CPA ONTARIO

Standards in Focus

ASPE Guide: Section 3400 – Revenue in Practice

Part 1 – Identifying Units of Account

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Introduction: Why This Topic Matters in Practice

Revenue is one of the most significant measures of an entity's financial performance. Recognizing revenue appropriately under Section 3400, *Revenue*, requires more than simply applying recognition criteria. It also requires understanding the substance of the earning process and how it unfolds in practice.

Modern commercial transactions are rarely straightforward. Entities often sell bundles of goods and services or provide multiple deliverables under a single arrangement. As a result, a critical early judgment is determining whether the arrangement should be accounted for as a single deliverable or as multiple deliverables. This assessment is referred to as identifying the appropriate unit(s) of account. Because the conclusions reached at this initial stage ultimately influence the timing and pattern of revenue recognition, getting the unit of account right is foundational to the faithful representation of revenue in the financial statements.

As the first installment in CPA Ontario's new revenue series, this article focuses on identifying units of account in revenue transactions under paragraph 3400.11 and the related application guidance in paragraphs 3400.A1-.A7, which form an integral part of the requirements in Section 3400. Relevant extracts from Section 3400 referenced throughout this article are reproduced in Appendix B.

This article is intended to help preparers step back from legal form, apply professional judgment consistently, and document conclusions that reflect the economic substance of revenue arrangements.

Subsequent articles in this series will explore other key areas under Section 3400 that frequently involve judgment, including:

- Allocating Arrangement Consideration to Multiple Elements
- Reporting Revenue Gross or Net
- Bill and Hold Arrangements
- Upfront Non-Refundable Fees or Payments
- The Percentage of Completion Method

The topics listed above are not intended to be exhaustive. CPA Ontario may publish additional guidance on other aspects of Section 3400 in the future as part of this series.

Additional Considerations

Not-for-Profit Organizations (NFPOs)

While this series is for private, for-profit entities, the principles in Section 3400 are equally important for not-for-profit organizations engaged in exchange transactions.

In accordance with ASNPO Section 4410, *Contributions – Revenue Recognition*, NFPOs must apply ASPE Section 3400 when accounting for exchange transactions, such as revenues arising from the sale of goods or rendering of services. This guidance does not apply to transactions within the scope of Sections 4410 and 4420, *Contributions Receivable*, such as contributions and related investment income received by NFPOs.

Decision Trees 1 and 2 in Appendix A are designed to be used together as a practical roadmap and should be revisited throughout this series as the analysis progresses. Decision Tree 1 provides a high-level framework for identifying the appropriate unit(s) of account by helping preparers evaluate contractual arrangements and determine whether contracts and deliverables should be accounted for together or separately.

Once the appropriate units of account have been identified, Decision Tree 2 provides a framework for determining when and how revenue is recognized for each unit.

Used together, they provide a structured way to move from complexity to clarity.

Identifying Units of Account: The Critical Initial Step

Before determining the amount and timing of revenue recognition, preparers must first identify the unit(s) of account. In practice, this assessment requires significant professional judgment and careful consideration of the substance of the transaction.

A unit of account represents a separately identifiable deliverable, or group of deliverables, to which revenue recognition criteria are applied.[1] In practice, this means looking beyond the legal contract structure to understand the substance of the arrangement, determine what deliverables an entity is providing, when performance for such deliverables is fulfilled and whether they represent separate units of account.

If an arrangement does not contain separately identifiable deliverables (components), it is treated as a single unit of account (e.g., a single contract to prepare and deliver a valuation report to a client). Conversely, when an arrangement includes multiple deliverables, an entity (vendor) evaluates all deliverables in the arrangement to determine whether they represent separate units of account (i.e., if they meet both criteria under paragraph 3400.A5) or should be combined with other deliverables (e.g., a contract to sell a home security package split into equipment, installation and monitoring services).

Consistent with paragraph 3400.11, revenue recognition criteria are generally applied to each transaction separately. When a single transaction contains multiple separately identifiable components, the recognition criteria are applied separately to each component to reflect the substance of the arrangement. Conversely, when multiple transactions or contracts are substantively linked and in essence form part of a single arrangement, they may need to be accounted for together. For example, separate agreements entered into at the same time for site preparation and the construction of a warehouse may, depending on the facts and circumstances, be considered a single arrangement for accounting purposes.

In all cases, revenue recognition criteria are applied to the identified unit of account in a manner that best reflects the underlying economics of the transaction.

1 Refer to paragraphs 3400.04-.18 for detailed guidance on revenue recognition criteria.

STEP ONE

Identifying the Arrangement – One Contract or Several?

Why This Step Matters

When identifying units of account, preparers should look beyond the legal form of an individual contract or group of contracts. The analysis requires a broader view, as analyzing each contract in isolation may fail to accurately reflect the economic substance of the transaction.

To identify units of account, an entity is first required to evaluate the following under paragraphs 3400.A1-.A4:

- Whether a transaction consists of a single contract or a group of contracts.
- If there are multiple contracts, whether all or some of those contracts must be combined to reflect the true commercial substance of the transaction.

What to Focus On

Paragraphs 3400.A1-.A4 emphasize the substance over legal form. When multiple contracts are negotiated in the same economic environment, with a single overall profit objective, relate to a single underlying arrangement with one or more customers, are closely interrelated in terms of pricing and economics, and are performed concurrently or in a continuous sequence, they should be combined and treated as a single contract. The accounting treatment is driven by the criteria in paragraph 3400.A3 and the underlying economics of the arrangement, regardless of how many separate legal documents are signed.



PRACTICAL TEST

If we step away from the paperwork, would the group of contracts be viewed as a single transaction with one overall commercial objective, structured under multiple contracts?

CASE STUDY

Assessment of Multiple Contracts

This fact pattern reflects a situation frequently encountered in practice where multiple contracts are entered into as part of a broader commercial arrangement.

The Facts

Ubari Inc. (the Company) enters a multi-phase construction project for a long-term customer relating to the development of a specialized industrial warehouse. For legal and risk management reasons, the arrangement is documented through two separate contracts executed on the same day:

- **Contract A ($400,000):** Site preparation specific to the warehouse design.
- **Contract B ($1.2 million):** Construction of the customized warehouse.

Contract A is estimated to cost $265,000, while Contract B is estimated to cost $1.1 million. The Company prices contracts to achieve an overall gross margin of approximately 15%.

The Accounting Issue

Should Contract A and Contract B be accounted for separately, potentially allowing for earlier revenue recognition on Contract A, or combined and treated as a single contract?

Analysis

An assessment of the economic substance using the criteria under paragraph 3400.A3 indicates that the following factors would indicate that the two contracts be treated as a single contract:

- The contracts are negotiated as a package in the same economic environment with an overall profit margin objective.
    - The pricing structure further supports the conclusion that the contracts were negotiated with an overall profit margin objective. Contract A is priced at an unusually high margin (approximately 34%), while Contract B is priced near cost (approximately 8%). When viewed together, the contracts generate a gross margin of approximately 15%, consistent with the Company's overall pricing policy.
- The contracts constitute, in essence, an agreement to execute a single arrangement with a single customer.
    - The customer's ultimate objective is a completed warehouse, rather than just a separate site preparation.
- The agreements are so closely interrelated that they are, in effect, part of a single arrangement with an overall profit margin.
    - The site preparation has little or no economic utility to the customer unless it is followed by completion of the warehouse.
- The work is performed in a continuous sequence, with site preparation followed by construction, and significant acts remain unfulfilled by the Company until construction of the warehouse is entirely complete.

Conclusion

Although documented through two legally separate agreements, Contracts A and B together represent a single profit-generating activity. Based on the criteria in paragraph 3400.A3, the contracts must be combined and treated as a single contract.

Key Takeaways

- The accounting treatment should reflect the substance of the transaction, not merely its legal form.
- Look beyond the separate agreements to assess the overarching economic arrangement.
- Deliverables that are economically interdependent and have limited stand-alone utility should be evaluated in the context of the overall arrangement.
- Front-loaded margins on early milestones may signal that contract combination is required.

STEP TWO

Identifying Separate Units of Account Within an Arrangement

Why This Step Matters

Once the arrangement has been identified, the preparer must identify all individual deliverables within the arrangement and evaluate whether they qualify as separate units of account.

Identifying separate units of account under paragraphs 3400.A5-.A7 is critical because it affects the timing and pattern of revenue recognition. Revenue may be recognized separately for individual deliverables or for a combined group of deliverables, depending on how the unit(s) of account are identified and when the applicable revenue recognition criteria are met. In practice, this assessment often requires significant professional judgment, particularly when a contract involves customized, highly integrated or interdependent goods or services.

Focusing on whether a deliverable provides stand-alone economic value to the customer helps ensure that revenue recognition reflects the true substance of the vendor's earning process, rather than artificial contractual labels or billing structures.

What to Focus On

Paragraphs 3400.A5-.A7 focus on economic utility, not how deliverables are labelled or invoiced. A deliverable qualifies as a separate unit of account when it meets the criteria in paragraph 3400.A5. This includes having value to the customer on a stand-alone basis and, when a general right of return exists, assessing whether delivery or performance of the remaining deliverables is probable and substantially within the vendor's control.



PRACTICAL TESTS

- If the arrangement includes a general right of return, is completion of the remaining deliverable(s) probable and substantially within the entity's control?
- Would the delivered item provide utility on a stand-alone basis, independent of the performance of the other elements of the arrangement?



CASE STUDY

Multiple Deliverables and Separate Units of Account

This fact pattern reflects a situation frequently encountered in practice where an entity sells multiple goods and services as part of a single arrangement for a bundled price.

The Facts

Leptis Inc. (the Company) sells a comprehensive home security package for a single bundled price of $1,600 that includes hardware, installation services and twelve months of monitoring services. Each component is also regularly sold separately by the Company and is also available for purchase from alternative third party vendors. The installation process is routine, does not require proprietary Company technology and can be performed the same day the hardware is delivered. The arrangement does not include a general right of return (i.e., where customers can return items for any reason, not just defects).

Accounting Issue

Does each deliverable in the arrangement constitute a separate unit of account, or do some or all of the deliverables need to be combined into one or more units of account?

Analysis

Under paragraph 3400.A5, deliverables in a multiple-deliverable arrangement must satisfy two core criteria to be treated as separate units of account. First, the arrangement must be evaluated for any general right of return alongside the probability of delivering the remaining components. Second, each separate deliverable must have value to the customer on a stand-alone basis.

Because the Company's contract explicitly contains no general right of return, the condition in paragraph 3400.A5(a) does not apply. Accordingly, the assessment focuses on whether the deliverables have value to the customer on a stand-alone basis under paragraph 3400.A5(b):

- **Hardware:** Has stand-alone value even if the customer switches installation and monitoring providers.
- **Installation:** Has stand-alone value as the installation is routine and available from alternative third-party vendors.
- **Monitoring:** Has stand-alone value as this is a distinct service that can be purchased from other alternative third-party vendors.

Each component of the package therefore represents a distinct deliverable with independent economic value.

Conclusion

Because each of the three deliverables has stand-alone value and the arrangement does not include a general right of return, the conditions under paragraph 3400.A5 are satisfied and the arrangement contains three separate units of account.

The following variations illustrate how changes in key facts can alter the accounting conclusion, even when many aspects of the arrangement remain unchanged.

Change in Facts and Impact on Conclusions

Scenario A

Assume the same fact pattern as in the base case scenario above, except:

- Customers have a 30-day general right of return on the hardware (i.e., refundable within 30 days, for any reason, not just defects).
- Installation and monitoring services are non-refundable and cannot be cancelled by the customer.
- The Company has an established history of successfully delivering installation and monitoring services and has direct control over service delivery.

Assessment of the Right of Return and Performance Probability (paragraph 3400.A5(a))

Under paragraph 3400.A5(a), the introduction of a general right of return for the hardware requires management to evaluate whether the performance of the remaining components remains probable and substantially within the Company's control.

Under this scenario, although the hardware is subject to a 30-day right of return, the installation and monitoring services are non-refundable. In addition, the Company can substantiate that delivery or performance of the remaining deliverables is probable and substantially within its control. Accordingly, the condition in paragraph 3400.A5(a) is satisfied.

Because there has been no change to the assessment made in the base case scenario that each deliverable has stand-alone value under paragraph 3400.A5(b), the conclusion remains unchanged from the base case scenario and the arrangement contains three separate units of account.

Scenario B

Assume the same facts as under Scenario A above, except:

- **Hardware** depends on the Company's proprietary installation technology to function as intended.
- **Installation** services are fully refundable if hardware is returned within 30 days.
- **Monitoring** services remain non-refundable and cannot be cancelled for a refund.

Under these facts, management must once again re-evaluate the units of account under paragraph 3400.A5.

Assessment of the Right of Return and Performance Probability (paragraph 3400.A5(a))

Under this scenario, although installation services are refundable if the hardware is returned within 30 days, the Company can still substantiate that delivery or performance of the remaining deliverables (i.e., monitoring services) is probable and substantially within its control. This assessment is supported by the Company's established operating history, direct control over service delivery and the non-refundable nature of the monitoring services. Accordingly, the condition in paragraph 3400. A5(a) is satisfied, and the Company proceeds to assess the deliverables for stand-alone value under paragraph 3400.A5(b).

Re-Evaluating Units of Account (ASPE 3400.A5(b)-.A7)

Once the right of return threshold is satisfied, the components must be evaluated for stand-alone value. Because the hardware cannot function as intended without the Company's proprietary installation services, management concludes that the hardware does not have stand-alone value within the meaning of paragraphs 3400. A5-.A6.

Accordingly, the hardware does not meet the criterion in paragraph 3400.A5(b) and cannot be accounted for as a separate unit of account. Consistent with paragraph 3400. A7, the hardware should be combined with the installation services into a single unit of account.

The monitoring services continue to have stand-alone value and therefore remain a separate unit of account. As a result, the arrangement contains two separate units of account (i.e., hardware and installation services combined as a single unit of account and monitoring services as a separate unit of account).

Key Takeaways

- At the inception of an arrangement, all deliverables must be evaluated to determine whether they represent separate units of account.
- A deliverable that has no stand-alone value to the customer, such as a customized or highly integrated element, cannot be accounted for as a separate unit of account.
- Where a contract includes a general right of return, a deliverable can be treated as a separate unit of account only if delivery or performance of the remaining deliverables is considered probable and substantially within the vendor's control and it has a stand-alone value.
- A general right of return is one of two criteria (i.e., in addition to that the deliverable(s) must have value to the customer on a stand-alone basis) that must be met and you need to assess whether separation remains appropriate, but it does not automatically make all deliverables one unit of account.

What Comes Next: Allocating Arrangement Consideration to Multiple Elements

Identifying units of account is only the first stage of the analysis and a prerequisite to allocating revenue under Section 3400. Once those units have been determined, an entity must allocate arrangement consideration to each unit of account before assessing the timing of revenue recognition.

Part 2 of this series builds directly on the analysis in this article and examines that allocation process, including the judgment involved in applying paragraphs 3400.A8-.A12 and common practical considerations.

What Can You Do?

1

Read Section 3400 and its Basis for Conclusions available for CPAs via Part II of the Accounting Handbook.

READ IT

2

Regularly visit CPA Ontario's **Guidance on Compliance Knowledge Hub** to stay current on evolving standards.

CHECK FOR UPDATES

3

Contact Professional Advisory Services by phone at **416 204.3106** or **1 800 387.0735 x 4456** or email us.

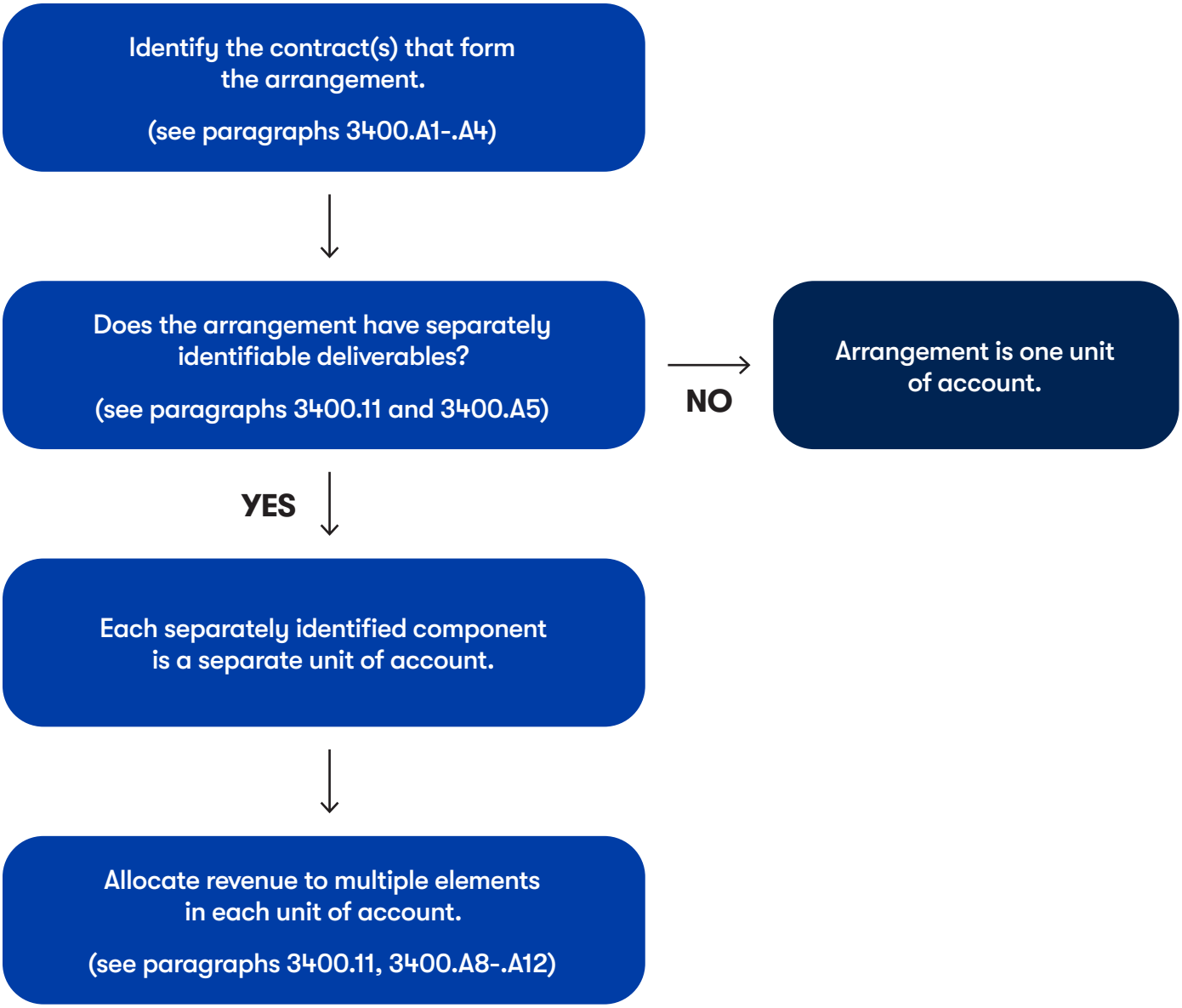
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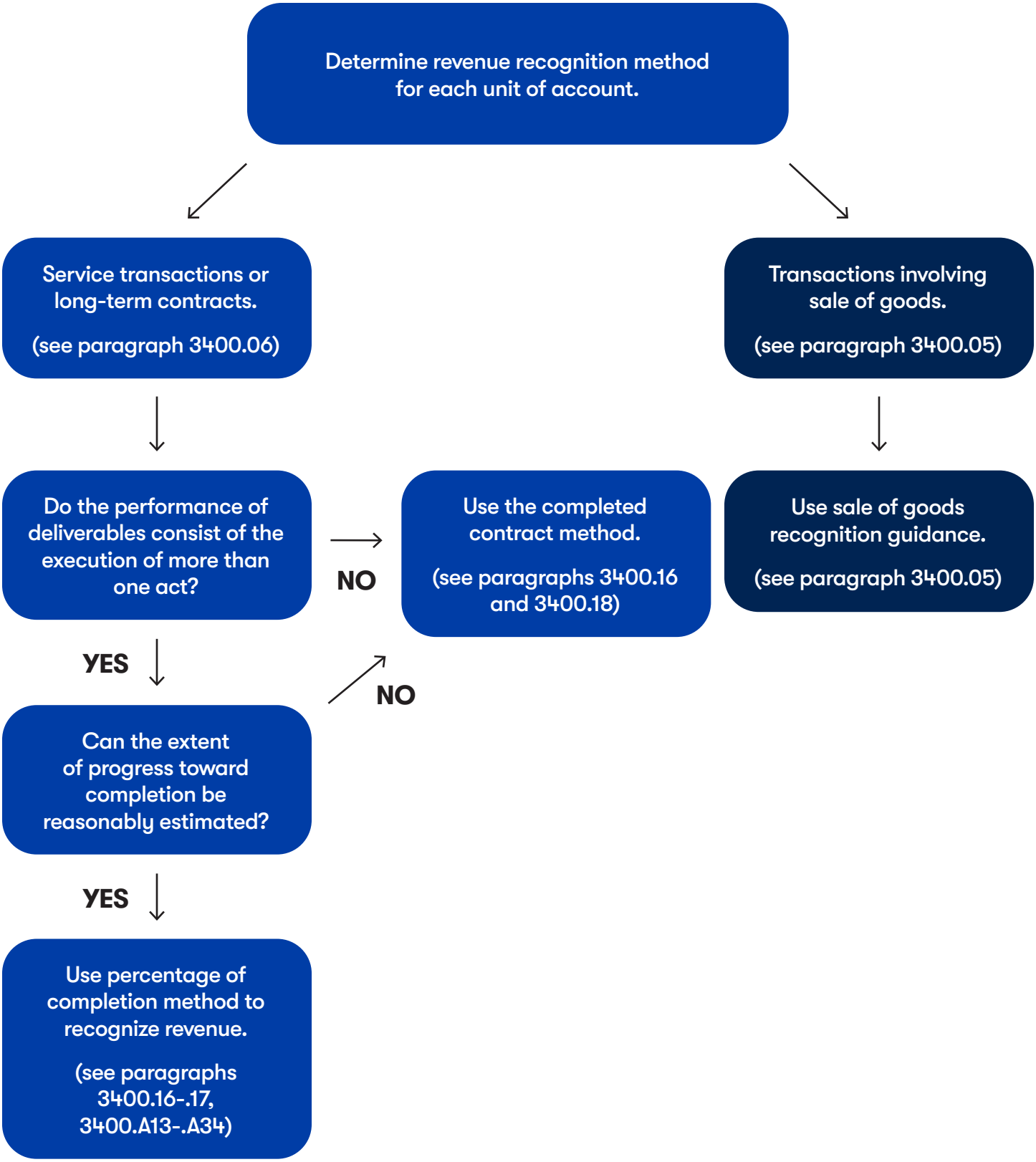
Appendices A and B are adapted from Section 3400, *Revenue*, in Part II of the Accounting Handbook.

Appendix A

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



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



Appendix B

Relevant Paragraphs From Section 3400

The below contains the relevant ASPE Section 3400 guidance on identifying units of account.

.11 The recognition criteria in this Section are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. A single sales transaction may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In some cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an enterprise may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction. In such a case, the two transactions are dealt with together. (Paragraphs 3400.A8-.A12 provide related application guidance.)

A1. The recognition criteria in this Section are usually applied separately to each transaction. An enterprise needs to determine whether the transaction consists of a group of contracts or a single contract. It may be necessary to combine a group of contracts to reflect the substance of the transaction. A single contract may include more than one deliverable. In those circumstances, it may be necessary to segment the contract into the separate deliverables (see paragraph 3400.A5)

A2. A group of contracts may be so closely related that they are, in effect, parts of a single arrangement with an overall profit margin, and accounting for the contracts individually may not reflect the substance of the transaction. For example, a group of construction-type contracts may be negotiated as a package with the objective of achieving an overall profit margin, although the profit margins on the individual contracts may vary. In those circumstances, if the individual contracts are performed and reported in different periods and accounted for separately, the reported profit margins in those periods will differ from the profit margin contemplated in the negotiations for reasons other than differences in performance.

A3. A group of contracts, whether with a single customer or with several customers, is treated as a single contract when the contracts:

(a) are negotiated as a package in the same economic environment with an overall profit margin objective;

(b) constitute in essence an agreement to do a single arrangement with a single customer;

(c) are so closely interrelated that they are, in effect, part of a single arrangement with an overall profit margin; and

(d) are performed concurrently or in a continuous sequence.

A4. A single contract or a group of contracts that meet the criteria in paragraph 3400.A3 for combining as a single contract, may include several deliverables. An enterprise transfers these deliverables to the customer and performance may occur at different times or over different periods of time, and the customer's payments for these deliverables may be fixed, variable or a combination thereof.

A5. At the inception of an arrangement, an enterprise evaluates all deliverables in the arrangement to determine whether they represent separate units of account. In an arrangement with multiple deliverables, the deliverables should be considered a separate unit of account, if both the following criteria are met:

(a) if the arrangement includes a general right of return relative to the deliverable(s), delivery or performance of the remaining deliverable(s) is considered probable and substantially in the control of the vendor; and

(b) the deliverable(s) have value to the customer on a stand-alone basis.

A6. The deliverable(s) have value on a stand-alone basis if they are sold separately by any vendor or the customer could resell the deliverable(s) on a stand-alone basis. In the context of a customer's ability to resell the deliverable(s), it is not required to have an existing observable market for the deliverable(s).

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

Disclaimer

This article is intended for general informational purposes only. It is your responsibility to ensure compliance with Section 3400, *Revenue*, as outlined in Part II of the Accounting Handbook, based on your specific situation. In the event of any discrepancy between this article and the applicable official standards or guidance, the official sources shall prevail. Users are encouraged to consult the original sources for complete and authoritative information.

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