immediately in the period if it is probable that they will occur regardless of the amount of work performed under the contract.

Refer to the Comprehensive Example at the end of this *Briefing* for illustrative examples on determining and recognizing expected losses on long-term contracts accounted for using the percentage of completion method.

What additional disclosure requirements were added to Section 3400 related to the percentage of completion method?

The Additional Guidance added specific disclosure requirements to Section 3400 for any contracts accounted for using the percentage of completion method to provide users of the financial statements with information regarding the significant estimates and assumptions involved in calculating income using this method. An enterprise is required to 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[10];

(d) The aggregate amount of holdbacks withheld[11]; and

(e) Uncertainties affecting the measurement of the degree of completion, in accordance with Section 1508, *Measurement Uncertainty* in Part II of the *Handbook*.

Sample Accounting Policy Note

(x) Revenue Recognition

Revenue from long-term contracts is recognized using the percentage of completion method as the contract activity is being performed. The Company measures the degree of completion based on the ratio of costs incurred to total estimated costs. Only those costs that reflect work performed are included in the costs incurred to date. However, the Company includes the cost of uninstalled materials delivered to the job site in the costs incurred used to measure the degree of completion.

Contract costs include costs that relate directly to the specific contract, costs that are attributable to contract activity in general and can be allocated to the contract, and such other costs that are specifically chargeable to the customer under the terms of the contract. The Company allocates the cost of equipment purchased for use on a contract over the period of its expected use unless title to the equipment is transferred to the customer by the terms of the contract. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a contract.

10 Advances are amounts received by a contractor before the related work is performed.

11 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.

Contract costs include costs attributable to a contract for the period from the date of securing the contract to final completion. However, costs that relate directly to a contract and 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 the contract will be obtained at the time the costs are incurred.

Earned revenue to date is computed by multiplying total estimated contract revenue by the percentage of completion. The excess of this amount over the earned revenue recognized in prior periods is the earned revenue recognized in the income statement for the current period. Cost of earned revenue to date is computed by multiplying total estimated contract costs by the percentage of completion of the contract. The excess of this amount over the cost of earned revenue recognized in prior periods is the cost of earned revenue recognized in the income statement for the current period.

When earned revenue exceeds progress billings, an asset called unbilled revenue[12] is recognized on the balance sheet for this excess. When progress billings exceed earned revenue, a liability called deferred revenue[13] is recognized on the balance sheet for this excess. Finally, when total costs incurred to date exceed the cost of revenue recognized to date, an asset called contracts receivable[14] is recognized on the balance sheet for this excess. When it is probable that total contract costs will exceed total contract revenue, the entire expected loss is recognized as an expense immediately.

Notes to the Financial Statements

X. Long-Term Contracts
As described in Note 2(x) to the financial statements, the Company recognizes revenue on long-term contracts using the percentage of completion method, with the degree of completion measured based on the ratio of costs incurred to total estimated costs. Application of this measure of the degree of completion requires management to estimate the costs required to complete each contract at the balance sheet date, the uncertainty inherent in which will not be resolved until each contract is completed. As at December 31, 20X1, the estimated cost to complete all contracts currently in progress is approximately $34,000,000 (20X0 - $29,000,000). It is reasonably possible that this amount could change by a material amount in the near term. This could result in a material change to the amount of earned revenue, cost of earned revenue and gross profit on some or all of the Company's long-term contracts recognized in future periods.

12 Alternatively, this asset may be called "costs and estimated earnings in excess of billings on uncompleted contracts."

13 Alternatively, this liability may be called "billings in excess of costs and estimated earnings on uncompleted contracts."

14 Alternatively, this asset may be called "work in progress" or "construction in progress."

The aggregate amount of costs incurred and recognized profits (less recognized losses) to date for contracts in progress as at December 31, 20X1, accounted for using the percentage of completion method is $67,000,000 (20X0 – $63,000,000). In addition, the following balances exist for such contracts in progress as at December 31, 20X1:

Holdbacks Witheld/Advances Received	20X1	20X0
Holdbacks withheld, included in accounts receivable	$ 6,000,000	$ 5,500,000
Advances received, included in deferred revenue	-	2,000,000

Reporting Revenue Gross or Net

With respect to reporting revenue on a gross or net basis, the guidance included in the body of Section 3400 remains unchanged as a result of the Additional Guidance. Instead, additional factors to consider when determining whether to recognize revenue on a gross or net basis were added as part of the new appendix to Section 3400 to help enterprises apply the guidance in the body of Section 3400.

Why is it relevant whether an enterprise reports revenue on a gross or a net basis?

By definition, 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. Revenue is a key performance indicator for many enterprises. Reporting amounts within revenue that are collected on behalf of third parties which do not meet the definition of revenue misrepresents the amount of revenue earned by the enterprise during the period.

In an agency relationship where an enterprise is acting as an agent, the gross inflows of economic benefits to the enterprise 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 (i.e., the net amount retained by the enterprise).

How do you determine whether an enterprise is acting as a principal or an agent?

Determining whether an enterprise should recognize revenue on a gross or a net basis depends on whether the enterprise is acting as a principal or an agent. If an enterprise is acting as a principal, revenue is recognized on a gross basis. If an enterprise is acting as an agent, revenue is recognized on a net basis. Professional judgment must be applied in order to assess whether an enterprise is acting as a principal or an agent in a revenue transaction, and this analysis can differ between revenue transactions, depending on the circumstances.

An enterprise is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or rendering of services. Features that indicate an enterprise is acting as a principal include, but are not limited to:

(a) The enterprise has the primary responsibility for providing the goods or services to the customer or for fulfilling the order (e.g., by being responsible for the acceptability of the products or services ordered or purchased by the customer);

(b) The enterprise has inventory risk before or after the customer order, during shipping or on return;

(c) The enterprise has latitude in establishing prices, either directly or indirectly (e.g., by providing additional goods or services); and

(d) The enterprise bears the customer's credit risk for the amount receivable from the customer.

One feature indicating 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.

What indicators should an enterprise consider when determining if revenue should be recognized on a gross basis?

In addition to the factors listed above, the Additional Guidance includes the following indicators, which may also be considered when determining 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.

What indicators should an enterprise consider when determining if revenue should be recognized on a net basis?

In addition to the indicators listed above, the Additional Guidance includes the following factors that indicate revenue should be recognized based on the net amount retained:

(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.

KEY CONCEPT

Revenue is a key performance indicator for most enterprises and therefore whether an enterprise recognizes revenue on a gross basis (as the principal in the transaction) or on a net basis (as the agent) has a significant impact on this key performance indicator. Section 3400 contains many factors and indicators for determining whether an enterprise is acting as a principal or an agent; however, professional judgment must be applied to conclude on the appropriate recognition.

ILLUSTRATIVE EXAMPLE 11

Short-Term Vacation Rentals Inc. (the Company) provides an online marketplace where customers can rent vacation properties on a short-term basis from owners of such properties. The Company charges each property owner a 15% commission on the booking fee (i.e., rental amount) paid by the customer. The Company collects a booking fee from the customer and remits the fee less its 15% commission to the owner after each vacation stay. Owners set their own daily rental rates and are responsible for providing the vacation property to the customer. Funds are collected from the customer at the time of booking.

In this case, revenue should likely be recognized on a net basis given that all three indicators are present by which revenue should be recognized based on the net amount retained. The supplier (i.e., the property owner) is the primary obligor in the arrangement as the owner is responsible for providing the property to the customer. The amount the Company earns is fixed at 15% of the amount paid by the customer. Finally, there is no credit risk as the rental fees are collected in full at the time of booking.

In addition, no indicators of gross reporting exist. The Company does not alter the vacation rental properties or perform part of the service, has no discretion in supplier selection (customers are able to select their own vacation property owners), does not determine the rental property specifications (i.e., the amenities) and bears no inventory risk. Based on the assessment above, the Company should likely recognize revenue on a net basis.

Bill and Hold Arrangements

What is a bill and hold arrangement?

The general performance criteria in paragraph 7 of Section 3400 indicate that, for the sale of goods, performance is regarded as achieved when persuasive evidence of an arrangement exists, delivery has occurred and the sellers' price to the buyer is fixed or determinable. However, in limited circumstances, performance may be regarded as achieved prior to delivery. An arrangement for the sale of goods that meets the performance criteria prior to delivery is called a bill and hold arrangement.

Some arrangements may appear to take the form of a bill and hold arrangement but are not. 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.

In some circumstances, a vendor may retain a form of title to goods delivered to customers until the customer makes payment so the vendor can recover the goods if the customer defaults on payment. Presuming all other revenue recognition criteria have been met, it is appropriate to recognize revenue at delivery if the only right a vendor retains with the title is that enabling recovery of the goods in the event of customer default and such rights cannot be maintained by other means.

When can revenue be recognized under a bill and hold arrangement?

The Additional Guidance specifies seven criteria that must all be met in order to recognize revenue in a bill and hold arrangement. The numerous criteria are meant to reflect the fact that revenue may be recognized only when delivery has not occurred in very specific and limited circumstances:

(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.

The Additional Guidance also includes the following factors, which 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 – If there has been a modification to such terms, the risks and rewards of ownership of the goods may not have transferred to the buyer;

(b) The seller's past experiences with and pattern of bill and hold transactions – If the seller has a longstanding history of bill and hold transactions, it is more likely that the seller has the proper systems and processes in place to ensure that the bill and hold criteria are appropriately met (e.g., processes for segregating inventory and obtaining a written request from the buyer to complete the transaction on a bill and hold basis, etc.) than if this is the seller's first bill and hold transaction;

(c) Whether the buyer has the expected risk of loss in the event of a decline in the market value of the goods – If the buyer has such risk, the risks and rewards of ownership of the goods may have transferred from the seller to the buyer;

(d) Whether the seller's custodial risks are insurable and insured – If such risks are insurable and insured, the risks and rewards of ownership of the goods may not have transferred from the seller to the buyer yet; 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) – If such exceptions exist, the risks and rewards of ownership of the goods may not have transferred from the seller to the buyer yet.

KEY CONCEPT

The general performance criteria in Section 3400 for the sale of goods require the goods be delivered to the customer in order for revenue to be recognized. However, in limited circumstances, the performance criteria for the sale of goods may be considered to be met prior to delivery if an enterprise is able to demonstrate it has met all seven criteria for the recognition of revenue from bill and hold arrangements included in Section 3400. If even one of the criteria is not met, revenue is deferred until the goods have been delivered.

ILLUSTRATIVE EXAMPLE 12

Custom Cabinets Inc. (the Company) manufactures custom kitchen cabinets for installation in homes and condominium units. The Company entered into a contract with a condominium construction company to sell 100 custom cabinets to the construction company for total consideration of $500,000 to be installed in a new condominium building in Richmond Hill, Ontario. The Company will only

manufacture the cabinets; installation will be performed by the construction company. Installation will occur throughout Years 1 and 2. However, the construction company has requested that all cabinets be complete by the end of Year 0 to ensure there are no delays in installation. The contract specifies ownership transfers to the construction company at that point. Due to the nature of the construction site, the construction company has requested the Company store the cabinets until required for installation. The Company will store the cabinets in an off-site warehouse as they are manufactured in order to allow for efficient delivery when required. At the end of Year 0, all 100 cabinets have been manufactured, packaged for shipment and stored in the Company's off-site warehouse. The Company must determine whether the revenue recognition criteria have been met and, therefore, whether revenue from manufacturing of the cabinets can be recognized in Year 0 or only when the cabinets are delivered.

In accordance with the guidance in paragraph 7 of Section 3400, assuming persuasive evidence of an arrangement exists, the seller's price to the buyer is fixed or determinable, and reasonable assurance exists regarding measurement of the consideration to be derived from the sale of the goods and the extent to which the goods may be returned, revenue can normally only be recognized when delivery has occurred. If delivery of the manufactured cabinets has not occurred as of the end of Year 0, normally, revenue cannot be recognized. However, the Company must determine whether the seven criteria for a bill and hold arrangement have been met. If so, revenue could be recognized at the end of Year 0:

- The risks of ownership must have passed to the buyer: Because the contract specifies ownership of the cabinets passes to the construction company at the end Year 0, this criterion is met.
- The customer must have made a fixed commitment to purchase the goods: The contract between the Company and the construction company for purchase of the cabinets demonstrates a fixed commitment to purchase the goods. Therefore, this criterion is met.
- The buyer, not the seller, must request the transaction be on a bill and hold basis, and the buyer must have a substantial business purpose for ordering the goods on this basis: The construction company has requested the cabinets be manufactured and held by the Company (i.e., that the transaction be on a bill and hold basis), as the construction company does not have the necessary facilities to store the cabinets (i.e., a substantial business purpose exists for the Company to hold the cabinets). Therefore, this criterion is met.

- 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): The contract stipulates the cabinets be delivered throughout Year 1 and 2 as they are needed for installation. This stipulation is consistent with the construction company's business purpose for the cabinets. Therefore, this criterion is met.
- The seller must not have retained any specific performance obligations such that the earning process cannot be completed: The cabinets have been fully manufactured and prepared for shipment by the end of Year 0 and, accordingly, no specific performance obligations need to be completed before the earning process is complete. Therefore, this criterion is met.
- The ordered goods must have been segregated from the seller's inventory and not be available to fill other orders: The cabinets are being held in an off-site warehouse and are ready for shipment to the construction company. In addition, the cabinets are customized to the unique specifications of the construction company. As a result, they cannot be used to fill other orders. Therefore, this criterion is met.
- The product must be complete and ready for shipment: The cabinets are complete and ready for shipment at the end of Year 0. Therefore, this criterion is met.

Based on the analysis above, the criteria for recognizing revenue prior to delivery under a bill and hold arrangement have been met and, therefore, the Company can recognize revenue for manufacturing all 100 cabinets during Year 0 rather than as the cabinets are delivered. It is important to note all seven criteria (above) were met in order to recognize revenue prior to delivery. If, for example, the cabinets were not customized, and were instead standard cabinets the Company kept in inventory, and the contract specified the Company have 100 such cabinets in stock at the end of Year 0, this arrangement would likely not meet the bill and hold criteria since the cabinets could be used to fulfil other orders and would not be segregated from the Company's inventory. Accordingly, this arrangement would fail the criterion listed in (f) above.

Sample Accounting Policy Note

(x) Revenue Recognition
The Company recognizes revenue from the sale of products when persuasive evidence of an arrangement exists, delivery of the products has occurred, the selling price is fixed or determinable and ultimate collection is reasonably assured.

If certain criteria are met, however, the Company recognizes revenue prior to the delivery of products when they are sold in a bill and hold arrangement. All of the following criteria must be met in order for the Company to recognize revenue in a bill and hold arrangement:

- The risks of ownership have passed to the buyer.
- The customer has made a fixed commitment to purchase the goods.
- The customer, not the Company, requested the transaction be on a bill and hold basis, and the customer has a substantial business purpose for ordering the goods on this basis.
- The schedule for delivery of the goods is reasonable and consistent with the customer's business purpose.
- The Company has not retained any specific performance obligations such that the earning process is not complete.
- The ordered goods have been segregated from the Company's inventory and are not subject to being used to fill other orders.
- The product is complete and ready for shipment.

If all seven criteria are not met prior to delivery, revenue is deferred and only recognized when the Company has delivered the goods to the customer.

Upfront Non-Refundable Arrangements

What are upfront non-refundable fees or payments?

Enterprises may negotiate arrangements in which they receive upfront non-refundable fees or payments upon entering into the arrangements or on certain specified dates. The fees may be received by the seller for a licence 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. The key is that the fees or payments are non-refundable and are received in advance of the enterprise's achievement of performance under the contract.

Can an enterprise recognize revenue from upfront non-refundable fees or payments?

Recognition of revenue from non-refundable upfront fees or payments is deferred unless the upfront fee is in exchange for products delivered or services performed that have utility to the buyer separate and independent of the enterprise's performance of the other

elements of the arrangement. In many 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, which is the basis for the deferral of revenue recognition.

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. 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 in which the fees are earned.

KEY CONCEPT

Upfront non-refundable fees or payments in a revenue arrangement are deferred and recognized systematically over the periods during which the products and/or services are delivered and/or performed, unless the upfront fees or payments are in exchange for products delivered or services performed that have utility to the buyer separate and independent of the enterprise's performance of the other elements of the arrangement.

ILLUSTRATIVE EXAMPLE 13

Best Images Inc. (the Company) sells licences to copyrighted images to customers for unlimited exclusive use for a specified period. Under the contract, a customer pays an upfront, non-refundable fee and receives the image. Contracts are typically for two years and contain no other performance obligations. In this case, despite the fact the contract is for two years, revenue can likely be recognized immediately since the customer has immediate access to the image and the Company has no other performance obligations (i.e., the image has utility to the customer separately and independent of the Company's performance of the other elements of the arrangement as there are no other elements).

ILLUSTRATIVE EXAMPLE 14

Gentle Greens Gold Club (the Club) operates an exclusive golf and country club in Muskoka, Ontario. The Club offers lifetime memberships to the public that require an upfront non-refundable, non-transferable initiation fee of $50,000, plus an annual fee required to be paid each year. The amount of the annual fee is determined at the beginning of each fiscal year of the Club.

The initiation fee is paid by each member for future access to the Club's facilities. The initiation fee, therefore, has no utility to a member that is separate and independent of the Club's performance of the other elements of the arrangement (i.e., use of the Club's facilities). In the absence of the Club's continuing involvement under the arrangement, a member would not have paid the initiation fees. As a result, the initiation fees cannot be recognized as revenue immediately and must therefore be deferred and recognized as revenue systematically over the period during which the fees are earned, which is the estimated time period over which a particular member will remain a member of the Club.

Revenue is recognized in this manner despite the fact that the member is required to pay annual fees, in addition to the initiation fee, to use the Club's facilities. This is because the upfront fee is wholly an advance payment for future services. The ongoing rights or services being provided are essential to the member receiving the expected benefit of the upfront payment. The upfront fee and the continuing performance obligation related to the services to be provided are assessed as an integrated package for the purpose of revenue recognition.

Transition

When does an enterprise have to apply the Additional Guidance?

The Additional Guidance is applicable to annual financial statements relating to fiscal years beginning on or after January 1, 2022. Except as specified below, an enterprise is required to apply the Additional Guidance retrospectively. Earlier application is permitted.

Has transitional relief been provided for the Additional Guidance?

Transitional provisions have been provided for the Additional Guidance related to identifying units of account, multiple-element arrangements and the percentage of completion method, as well as the new disclosure requirements for the percentage of completion method. An enterprise may choose to apply the Additional Guidance related to these topics either:

(a) At the beginning of the earliest period presented (as at January 1, 2021 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date), 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 (as at January 1, 2022 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date), recording the cumulative effect of applying the amendments in opening retained earnings of the fiscal year in which the amendments are first applied.

In addition, when the Additional Guidance related to the percentage of completion method is 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 (during the year ended December 31, 2021 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date); or

(b) The fiscal year in which the amendments are first applied (during the year ended December 31, 2022 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date).

Finally, when the Additional Guidance related to multiple-element arrangements is 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 (during the year ended December 31, 2021 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date); or

(b) The fiscal year in which the amendments are first applied (during the year ended December 31, 2022 for an enterprise with a calendar year-end if the Additional Guidance is applied on the effective date).

What disclosures are required in the period in which the Additional Guidance is first applied?

Paragraph 34 of Section 1506, *Accounting Changes* in Part II of the *Handbook* specifies that when initial application of a primary source of generally accepted accounting principles (GAAP) (such as the Additional Guidance) has an effect on the current period or any prior period or would have such an effect except that it is impracticable to determine the amount of the adjustment, certain disclosures are required. Such disclosures include:

(a) The title of the primary source of GAAP;

(b) When applicable, that the change in accounting policy is made in accordance with its transitional provisions;

(c) The nature of the change in accounting policy;

(d) When applicable, a description of the transitional provisions;

(e) For each prior period presented, to the extent practicable, the amount of the adjustment for each financial statement line item affected;

(f) The amount of the adjustment relating to periods before those presented, to the extent practicable; and

(g) If retrospective application required by (a) – (c) above is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Sample Transition Note Disclosure

X. Change in Accounting Policy
On January 1, 2022, the Company adopted the amendments to Section 3400, *Revenue* of Part II of the *CPA Canada Handbook – Accounting,* Canadian Accounting Standards for Private Enterprises (ASPE) pertaining to its long-term contracts accounted for using the percentage of completion method. The amendments contain explicit guidance on categories of contract costs to be included and excluded from the costs incurred to date in measuring the degree of completion on long-term contracts accounted for using the percentage of completion method based on the ratio of costs incurred to total estimated costs.

The Company applied the amendments retrospectively except that, in accordance with the transitional provisions of the amendments, the Company has not made retrospective adjustments for contracts accounted for using the percentage of completion method that were completed during the years ended December 31, 2021 or December 31, 2022. The impact of the adoption of the amendments as at and for the year ended December 31, 2022 is as follows:

Financial Statement Line Item	Previously Reported Amount	Adjustment	Restated Amount
Balance Sheet			
Contracts receivabe	$ 4,000,000	$ 100,000	$ 4,100,000
Unbilled revenue	1,500,000	120,000	1,620,000
Deferred revenue	6,000,000	200,000	6,200,000
Income Statement			
Earned revenue	45,000,000	(30,000)	44,970,000
Cost of earned revenue	43,000,000	(100,000)	42,900,000
Gross profit	2,000,000	70,000	2,070,000
Statement of Retained Earnings			
Retained earnings – beginning of year	5,500,000	(50,000)	5,450,000
Retained earnings – end of year	6,200,000	20,000	6,220,000

Consequential Amendments

Were there any consequential amendments to the *Handbook* as a result of the Additional Guidance?

The only consequential amendments were to Section 1500, *First-Time Adoption* in Part II of the *Handbook* to add an optional exemption for an enterprise adopting ASPE for the first time to apply the transitional provisions added to Section 3400 as a result of the Additional Guidance. A similar optional exemption was added to Section 1501, *First-Time Adoption by Not-for-Profit Organizations* in Part III of the *Handbook*.

Application to Not-for-Profit Organizations

How does the Additional Guidance impact not-for-profit organizations?

Paragraph 1 of Section 4410, *Contributions – Revenue Recognition,* in Part III of the *Handbook* states that a not-for-profit organization applies Section 3400 for guidance on the recognition of revenue arising from the sales of services or goods. Accordingly, the Additional Guidance is applicable to not-for-profit organizations to the extent the organization earns revenue from the sales of services or goods (i.e., revenue that is not a contribution).

Potential Assurance Impacts

The Additional Guidance may impact auditors and practitioners conducting audit and review engagements, respectively. The reason for this is that the Additional Guidance may impact the amount and timing of revenue recognition and revenue is one of the most important and material financial statement line items for many enterprises. In addition, significant accounting estimates may be impacted by the Additional Guidance, such as those required to measure the degree of completion in accounting for revenue using the percentage of completion method and in allocating the arrangement consideration to multiple deliverables in a single contract or group of contracts accounted for as a single contract. It is the significant estimates used in the determination of revenue combined with the focus of many financial statement users on the amount of revenue earned in a period that result in the assurance impacts described below.

How will the Additional Guidance impact audit engagements?

Paragraph 27 of Canadian Auditing Standard 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (CAS 240) in the *CPA Canada Handbook – Assurance* indicates:

> when identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 48 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud.

Due to the nature of some of the estimates involved in applying the Additional Guidance to revenue arrangements, as well as some of the judgments involved in applying the Additional Guidance (e.g., determining whether the criteria to recognize revenue under a bill and hold arrangement have been met), there may be more opportunities to commit fraud in revenue recognition for entities impacted by the Additional Guidance. Accordingly, it may be more difficult to rebut the presumed risk of material misstatement due to fraud in revenue recognition described in CAS 240. As a result, this risk may be deemed a significant risk for the purposes of the audit. In accordance with paragraph 21 of Canadian Auditing Standard 330, *The Auditor's Responses to Assessed Risks:*

> if the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

In addition, Canadian Auditing Standard 540, *Auditing Accounting Estimates and Related Disclosures* (CAS 540) in the *CPA Canada Handbook – Assurance* provides specific requirements for auditors to follow in auditing accounting estimates. The overall requirement described in paragraph 9 is for:

> the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

To do so, the auditor must assess the risks of material misstatement related to the accounting estimates made by management and perform adequate procedures to be able to obtain sufficient appropriate audit evidence that the estimates made by management are reasonable and that the financial statements are not materially misstated. Auditors must therefore be aware of the impact of the Additional Guidance on the estimates made by their clients when performing the audit.

How will the Additional Guidance impact review engagements?

Paragraph 46 of Canadian Standard on Review Engagements 2400, *Engagements to Review Historical Financial Statements* (CSRE 2400) in the *CPA Canada Handbook – Assurance* indicates:

> in obtaining sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, the practitioner shall design and perform inquiry and analytical procedures: (a) to address all material items in the financial statements, including disclosures; and (b) to focus on addressing areas in the financial statements where material misstatements are likely to arise.

In addition, paragraph 47(a) of CSRE 2400 indicates:

> the practitioner's inquiries of management and others within the entity, as appropriate, shall include the following: (a) how management makes the significant accounting estimates required under the applicable financial reporting framework.

Finally, paragraph 77(d)(iv) of CSRE 2400 indicates:

> to form the conclusion required by paragraph 76, the practitioner shall determine whether limited assurance has been obtained that the financial statements as a whole are free from material misstatement. In making this determination, the practitioner shall evaluate whether, in the context of the requirements of the applicable financial reporting framework and the results of procedures performed, accounting estimates made by management appear reasonable.

As noted above, the Additional Guidance may impact accounting estimates made by management. Further, as evident from the excerpts from CSRE 2400, there is a focus on inquiry and analytical procedures by the practitioner in a review engagement on significant estimates made by management. Accordingly, practitioners will need to understand how the Additional Guidance may impact estimates made by their clients in the recognition of revenue.

Additional Resources

- Section 3400, *Revenue* – Background Information and Basis for Conclusions
- CAS 540, *Auditing Accounting Estimates and Related Disclosures:* Frequently Asked Questions
- Revised CAS 540: Guidance Resources

Contact

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Comprehensive Example

Applying the Percentage of Completion Method

Purpose

This comprehensive example illustrates the calculation of the degree of completion on a long-term contract accounted for under the percentage of completion method using two different inputs:

1. ratio of costs incurred to total estimated costs
2. ratio of labour hours performed to date to estimated total labour hours at completion

The computation of income earned for the period under the percentage of completion method is also illustrated using both Alternative A and Alternative B (as described earlier in this *Briefing*). In addition, the comprehensive example illustrates the journal entries arising from the aforementioned computations of income, as well as the resulting income statement and balance sheet account presentations.

Under Scenario A, the degree of completion is calculated based on the ratio of costs incurred to total estimated costs. Income earned for the period is computed using Alternative A (as described earlier in this *Briefing*). Under Scenario B, the degree of completion is also calculated based on the ratio of costs incurred to total estimated costs. However, income earned for the period is computed using Alternative B (as described earlier in this *Briefing*). Under Scenario C, the degree of completion is calculated based on the ratio of labour hours performed to date to estimated total labour hours. Income earned for the period is computed using Alternative A (as described earlier in this *Briefing*). Finally, under Scenario D, the degree of completion is also calculated based on the ratio of labour hours performed to date to estimated total labour hours. However, income earned for the period is computed using Alternative B (as described earlier in this *Briefing*).

Background for the comprehensive example

Major Leagues Sports and Entertainment (MLSE), a professional sports and commercial real estate company, decided to invest in a brand new, state-of-the art basketball arena and entertainment complex. ERFF Construction Limited (the Company) is engaged to construct the new arena, as well as an adjacent hotel that will be available to the public, for total consideration of $600 million. Construction is estimated to take approximately four years and cost a total of $534,250,000. The Company has determined it is able to reasonably estimate its progress toward completion; performance does not consist of execution of a single act. Accordingly, use of the percentage of completion method for the purpose of revenue recognition is appropriate. The information necessary for determining the degree of completion will be provided in each scenario of the comprehensive example.

Identifying the units of account

As described above, the contract between the Company and MLSE includes the construction of a basketball arena and an adjacent hotel. Before the percentage of completion method can be applied to revenue recognition, a determination must be made as to whether the basketball arena and the hotel represent separate deliverables in a single contract. In this case, it is unlikely the contract includes a general right of return, the hotel and basketball arena are likely to have value to the customer on a stand-alone basis since the services to construct each asset can be procured separately from the Company or another similar vendor and each asset can be used separately. Accordingly, the basketball arena and hotel represent separate deliverables in a single contract.

Allocation of revenue to multiple elements

Since the arrangement has been determined to contain multiple elements, the contract revenue of $600 million must be allocated to each deliverable (i.e., the basketball arena and the hotel) in the contract. Based on its internal cost models, the Company has determined that, had it been engaged separately to construct either the hotel or the basketball arena, the stand-alone selling price of the basketball arena would have been $580,650,000 and the stand-alone selling price of the hotel would have been $49,350,000. Accordingly, based on contract revenue of $600 million, $553 million is allocated to the basketball arena ($600,000,000 x ($580,650,000 ÷ ($580,650,000 + $49,350,000))) and $47 million is allocated to the hotel ($600,000,000 x ($49,350,000 ÷ ($580,650,000 + $49,350,000))). The comprehensive example will demonstrate the accounting implications of the construction of the basketball arena only.

Revisions to revenue

During Year 2, to account for cost overruns, the Company negotiated an increase in contract revenue specifically pertaining to the construction of the basketball arena of $67 million. There were no other revisions to contract revenue.

Progress billings

Under the terms of the original contract, the Company is able to bill MLSE $216,998,192 during Year 1, $68,354,430 during Year 2, $184,448,463 during Year 3 and $130,198,915 during Year 4. Using the allocation percentage calculated above of 92.167%,[15] the progress billings pertaining to the basketball arena are therefore $200 million during Year 1, $63 million during Year 2, $170 million during Year 3 and $120 million during Year 4. In addition, the Company was able to bill the entire $67 million increase in contract revenue (described above) during Year 2. Finally, under the terms of the contract, the customer is not required to pay 10% of all progress billings until one year after completion of the contract (i.e., there is a 10% holdback by the customer).

15 This percentage is calculated as the stand-alone selling price of the basketball arena of $580,650,000 divided by the sum of the stand-alone selling prices of the basketball arena and the hotel ($580,650,000 and $49,350,000, respectively).

Contract costs

At inception of the contract, management estimates total costs to complete the arena will be $492.4 million. The revised estimated total costs to complete the arena are $492.4 million at the end of Year 1, $552.4 million at the end of Year 2 and $622.4 million at the end of Year 3 and Year 4. Total contract revenue at the end of Year 3 is $620 million compared to estimated total contract costs of $622.4 million. It is probable that total contract costs will exceed total contract revenue at the end of Year 3. Accordingly, the entire expected loss of $2.4 million is recognized as an expense in the period.

Scenario A

Under Scenario A, the degree of completion is calculated based on the ratio of costs incurred to total estimated costs and income earned for the period is computed using Alternative A.

Contract costs

Contract costs incurred consist of $125,789,360 during Year 1, $185,531,920 during Year 2, $130,325,440 during Year 3 and $178,753,280 during Year 4. Included in contract costs incurred during Year 1 are $5 million of uninstalled materials purchased during Year 1 that were not delivered to the job site at year end. In addition, costs of $3 million[16] were incurred during Year 0 that related to securing the contract. Finally, surplus materials were sold during Year 2 for a gain of $1 million.

Calculation of the degree of completion

The calculation of the degree of completion for each year of the contract is included in the schedule below:

Calculation of the Degree of Completion		Year 0	Year 1	Year 2	Year 3	Year 4
Prior period costs incurred related to contract		$ –	$ 3,000,000	$ 128,789,360	$ 313,321,280	$ 443,646,720
Current period costs incurred related to contract		3,000,000	125,789,360	185,531,920	130,325,440	178,753,280
Incidental income		–	–	(1,000,000)	–	–
Cumulative costs incurred related to contract		3,000,000	128,789,360	313,321,280	443,646,720	622,400,000
Less: Current period costs incurred related to future activity		(3,000,000)	(5,000,000)	–	–	–
Cumulative costs incurred related to activity during the period	A	$ –	$ 123,789,360	$ 313,321,280	$ 443,646,720	$ 622,400,000

16 These costs relate directly to the contract, were incurred in securing the contract and can be separately identified and measured reliably. At the time they were incurred, it was probable that the contract would be obtained.

Calculation of the Degree of Completion		Year 0	Year 1	Year 2	Year 3	Year 4
Prior period estimated total costs		$ –	$ 492,400,000	$ 492,400,000	$ 552,400,000	$ 622,400,000
Revisions to estimated costs during the period		–	–	60,000,000	70,000,000	–
Current period estimated total costs	B	$ –	$ 492,400,000	$ 552,400,000	$ 622,400,000	$ 622,400,000
Degree of completion	C = A / B	0.00%	25.14%	56.72%	71.28%	100.00%

Calculation of earned revenue

The calculation of earned revenue for each year of the contract is included in the schedule below:

Calculation of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Prior period contract revenue		$ 553,000,000	$ 553,000,000	$ 620,000,000	$ 620,000,000
Revisions during the period		–	67,000,000	–	–
Current period contract revenue		$ 553,000,000	$ 620,000,000	$ 620,000,000	$ 620,000,000
Current period contract revenue	D	$ 553,000,000	$ 620,000,000	$ 620,000,000	$ 620,000,000
Degree of completion	C	25.14%	56.72%	71.28%	100.00%
Cumulative earned revenue	E = D x C	139,024,200	351,664,000	441,936,000	620,000,000
Earned revenue recognized in previous periods		–	(139,024,200)	(351,664,000)	(441,246,720)
Current period earned revenue before adjustment		139,024,200	212,639,800	90,272,000	178,753,280
Adjustment for expected loss on contract	H	–	–	(689,280)	–
Current period earned revenue		$ 139,024,200	$ 212,639,800	$ 89,582,720	$ 178,753,280
Calculation of revenue adjustment for Year 3					
Cumulative earned revenue at the end of Year 2 (calculated above)				$ 351,664,000	
Cumulative cost of earned revenue at the end of Year 2 (calculated below)				313,321,280	
Cumulative gross profit recognized at the end of Year 2				38,342,720	
Expected loss on contract				(2,400,000)	

Calculation of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Required gross profit for Year 3	F			$ (40,742,720)	
Earned revenue based on degree of completion (calculated above)				$ 90,272,000	
Cost of earned revenue based on degree of completion (calculated below)				130,325,440	
Gross profit based on degree of completion	G			$ (40,053,440)	
Adjustment required for computation of Year 3 earned revenue*	H = F – G			$ (689,280)	

*This computation determines the required adjustment to Year 3 earned revenue due to the expected loss on the contract. Total earned revenue in Year 3 is $89,582,720. Refer to the journal entries below for the full income statement impacts of the contract in Year 3.

Calculation of the cost of earned revenue

The calculation of the cost of earned revenue for each year of the contract is included in the schedule below:

Calculation of the Cost of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period estimated total contract costs	B	$ 492,400,000	$ 552,400,000	$ 622,400,000	$ 622,400,000
Degree of completion	C	25.14%	56.72%	71.28%	100.00%
Cumulative cost of earned revenue	I = B x C	123,789,360	313,321,280	443,646,720	622,400,000
Cost of earned revenue recognized in previous periods		–	(123,789,360)	(313,321,280)	(443,646,720)
Current period cost of earned revenue		$ 123,789,360	$ 189,531,920	$ 130,325,440	$ 178,753,280

Journal entries

Year 0	Debit	Credit
Contracts receivable	$ 3,000,000	
Accounts payable		$ 3,000,000
To recognize costs incurred in securing the contract		

Year 1	Debit	Credit
Contracts receivable	$ 125,789,360	
Accounts payable		$ 125,789,360
To recognize costs incurred during the period		
Accounts receivable	$ 180,000,000	
Holdbacks receivable	$ 20,000,000[17]	
Progress billings		$ 200,00,000
To recognize progress billings during the period		
Progress billings	$ 139,024,200	
Earned revenue		$ 139,024,200
To recognize earned revenue during the period		
Cost of earned revenue	$ 123,789,360	
Contracts receivable		$ 123,789,360
To recognize cost of earned revenue during the period		

Year 2	Debit	Credit
Contracts receivable	$ 184,531,920	
Proceeds receivable from sale of surplus materials	$ 1,000,000	
Accounts payable		$ 185,531,920
To recognize costs incurred during the period and income earned on sale of surplus materials		
Accounts receivable	$ 117,000,000	
Holdbacks receivable	$ 13,000,000	
Progress billings		$ 130,000,000
To recognize progress billings during the period		
Progress billings	$ 212,639,800	
Earned revenue		$ 212,639,800
To recognize earned revenue during the period		
Cost of earned revenue	$ 189,531,920	
Contracts receivable		$ 189,531,920
To recognize cost of earned revenue during the period		

17 10% of the amount billed to the customer has been separately presented on the balance sheet within holdbacks receivable.

Year 3	Debit	Credit
Contracts receivable	$ 130,325,440	
Accounts payable		$ 130,325,440
To recognize costs incurred during the period		
Accounts receivable	$ 153,000,000	
Holdbacks receivable	$ 17,000,000	
Progress billings		$ 170,000,000
To recognize progress billings during the period		
Progress billings	$ 89,582,720	
Earned revenue		$ 89,582,720
To recognize earned revenue during the period		
Cost of earned revenue	$ 130,325,440	
Contracts receivable		$ 130,325,440
To recognize cost of earned revenue during the period		

Year 4	Debit	Credit
Contracts receivable	$ 178,753,280	
Accounts payable		$ 178,753,280
To recognize costs incurred during the period		
Accounts receivable	$ 108,000,000	
Holdbacks receivable	$ 12,000,000	
Progress billings		$ 120,000,000
To recognize progress billings during the period		
Progress billings	$ 178,753,280	
Earned revenue		$ 178,753,280
To recognize earned revenue during the period		
Cost of earned revenue	$ 178,753,280	
Contracts receivable		$ 178,753,280
To recognize cost of earned revenue during the period		

Balance sheet and income statement presentation

Excerpts from the balance sheet and income statement of the Company at the end of each year are as follows:

Financial Statement Line Item	Year 0	Year 1	Year 2	Year 3	Year 4
Income Statement					
Earned revenue	$ –	$ 139,024,200	$ 212,639,800	$ 89,582,720	$ 178,753,280
Cost of earned revenue	–	123,789,360	189,531,920	130,325,440	178,753,280
Gross profit	$ –	$ 15,234,840	$ 23,107,880	$ (40,742,720)	$ –
Balance Sheet					
Total costs to date	$ 3,000,000	$ 128,789,360	$ 313,321,280	$ 443,646,720	$ 622,400,000
Cost of earned revenue recognized to date	–	123,789,360	313,321,280	443,646,720	622,400,000
Contracts receivable	$ 3,000,000	$ 5,000,000	$ –	$ –	$ –
Earned revenue	$ –	$ 139,024,200	$ 351,664,000	$ 441,246,720	$ 620,000,000
Progress billings	–	200,000,000	330,000,000	500,000,000	620,000,000
Unbilled revenue (deferred revenue)	$ –	$(60,975,800)	$ 21,664,000	$(58,753,280)	$ –

Scenario B

Under Scenario B, the degree of completion is calculated based on the ratio of costs incurred to total estimated costs; however, income earned for the period is computed using Alternative B. Contract costs are the same as described above in Scenario A. The only difference between Scenario A and Scenario B is the method by which current period earned revenue is calculated. As will be demonstrated by the calculations below, the amount of earned revenue for the period is the same as in Scenario A. Accordingly, calculation of the degree of completion, cost of earned revenue, journal entries and balance sheet and income statement excerpts are not provided as they would be identical to Scenario A.

Calculation of earned revenue

The calculation of earned revenue for each year of the contract is included in the schedule below:

Calculation of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period contract revenue		$ 553,000,000	$ 620,000,000	$ 620,000,000	$ 620,000,000
Current period estimated total contract costs		492,400,000	552,400,000	622,400,000	622,400,000
Estimated gross profit on the contract	J	60,600,000	67,600,000	(2,400,000)	(2,400,000)
Degree of completion	C	25.14%	56.72%	71.28%	100.00%
Cumulative gross profit before adjustment	K = J x C	15,234,840	38,342,720	(1,710,720)	(2,400,000)
Adjustment for expected loss on contract	L	–	–	(689,280)	–
Cumulative gross profit		15,234,840	38,342,720	(2,400,000)	(2,400,000)
Gross profit earned in prior periods		–	(15,234,840)	(38,342,720)	2,400,000
Gross profit earned during the period		15,234,840	23,107,880	(40,742,720)	–
Current period cost of earned revenue		123,789,360	189,531,920	130,325,440	178,753,280
Current period earned revenue		$ 139,024,200	$ 212,639,800	$ 89,582,720	$ 178,753,280
Calculation of revenue adjustment for Year 3					
Expected loss on contract				$ (2,400,000)	
Calculated cumulative gross profit based on degree of completion				(1,710,720)	
Adjustment required for computation of Year 3 earned revenue*			L	$ (689,280)	

* This computation determines the required adjustment to Year 3 earned revenue due to the expected loss on the contract. Total earned revenue in Year 3 is $89,582,720.

Scenario C

Under Scenario C, the degree of completion is calculated based on the ratio of labour hours performed to date to estimated total labour hours at completion; income earned for the period is computed using Alternative A. Contract costs are the same as described above in Scenario A.

Labour hour data and calculation of the degree of completion

The labour hour data required to calculate the degree of completion is based on the ratio of labour hours performed to date to estimated total labour hours at completion. The calculation of the degree of completion for each year of the contract is included in the schedule below:

Calculation of the Degree of Completion		Year 1	Year 2	Year 3	Year 4
Prior period labour hours incurred		–	23,000,000	55,000,000	73,000,000
Labour hours incurred during the period		23,000,000	32,000,000	18,000,000	32,520,000
Cumulative labour hours incurred	A	23,000,000	55,000,000	73,000,000	105,520,000
Prior period estimated total labour hours at completion		91,520,000	91,520,000	97,520,000	103,520,000
Revisions during the period		–	6,000,000	6,000,000	2,000,000
Current period estimated total labour hours at completion	B	91,520,000	97,520,000	103,520,000	105,520,000
Degree of completion	C = A / B	25.13%	56.40%	70.52%	100.00%

Calculation of earned revenue

The calculation of earned revenue for each year of the contract is included in the schedule below:

Calculation of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period contract revenue	D	$ 553,000,000	$ 620,000,000	$ 620,000,000	$ 620,000,000
Degree of completion	C	25.13%	56.40%	70.52%	100.00%
Cumulative earned revenue	E = D x C	138,968,900	349,680,000	437,224,000	620,000,000
Earned revenue recognized in previous periods		–	(138,968,900)	(349,680,000)	(436,516,480)
Current period earned revenue before adjustment		138,968,900	210,711,100	87,544,000	183,483,520
Adjustment for expected loss on contract	H	–	–	(707,520)	–
Current period earned revenue		$ 138,968,900	$ 210,711,100	$ 86,836,480	$ 183,483,520

Calculation of Earned Revenue	Year 1	Year 2	Year 3	Year 4
Calculation of revenue adjustment for Year 3				
Cumulative earned revenue at the end of Year 2 (calculated above)			$ 349,680,000	
Cumulative cost of earned revenue at the end of Year 2 (calculated below)			311,553,600	
Cumulative gross profit recognized at the end of Year 2			38,126,400	
Expected loss on contract			(2,400,000)	
Required gross profit for Year 3		**F**	$ (40,526,400)	
Earned revenue based on degree of completion (calculated above)			$ 87,544,000	
Cost of earned revenue based on degree of completion (calculated below)			127,362,880	
Gross profit based on degree of completion		**G**	$ (39,818,880)	
Adjustment required for computation of Year 3 earned revenue*		**H = F – G**	$ (707,520)	

*This computation determines the required adjustment to Year 3 earned revenue due to the expected loss on the contract. Total earned revenue in Year 3 is $86,836,480. Refer to the journal entries below for the full income statement impacts of the contract in Year 3.

Calculation of the cost of earned revenue

The calculation of the cost of earned revenue for each year of the contract is included in the schedule below:

Calculation of the Cost of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period estimated total contract costs	**I**	$ 492,400,000	$ 552,400,000	$ 622,400,000	$ 622,400,000
Degree of completion	**C**	25.13%	56.40%	70.52%	100.00%
Cumulative cost of earned revenue	**J = I x C**	123,740,120	311,553,600	438,916,480	622,400,000
Cost of earned revenue recognized in previous periods		–	(123,740,120)	(311,553,600)	(438,916,480)
Current period cost of earned revenue		$ 123,740,120	$ 187,813,480	$ 127,362,880	$ 183,483,520

Journal entries

Year 0	Debit	Credit
Contracts receivable	$ 3,000,000	
Accounts payable		$ 3,000,000
To recognize costs incurred in securing the contract		

Year 1	Debit	Credit
Contracts receivable	$ 125,789,360	
Accounts payable		$ 125,789,360
To recognize costs incurred during the period		
Accounts receivable	$ 180,000,000	
Holdbacks receivable	$ 20,000,000	
Progress billings		$ 200,00,000
To recognize progress billings during the period		
Progress billings	$ 138,968,900	
Earned revenue		$ 138,968,900
To recognize earned revenue during the period		
Cost of earned revenue	$ 123,740,120	
Contracts receivable		$ 123,740,120
To recognize cost of earned revenue during the period		

Year 2	Debit	Credit
Contracts receivable	$ 184,531,920	
Proceeds receivable from sale of surplus materials	$ 1,000,000	
Accounts payable		$ 185,531,920
To recognize costs incurred during the period and income earned on sale of surplus materials		
Accounts receivable	$ 117,000,000	
Holdbacks receivable	$ 13,000,000	
Progress billings		$ 130,000,000
To recognize progress billings during the period		

Year 2	Debit	Credit
Progress billings	$ 210,711,100	
Earned revenue		$ 210,711,100
To recognize earned revenue during the period		
Cost of earned revenue	$ 187,813,480	
Contracts receivable		$ 187,813,480
To recognize cost of earned revenue during the period		

Year 3	Debit	Credit
Contracts receivable	$ 130,325,440	
Accounts payable		$ 130,325,440
To recognize costs incurred during the period		
Accounts receivable	$ 153,000,000	
Holdbacks receivable	$ 17,000,000	
Progress billings		$ 170,000,000
To recognize progress billings during the period		
Progress billings	$ 86,836,480	
Earned revenue		$ 86,836,480
To recognize earned revenue during the period		
Cost of earned revenue	$ 127,362,880	
Contracts receivable		$ 127,362,880
To recognize cost of earned revenue during the period		

Year 4	Debit	Credit
Contracts receivable	$ 178,753,280	
Accounts payable		$ 178,753,280
To recognize costs incurred during the period		
Accounts receivable	$ 108,000,000	
Holdbacks receivable	$ 12,000,000	
Progress billings		$ 120,000,000
To recognize progress billings during the period		

Year 4	Debit	Credit
Progress billings	$ 183,483,520	
Earned revenue		$ 183,483,520
To recognize earned revenue during the period		
Cost of earned revenue	$ 183,483,520	
Contracts receivable		$ 183,483,520
To recognize cost of earned revenue during the period		

Balance sheet and income statement presentation

Excerpts from the balance sheet and income statement of the Company at the end of each year are as follows:

Financial Statement Line Item	Year 0	Year 1	Year 2	Year 3	Year 4
Income Statement					
Earned revenue	$ –	$138,968,900	$ 210,711,100	$ 86,836,480	$ 183,483,520
Cost of earned revenue	–	123,740,120	187,813,480	127,362,880	183,483,520
Gross profit	$ –	$ 15,228,780	$ 22,897,620	$ (40,526,400)	$ –
Balance Sheet					
Total costs to date	$ 3,000,000	$ 128,789,360	$ 313,321,280	$ 443,646,720	$ 622,400,000
Cost of earned revenue recognized to date	–	123,740,120	311,553,600	438,916,480	622,400,000
Contracts receivable	$ 3,000,000	$ 5,049,240	$ 1,767,680	$ 4,730,240	$ –
Earned revenue	$ –	$138,968,900	$ 349,680,000	$ 436,516,480	$ 620,000,000
Progress billings	–	200,000,000	330,000,000	500,000,000	620,000,000
Unbilled revenue (deferred revenue)	$ –	$(61,031,100)	$ 19,680,000	$ (63,483,520)	$ –

Scenario D

Under Scenario D, the degree of completion is calculated based on the ratio of labour hours performed to date to estimated total labour hours at completion. Income earned for the period is computed using Alternative B. The only difference between Scenario C and Scenario D is the method by which current period earned revenue is calculated. All labour hour data and, as will be demonstrated by the calculations below, amount of earned revenue and cost of earned revenue for the period are the same as in Scenario C. Accordingly, calculation of the degree of completion, journal entries and balance sheet and income statement excerpts are not provided as they would be identical to Scenario C.

Calculation of the cost of earned revenue

The calculation of the cost of earned revenue for each year of the contract is included in the schedule below:

Calculation of the Cost of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period estimated total contract costs	I	$ 492,400,000	$ 552,400,000	$ 622,400,000	$ 622,400,000
Degree of completion	C	25.13%	56.40%	70.52%	100.00%
Cumulative cost of earned revenue	J = I x C	123,740,120	311,553,600	438,916,480	622,400,000
Cost of earned revenue recognized in previous periods		–	(123,740,120)	(311,553,600)	(438,916,480)
Current period cost of earned revenue		$ 123,740,120	$ 187,813,480	$ 127,362,880	$ 183,483,520

Calculation of earned revenue

The calculation of earned revenue for each year of the contract is included in the schedule below:

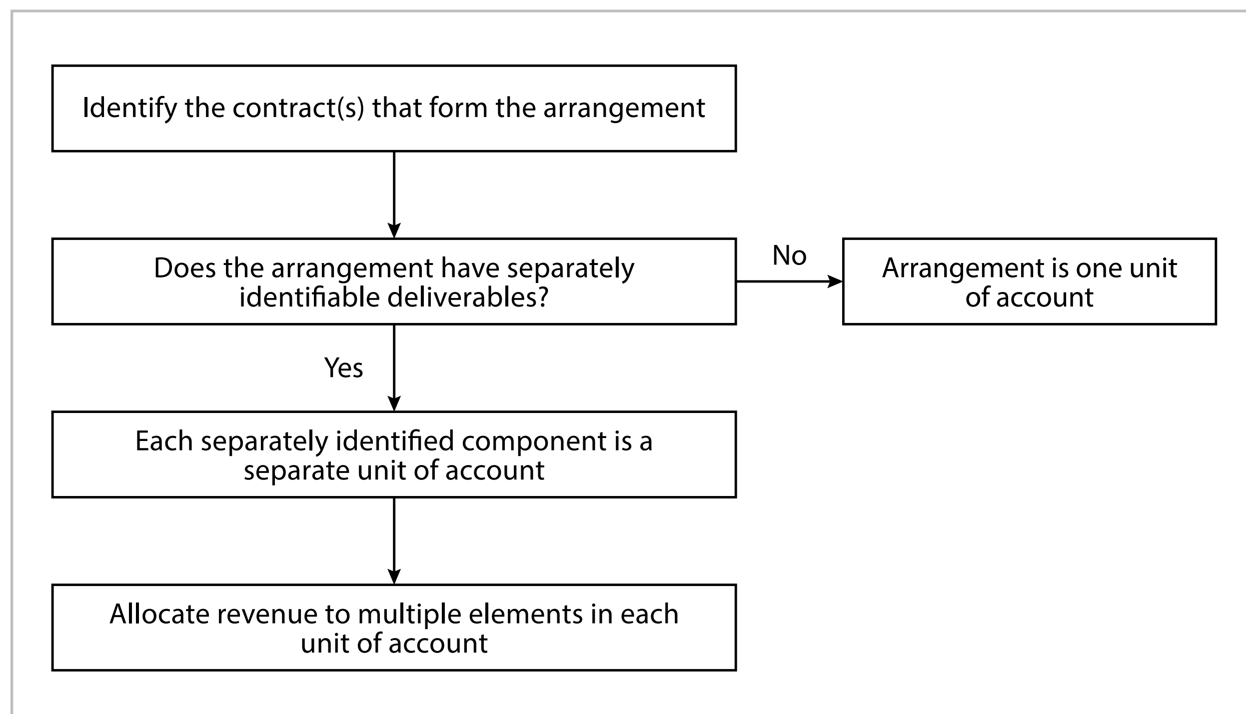
Calculation of Earned Revenue		Year 1	Year 2	Year 3	Year 4
Current period contract revenue		$ 553,000,000	$ 620,000,000	$ 620,000,000	$ 620,000,000
Current period estimated total contract costs		492,400,000	552,400,000	622,400,000	622,400,000
Gross profit on the contract	K	60,600,000	67,600,000	(2,400,000)	(2,400,000)
Degree of completion	C	25.13%	56.40%	70.52%	100.00%
Cumulative gross profit before adjustment	L = K x C	15,228,780	38,126,400	(1,692,480)	(2,400,000)
Adjustment for expected loss on contract	M	–	–	(707,520)	–
Cumulative gross profit		15,228,780	38,126,400	(2,400,000)	(2,400,000)
Gross profit earned in prior periods		–	(15,228,780)	(38,126,400)	2,400,000

Calculation of Earned Revenue	Year 1	Year 2	Year 3	Year 4
Gross profit earned during the period	15,228,780	22,897,620	(40,526,400)	–
Current period cost of earned revenue	123,740,120	187,813,480	127,362,880	183,483,520
Current period earned revenue	$ 138,968,900	$ 210,711,100	$ 86,836,480	$ 183,483,520
Calculation of revenue adjustment for Year 3				
Expected loss on contract			$ (2,400,000)	
Calculated cumulative gross profit based on degree of completion			(1,692,480)	
Adjustment required for computation of Year 3 earned revenue*		M	$ (707,520)	

*This computation determines the required adjustment to Year 3 earned revenue due to the expected loss on the contract. Total earned revenue in Year 3 is $86,836,480.

Decision Trees[18]

Decision Tree 1 – Identifying Units of Account for All Revenue Arrangements and Allocation of Revenue



18 Taken from Section 3400, *Revenue* in Part II of the *Handbook*.

Decision Tree 2 – Recognition of Revenue for Each Unit of Account