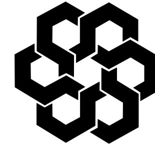

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**12 December 2007, London**
Project:	**Revenue Recognition**
Subject:	**Measurement model - Part 3: reporting changes in the exit price of the contract asset or liability in profit or loss (Agenda paper 7B)**

PLEASE NOTE THAT THIS PAPER WAS ORIGINALLY POSTED AS AGENDA PAPER 4E FOR NOVEMBER'S IASB MEETING, BUT WAS NOT DISCUSSED AT THAT MEETING.

PURPOSE OF THIS MEMO

1. This memo discusses the presentation issues in profit or loss raised by measuring the contract asset or liability at current exit price.

INTRODUCTION

2. The discussion and illustration of the accounting subsequent to contract inception in the papers discussed in November[1] focussed on changes in the measurement of the contract asset or liability that arise from the satisfaction of the underlying contractual rights and contractual obligations. However, because the contract asset or liability is measured at its current exit price both at contract inception and subsequently, its carrying amount might change for

[1] November's Agenda Paper 4D, included as Appendix B to this paper.

reasons other than the satisfaction of the rights and obligations. For instance, the contract asset or liability measured at current exit price may change simply because of a change in the price of the underlying goods and services yet to be provided to the customer.

3. The following paragraphs discuss some of the presentation issues in profit or loss that arise when measuring the underlying contractual obligations after contract inception at current exit price.

Revenue as a current value measure

4. In November's papers[2], the staff emphasised that revenue itself is not measured. Rather, the amount of revenue that is recognised is derived from the increase in the exit price of the contract asset or decrease in the exit price of the contract liability (or combination of the two) that occurred in the reporting period. Therefore, if revenue is defined as discussed in November[3], ie as:

> an increase in a contract asset or a decrease in a contract liability (or a combination of the two) that results from (a) obtaining an enforceable contract with a customer to provide goods and services and (b) providing those goods and services to a customer.

revenue would reflect the change in the exit price of the contract asset or contract liability from providing goods and services *at the date the goods and services are provided*. The following example illustrates the potential consequences of this.

On 30 June a customer contracts with Distributor for the delivery of a widget on 31 August. The customer prepays the contract price of CU1,000 on 30 June.

[2] See Appendix B, paragraph 32.
[3] See Appendix B, paragraph 5.

5. Suppose that the exit price of the contract liability on 30 June is CU900, that is to say, Distributor would need to pay a market participant CU900 for it to assume all of the remaining unperformed obligations under the contract. Accordingly, Distributor records the following accounting entry:

Dr cash	1,000	
Cr contract liability		900
Cr revenue (from contracting)		100

6. Suppose that on 31 July there is an increase in the price of widgets to distributors that is not absorbed by distributors. As a result, the price that a market participant would demand at 31 July to assume the remaining obligations increases to CU950. Therefore, Distributor needs to increase the carrying amount of the contract liability from CU900 to CU950 to reflect its revised current exit price and to record the corresponding debit entry of CU50 in profit or loss. This debit entry does not meet the definition of revenue above, because it is an *increase* in the contract liability and does not result from providing goods and services to the customer. Suppose that the debit is described as a contract loss. Distributor therefore records the following accounting entry:

Dr contract loss	50	
Cr contract liability		50

7. When Distributor satisfies its contractual obligations by delivering the widget on 31 August, it extinguishes its contract liability and records the following accounting entry:

Dr contract liability	950	
Cr revenue		950

8. The above journals can be summarised as follows:

	June	July	August	Total
Income Statement extracts				
Revenue	100	-	950	1,050
Contract loss		(50)		(50)
Statement of Financial Position extracts				
Cash	1,000	1,000	1,000	
Contract liability	(900)	(950)	-	

9. The point to note in this example is that the total amount of revenue recognised from this contract is CU1,050, which is CU50 more than the contract consideration. Conversely, if the exit price had decreased by CU50 in July, then a contract gain of CU50 would have been recognised in July and revenue of CU850 recognised in August. So in this case, the total amount of revenue recognised would have been CU950.

10. Recognising revenues that do not equal the amount of contract consideration would typically be different from existing revenue recognition models. However, it would be a consequence of measuring the contract asset or liability at its current exit price and treating the revenue as the residual. In effect, since revenue is derived from the changes in the *current* price of the contract asset or liability, revenue itself becomes a current value measure. For instance, in the above example, the revenue recognised in August reflects the price market participants would charge at that date for providing the goods and services, not the price they would have charged at contract inception. In contrast, as noted in Appendix A, existing revenue recognition models typically lock or freeze all measurements at contract inception. For instance, in the above example, the measurement of the contract liability at 31 July would be by reference to the prices that existed at contract inception and would not reflect the subsequent price change. Hence, the revenue that is recognised under existing models reflects *past* prices of goods and services rather than *current* prices.

11. Some think that a revenue line that reports the current value of the goods and services provided to customers when they were provided gives users useful

information. This is because the amount of revenue that is recognised may be more predictive of future revenues because it reflects *current* prices rather than the prices that existed at contract inception. For instance, in this example, if Distributor was to increase its prices in line with other market participants at 31 July, it would charge customers on new contracts CU1,050 rather than CU1,000.

12. Others observe that if Distributor in this example does not, or could not, pass on the increase in the price of widgets to its customers, then reporting revenue of CU950 in August rather than CU900 would be misleading. This is because revenue of CU950 would suggest that revenues from future contracts will increase. However, if Distributor did absorb the price increase and on 31 August entered into an identical contract to that on 30 June, then it would recognise revenue on contract inception of CU50 (ie cash of CU1,000 less contract liability of CU950) rather than CU100, as on the first contract. And, assuming no further price changes, it would recognise revenue of CU950 on 31 October when it extinguishes its contract liability. Hence, the revenue that is reported from fulfilling the first contract of CU950 would be predictive of the revenue that will be reported on fulfilling the second contract.

Role of contract consideration in display

13. Proponents of the measurement model acknowledge that the total amount of revenue recognised in the above example would be troublesome for some. Discussions with some constituents have highlighted a firmly held view that the consideration received (or receivable) from the customer should be displayed in profit or loss. This is because they equate revenue with the contract consideration. In other words, they think that revenue should reflect the amount that the entity *receives* from customers for providing goods and services. In contrast, in the above examples, revenue reflects the value of the goods and services at the time they are *provided* to customers.

14. Some of those who are troubled by the amount of revenue recognised in the above examples observe that the problem of revenue being a different amount than the contract consideration would not arise if the contract was not remeasured for price changes. However, proponents of the measurement

model think that departing from the principle of explicitly measuring the contract at each reporting date would conflict with the overall objective of the model. As noted in Appendix A, in their view the most appropriate way of determining how much revenue should be recognised is to determine by how much the assets and liabilities have changed.

15. One point to note is that the cash consideration received from customer is in fact reported in the statement of cash flows. Given that the financial statements have a limited capacity for reporting financial information, some argue that this capacity should not be wasted in reporting numbers that are redundant.

16. Nonetheless, in the light of these concerns about the role of the contract consideration in display, the following other options for displaying the changes in the exit price of the contract were considered:

- report the effects of price changes as revenue (paragraphs 17–21)
- report the effects of price changes outside revenue (paragraphs 22–23)
- report the effects of price changes as an adjustment to revenue (paragraphs 24–30).

Report the effects of price changes as revenue

17. One option would be to report the effects of prices changes as revenues. For instance, suppose that in the above example, the increase in the contract liability at 31 July arising from the price change was also reported as revenue (ie ‘negative revenue’) rather than as another component of comprehensive income. The table in paragraph 8 would then be as follows:

	June	July	August	Total
Income Statement extracts				
Revenue	100	(50)	950	1,000
Statement of Financial Position extracts				
Cash	1,000	1,000	1,000	
Contract liability	(900)	(950)	-	

18. Unlike in the table in paragraph 8, the total amount of revenue recognised from the contract is CU1,000, ie the contract consideration. If the exit price had decreased by CU50 in July, then 'positive' revenue of CU50 would have arisen in July and CU850 in August. So again the total amount of revenue would be CU1,000.

19. The advantage of this option is its simplicity. This is because changes in the contract asset and liability from satisfying contractual obligations would not be reported in profit or loss separately from the effects of price changes. Hence, an entity would need to measure the contract asset or liability only at the end of the reporting period. And if the above contract was entered into and completed in a single reporting period, there would be no need to separately record the price change.

20. In contrast, if the effects of a price change on the contract asset or liability are reported separately, then the contract asset or liability would (at least in theory) need to be remeasured whenever there is a price change. This would be the case even if the contract is entered into and completed in a single reporting period. Otherwise, entities might report different amounts of revenues and contract gains and losses depending on the frequency of remeasurement even if they would report the same amount of profit or loss In other words, unless the disaggregation between changes in the contract asset or liability arising from satisfaction of obligations and price changes is done consistently, then the revenue and contract gains and losses lines become less representationally faithful or less comparable.

21. However, there are two things to note about this option.

- Revenue is typically regarded as a positive component of comprehensive income. Therefore, reporting negative revenue could imply to some that too much revenue was recognised in previous periods and, hence, that revenue in earlier periods was incorrect. However, in this example, the debit of CU50 reported in profit or loss in July has nothing to do with earlier periods. Rather, it depicts an economic event that took place in July. It reflects that the entity locked into a fixed price contract on 30 June and that subsequently the value of the goods and services that the entity committed to provide to the customer under that contract, measured by reference to their current market price, increased by CU50.

- When this contract is aggregated with other contracts, revenues in July would reflect positive revenues from obtaining contracts and satisfying obligations in that month and negative revenues from the price changes. Netting the effects of price changes on the entity's contract assets and liabilities and the effects of satisfying contractual obligations would mask two separate economic events—the effect of the entity's performance on its contract assets and liabilities and the effect of market price changes. To the extent feasible, it would be more helpful to users to show separately the effects of these events. This should help users better understand the reasons for the changes in the contract assets and liabilities and, hence, the reasons for the profit or loss that is reported in the period.

21A In addition, this option would require the definition of revenue in paragraph 4 to be broadened, so that an increase or decrease in a contract asset or a contract liability from a price change would also meet the definition of revenue.

Report the effects of price changes outside revenue

22. Another option would be to isolate all of the effects of the price changes and report them outside the revenue line. For instance, in the above example, having recognised a contract loss of CU50 on 31 July, that loss could be

recognised as a contract gain rather than revenue when the obligations are satisfied on 31 August. The table in paragraph 8 would then be as follows:

	June	July	August	Total
Income Statement extracts				
Revenue	100		900	1,000
Contract gain/(Loss)		(50)	50	-
Statement of Financial Position extracts				
Cash	1,000	1,000	1,000	
Contract liability	(900)	(950)	-	

23. Again, unlike in the table in paragraph 8, the total amount of revenue that is recognised from the contract is the contract consideration of CU1,000. In addition, unlike the table in paragraph 17, this table shows separately the effects of the price change and satisfying obligations. However, two things should be noted about this presentation.

- The revenue line is inconsistent with the underlying premise of the measurement model. This is because the revenue of CU900 in August does not represent the *current* value of anything. Rather, it represents the amount of the obligations satisfied in August, but with the value of those obligations locked at prices as at contract inception.
- Although the contract gain in August is likely to offset higher costs than those expected at the inception of the contract, by itself it does not depict any real world event. In essence, it is just a balancing number.

Report the effects of price changes as an adjustment to revenue

24. Another option would be to record the effects of price changes on the contract asset or liability as adjustments to revenues ('revenue adjustments'). For instance, an increase in a contract liability arising from an increase in its exit price would be debited to 'Revenue Adjustments—Losses from Contracts' and a decrease would be credited to 'Revenue Adjustments—Gains from Contracts'. As a result, the 'revenues section' of the income statement for the above example would be along the following lines:

	June	July	August	Total
Income Statement extracts				
Current value revenues	100		950	1,050
Revenue adjustments:				
Gains from contracts				
Losses from contracts		(50)		(50)
Contract revenue	100	(50)	950	1,000

25. The ‘current value’ (ie top line) revenues would reflect the value of the goods or services provided to the customer on the date they were provided, thereby preserving that aspect of the measurement model, and the ‘contract revenues’ line would capture the amount of consideration actually agreed to in the contract. Thus, the current exit price focus of the model would be reflected in profit or loss. But at the same time an additional revenue line (‘contract revenue’) would be included that would limit the total amount revenues recognised to the amount of the contract consideration. Hence, total contract revenues recognised would equal the contract consideration. (Although it should be noted that total revenue column is a memo item in the above tables; it is not actually reported in the financial statements.)

26. Some observe that although the total column in the above table depicts the relationship between the value of the goods and services provided to the customer at the date they are provided and the amount of the consideration agreed to in the contract, the current value revenues and the contract revenues lines in the individual months do not depict anything about that relationship.

27. This is because the CU50 loss in the above example was incurred in July when the exit price of the remaining unperformed obligations increased. This amount must be recognised in the July reporting period to ensure that the contract liability is measured at its current exit price at the end of that period. As noted, its inclusion in July’s profit or loss also depicts an economic event that took place in that reporting period. However, the loss relates to the remaining unperformed obligations in the contract as a whole. In this example, it does not relate to any goods or services provided in July; it relates

to the goods and services that will be provided in subsequent periods. Therefore, this makes the relationship between the current value revenue and the contract revenue difficult to interpret in July and then subsequently August. For instance, the table in paragraph 24 begs the questions of why does the entity have negative contract revenues in July and then why are the contract and the current value revenues the same in August?

28. Some argue that if the contract revenue line is deemed to be important to users, then more meaningful information could be provided by displaying only the amount of contract loss/gain that pertains to goods and services provided in the reporting period as the revenue adjustment. Any remaining contract loss/gain could be displayed lower down in the income statement. This loss/gain could then be reclassified as a revenue adjustment in the period in which the goods and services to which it pertains are provided. For instance, the above example could be presented along the following lines:[4]

	June	July	August	Total
Income Statement extracts				
Revenues	100	-	950	1,050
Revenue adjustments:				
Previously recognised gains from contracts				
Previously recognised losses from contracts			(50)	(50)
Contract revenue	100	-	900	1,000
Contract expenses	(25)		(800)	(825)
Margin	75	-	100	175
Contract losses on unfulfilled obligations	-	(50)	50	-
Net margin	75	(50)	150	175

29. The above presentation reconciles the current value revenues and the amounts actually expected as future revenue as of the beginning of the contract. Therefore, in addition to information provided in the table in paragraph 24, it

[4] To provide a more complete illustration, contract expenses have been included in this illustration.

provides additional feedback information about the entity's performance under the contract.

30. The above is a fairly simple example and the presentation poses few practical difficulties. However, in a contract in which the obligations are being satisfied continuously over time, it could be more difficult to determine the amount of contract losses or gains to reclassify in each subsequent reporting period.

Conclusions

31. This section has considered some of the display issues that arise from measuring a contract at current exit value, specifically the effects of measuring the remaining unperformed contractual at current exit value.

32. The preference of proponents of the measurement model is that after contract inception, revenues should reflect the current value of the goods and services that have been provided to the customer in the period. Under this view, revenue would reflect the change in the exit price of the contract asset or liability from providing goods and services to the customer. Changes in the exit price of the contract asset or liability for reasons other than the entity providing goods and services to the customer (eg as a result of a price change) would be reported outside of revenue.

33. The simplest form of presentation to achieve this separation would be to report the effects of price changes as contract gains and losses, as in the table in paragraph 8. However, proponents of this model acknowledge that additional information could be provided in the income statement by reconciling the current value revenues to the amount that customer was charged for the goods and services, as in the tables in paragraphs 24 and 28. This would also result in reporting a contract revenue line that is more consistent with revenue that is reported under existing models.

34. Proponents of this model acknowledge that any approach that requires changes in the exit price of the contract asset or liability from providing goods and services to be reported separately to other changes results in additional complexity. In that regard, they note that the simplest approach would be to report all changes in the contract asset and liability—both positive and

negative—as revenue, as in the table in paragraph 17. The Boards are therefore interested to hear from constituents about whether the benefits to users from reporting the change in the exit price of the contract asset or liability from providing goods and services separately to the other changes would outweigh the costs involved in providing that additional information.