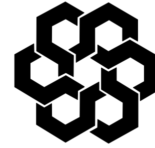

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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting: **14 November 2007, London**

Project: **Revenue Recognition**

Subject: **Measurement model—Accounting for the contract with the customer (Agenda paper 4D)**

PURPOSE OF THIS MEMO

1. This memo explains the implications of applying the measurement principle discussed in Memo 97 to the contract-based revenue definition discussed in Memo 96.

INTRODUCTION

2. Memo 96 explained how and why entering into an enforceable contract with a customer to provide goods and services results in an entity obtaining a contract asset or a contract liability. It also explained how that asset or liability changes subsequently as a result of the entity's performance under the contract, namely by satisfying the obligations under the contract. This results in either an increase in the contract asset or decrease in the contract liability. Memo 97 proposed that the contract asset or contract liability be measured initially and subsequently at its current exit price, that is to say, at the amount that the entity would expect to receive or pay to transfer its remaining contractual rights and obligations to a market participant.

3. This section brings together these conclusions and explores their implications for revenue recognition.

DEFINITION OF REVENUE

4. Memo 96 explained that revenue arises from changes in specified assets and liabilities. It noted that there are various possible sets of assets and liabilities

from which revenue might arise. However, the discussion so far has focussed almost entirely on the set of assets and liabilities that arise directly from the contract with the customer, namely the contract asset or contract liability arising from the remaining rights and obligations in the contract.

5. Suppose that revenue was defined in terms of changes of this set of assets and liabilities. In other words, that revenue is linked directly to increases in an entity's assets or decreases in its liabilities that arise from the contract with the customer. Memo 96 proposed such a definition of revenue. For this model, that definition could now be expanded as follows to explain *which* increases (decreases) in the contract asset (liability) give rise to revenue:

Revenue is 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.

6. To aid later discussion, this definition of revenue will be described as the 'customer contract definition of revenue'. With this definition, revenue reflects the increase in the entity's net position in an enforceable contract with a customer from obtaining that contract and subsequently providing goods and services to customers. Memo 100 will consider whether the set of assets and liabilities captured by this definition is too narrow.

7. The following paragraphs consider the application of this definition of revenue and propose criteria for revenue recognition. They consider revenue recognition:

- before contract inception (paragraph 8),
- at contract inception (paragraphs 9–29), and
- after contract inception (paragraphs 30–47).

CRITERIA FOR REVENUE RECOGNITION

Before contract inception

Revenues cannot arise before a contract with a customer exists.

8. This may seem self-evident, but it should be noted that under the customer contract definition of revenue, revenues could not *arise* until a contract (which by definition is enforceable) exists. Before a contract exists, the entity does not have any contractual rights or contractual obligations. It is these contractual rights and obligations that are fundamental to the existence of contract assets and liabilities and hence revenue.

At contract inception

When an entity becomes party to a contract with a customer to provide goods and services, the entity recognises a contract asset or a contract liability from the combination of its rights and obligations in the contract.

If the entity recognises a contract asset, that increase in contract assets is recognised as revenue.

If the entity recognises a contract liability, that increase in contract liabilities is recognised as a loss.

9. In a contract in which the exit price of the underlying contractual rights exceeds the exit price of the underlying contractual obligations, the entity recognises a contract asset when it becomes party to the contract. That increase in the contract asset meets the definition of revenue in paragraph 5. If the exit price of the underlying contractual obligations exceeds the exit price of the underlying contractual rights, the entity recognises a contract liability when it becomes a party to a contract. That increase in the contract liability does not meet the definition of revenue in paragraph and would be recognised as a contract loss.

10. In some contracts, immediately after contract inception, the customer pays in advance in full. Hence, the rights in the contract are satisfied, but obligations still exist, so that the entity's net position in the contract immediately becomes a liability. Although two events have occurred (the entity has obtained a contract and then the customer has performed fully), it typically would not be necessary to separately account for these events. Instead, the amount of any revenue to be recognised at contract inception could effectively be determined as the excess of the cash (or other consideration) obtained from the rights in the contract over the current exit price of the entity's contract liability. Conversely, if the exit price of the contract liability is more than the cash (or other consideration) obtained from the rights in the contract, the entity recognises the excess as a contract loss.

Which rights and obligations are included in the contract asset and liability?

11. The rights include the enforceable rights to consideration under the contract or the enforceable rights to the customer's promise to pay that consideration that is contingent upon the entity's performance under the contract.

12. The obligations include *all* of the enforceable obligations to the customer that arise from entering into the contract. This includes explicitly stated obligations to transfer (or to stand ready to transfer) economic resources to the customer. It also includes those obligations stemming from the promises that are *implied* by the entity's customary business practices if a court would enforce those promises. For instance, these may include obligations to accept returns that are not required under the explicit terms of the contract.

13. Obligations to transfer economic resources to customers include obligations that require the entity to stand ready to perform. For instance, an entity that is providing a guarantee on a loan is providing a service (of guaranteeing the loan) to its customer for the duration of the guarantee, even though ultimately it might not have pay any cash if the borrower does not default.

14. Note that the contractual obligations include those obligations that are sometimes referred to as 'post-performance' obligations, such as a manufacturer's standard warranty and a return or cancellation right (ie the

remaining obligations that an entity has after providing the main deliverable(s) in the contract). In other words, all obligations (explicit or implicit) that would require the entity to transfer an economic resource to the customer as a result of entering into a contract with the customer would result in contractual obligations.

Revenue from contracting

15. Revenue recognised at contract inception is the revenue that arises from obtaining a contract with a customer.

16. Recognising revenue on entering into an enforceable contract will be unfamiliar to many. It may also raise concerns that revenue is being recognised prematurely or 'front loaded'. To consider this issue, consider the following example.

> Engineering Co is a distributor and installer of factory machinery.
>
> Suppose that during June, a potential customer contacts Engineering Co about purchasing one of its machines. A salesman from Engineering Co visits the customer and discusses the various options with the potential customer and prepares a quotation. On 30 June, after further discussion between the potential customer and the salesman, Engineering Co enters into a contract with the customer to provide, deliver and install the machine.
>
> The contract specified that the customer must pay in full the contract price of CU2,000 on completion of the installation of the machine.
>
> Engineering Co will deliver and install the machine in July. As a result of obtaining the contract, Engineering Co's salesman is due a commission of CU200.
>
> Assume that a market participant would demand CU1,600 to fulfil all of the obligations in this contract. Therefore, ignoring the time value of money and the risk of default by the customer, Engineering Co recognises a contract asset of CU400 (ie CU2,000 less CU1,600) on 30 June, when it becomes a party to this contract. The increase in this contract asset meets the definition of revenue in paragraph 5. Hence, on 30 June Engineering Co recognises revenue of CU400.

17. Some of the concerns about recognising revenue of CU400 in this example at contract inception may relate to viewing the transaction from the customer's perspective. This is because a customer might perceive that it derives utility from the contract only from the provision of the deliverables in the contract. By itself, the inception of the contract does not provide any separate utility to the customer. Hence, in this example, the *customer* might not judge the entity to have performed or done anything at 30 June. Even if the customer acknowledged the costs that Engineering Co incurs in obtaining the contract, it might regard those costs as an integral part of the cost of the goods and services to be provided under the contract. This is because the customer cannot acquire the goods and services from the entity without also compensating Engineering Co for the costs of obtaining the contract.

18. However, the objective is to address Engineering Co's—the reporting entity's—accounting, ie to faithfully depict its remaining rights and obligations under the contract. Hence, the transaction should be viewed from Engineering Co's perspective.

19. Viewed from this perspective, it is apparent that Engineering Co *has* done something economically significant on 30 June. Although it has not fulfilled any of the obligations under the contract, it has obtained a contract that has value. Assuming that the contract was not underpriced, Engineering Co would not give it away without compensation. Hence, if it were to transfer its remaining rights and obligations, it would expect to be paid for those rights and obligations. Furthermore, a third party would be prepared to pay for those rights and obligations. This is because that third party would not need to obtain the contract, but rather would only need to fulfil the contract and would then be able to collect the contract consideration. That is why the contract has a positive value and is recognised as an asset.

20. Even if the contract is viewed from a customer's perspective, then the activities that an entity undertakes before the contract is obtained can be viewed as services provided to the customer. They are the services the entity renders in conjunction with inducing the customer to enter into the contract; for example, services in assisting customers choosing between different products, educating the customer about the products, arranging for delivery and installation. These selling services are not separately priced and a customer might not explicitly acknowledge them. However, the customer is implicitly required to pay for them. In that regard, customers pay for more than just the goods and services *yet to be* provided. And in some cases there is evidence that customers do place value on those pre-contractual activities. For instance, consider a 'virtual' retailer that sells goods and services on the internet and another 'bricks and mortar' retailer that sells identical goods and services through a retail outlet. The retailer selling through an outlet may charge a higher price for its goods and services compared to the internet retailer because it provides more selling services. And customers will be prepared to pay a higher price because they implicitly place a value on those selling services (eg the ability to discuss the goods and services with sales staff, etc). Another example would be an entity that sells tickets for performances of Broadway or West End shows. Such entities often charge customers explicit fees for those tickets (that is, prices above the face price of the ticket or the price the customer would have to pay if it went directly to the theatre's own ticket booth).

21. The nature and extent of the activities involved in contracting or providing selling services will vary from contract to contract. For instance in the case of a sale of a commodity they will be relatively insignificant, because by definition commodities are traded relatively easy. However, in most cases, the activities involved in obtaining customer are significant.

Relationship of revenue from obtaining a contract with expenses incurred in obtaining a contract

22. Although an entity may recognise revenue at contract inception, this revenue does not necessarily result in reporting a corresponding amount of *profit*. This

is because the entity will have incurred expenses in obtaining the contract (although some of these may have been recognised in prior reporting periods). Hence, in considering the appropriateness or otherwise of the revenue that is recognised at contract inception, the treatment of the costs that have been incurred in obtaining that contract should also be considered.

23. Consider again the contract in paragraph 16. In this example, on obtaining the contract Engineering Co incurs a commission expense of CU200. Therefore, as well as recognising revenue of CU400 on 30 June, Engineering Co would also recognise a direct contract origination expense of CU200. In addition, Engineering Co would already have recognised expenses from various indirect costs incurred associated with obtaining the contract (eg marketing expenses, staff wages, etc). Assume that these could be identified and total CU150.

24. Hence, at 30 June, Engineering Co reports:

	CU
Revenue from contracting	400
Direct expenses from contracting	(200)
	200
Indirect expenses included in selling and administrative expenses	(150)
Profit from contracting	50

25. Accordingly, if *no* revenue is attributed to the act of obtaining a contract, then Engineering Co would recognise a net *loss* of CU350 on 30 June (ie from the direct and indirect expenses of obtaining the contract). Some argue that that reporting a loss when an entity has acquired a contract is not a faithful depiction of the entity's position, except in the unusual circumstances that an entity has entered into a loss-making contract. This is because entities are typically better off as a result of obtaining a contract. For instance, a listed entity that announces the obtaining of a large contract is likely to see an increase in its share price.

26. To prevent the recognition of a loss on obtaining a contract, some argue that at least the direct costs of obtaining the contract should be deferred and then amortised as the entity fulfils the contract. However, conceptually there is no distinction between a direct cost of obtaining a contract (eg a commission payment) and indirect costs (eg salary of order processing administrator). Furthermore, costs of obtaining a contract do not in themselves represent the cost of an asset. For instance, if an entity pays sales commission, it does not control any new resource as a result of paying that commission. Rather it has *consumed* resources as part of the process of obtaining a new resource, ie the contract. However, in this model, the contract is already being accounted for separately and measured explicitly (either as a contract asset or contract liability). (Although an entity may have obtained another resource as a result

of incurring contract origination expenses, eg a customer relationship intangible asset, discussion of such assets is outside the scope of this paper.)

27. Proponents of the measurement model conclude that all contract origination costs are expenses and should be recognised as such. They also view the accounting in paragraph 24 to be a more faithful depiction of what has occurred in the period. This is because it reports separately and independently in profit or loss the effects of *all* the assets consumed in contemplation of obtaining a contract (as and when they are consumed) and the effects of the assets obtained as a result of obtaining the contract (excluding customer relationship intangible assets) as and when that contract is obtained. Because the expenses and the contract are accounted for independently, the accounting is neutral. The entity reports net losses if it has consumed more resources in obtaining the contract than the assets resulting from obtaining it, and net profits if the assets obtained are more than the resources consumed in obtaining the contract.

28. In addition, all of the questions that arise in practice under existing revenue recognition models about which contract origination expenses should be expensed and which can be deferred are avoided. Said another way, precluding the recognition of revenue at contract inception tends only to cause difficulties in the accounting for costs.

Premature recognition of profit?

29. An important point to note is that recognising the value attributable to obtaining the contract does *not* mean that the *entire* profit expected from the contract is recognised on obtaining the contract. This is because the exit price measurement of the contract asset or liability at contract inception includes the margin that a market participant would require for providing the goods and services. Hence, this margin has not been recognised in profit or loss at contract inception. As will be discussed, this margin will be reported only as those goods and services are provided. Put another way, the revenue that is recognised at contract inception reflects the fact that if the contract was immediately transferred to a market participant, that market participant would not need to obtain the customer; it would need only to fulfil the contract.

After contract inception

Revenue is recognised after contract inception as the entity satisfies the obligations in the contract with the customer, thus increasing the contract asset or decreasing the contract liability (or a combination of the two).

30. If the customer has not prepaid, the contract asset increases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would expect to receive from a market participant to transfer the remaining unperformed rights and obligations in the contract would increase. The resulting increase in the contract asset meets the definition of revenue.

In the example in paragraph 16, payment is due from Customer on completion of the installation of the machine. Hence, at contract inception Engineering Co has obligations to provide, deliver and install the machine and a right to the customer's promise to pay the contract consideration of CU2,000.

Suppose that on 31 July, Engineering Co delivers the machine to the customer. Further suppose that after delivering the machine to Customer, the exit price of Engineering Co's contract asset increases to CU1,500 at that date, representing the amount a market participant would pay for the customer's promise of CU2,000 less the amount it would charge to install the machine of CU500. The increase in the contract asset of CU1,100 (ie CU1,500 – CU400) is recognised as revenue.

Suppose that in August, Engineering Co installs the machine. For simplicity, suppose that Engineering Co's obligations are now fully satisfied (in practice, it may have a remaining obligation for warranties). The exit price of Engineering Co's contract asset now increases to CU2,000, representing the amount a market participant would pay for the customer's promise of CU2,000. The increase in the contract asset of CU500 (ie CU2,000 – CU1,500) is recognised as revenue.

31. If the customer has prepaid, the contract liability decreases as the entity satisfies the obligations in the contract by providing goods and services to the customer. This is because, all things being equal, as the entity satisfies its obligations, the price that the entity would have to pay a market participant to assume the remaining unperformed obligations in the contract would decrease. The resulting decrease in the contract liability meets the definition of revenue.

Suppose that in the above example, Customer prepays the contract price of CU2,000 on 30 June. In this case, immediately after contract inception, Engineering Co has obligations to provide, deliver and install the machine and has no remaining rights. Engineering Co would therefore recognise a contract liability of CU1,600 on 30 June.

Suppose that on 31 July, Engineering Co delivers the machine to the customer. Further suppose that after delivering the machine to Customer, the exit price of Engineering Co's contract liability decreases to CU500 at that date, representing the amount a market participant would charge to install the machine. The decrease in the contract liability of CU1,100 (ie CU1,600 – CU500) is recognised as revenue.

Suppose that in August, Engineering Co installs the machine. For simplicity, suppose that Engineering Co's obligations are now fully satisfied (in practice, it may have a remaining obligation for warranties). Engineering Co's contract liability is now extinguished. The decrease in the contract liability of CU500 (ie CU500 – CU0) is recognised as revenue.

32. Hence, applying the above principles would result in revenue (as defined in paragraph 5) being recognised in the accounting period in which it arose, measured at the exit price of the changes in the contract asset or liability on the

date that those changes arose. Note that the amount of revenue recognised in each reporting period was not measured independently. Rather, it was derived from the change in the exit price of the contract asset or liability. And because the exit price of the contract asset or liability, is a current value measurement, revenue therefore reflects the value of the goods and services that have been provided to the customer *at the date they are provided*. Memo 99 considers further the implications of this.

When are contractual obligations satisfied?

33. Contractual obligations are satisfied when an entity no longer has an obligation to transfer an economic resource in the future. This occurs when the entity either transfers the economic resources called for in a contract (whether a good, service, or refund of the original consideration), when the entity is forgiven or otherwise relieved of the obligation by the customer or court action, or when the entity legally lays off the obligation whereby the customer no longer has any claim against the entity. Typically, an entity will satisfy its obligations to a customer by transferring the goods and services called for in the contract.

34. In that regard, there is often a direct connection between the point at which an entity's obligation is satisfied and the point at which the entity transfers an asset or resource (and derecognises that asset if it was previously recognised). This is because in some cases the obligation is satisfied by transferring an economic resource to the customer that was previously a recognised asset of the entity. Therefore, an obvious approach to determine when an obligation is satisfied is to determine when the entity transfers an asset or otherwise provides an economic resource to the customer. This will be when the entity cedes control of those assets or economic resources.

35. Under this approach, an obligation to provide a good is satisfied when an entity passes possession of it to the customer and the good is no longer the entity's asset.

36. In some cases, the entity may retain physical possession of the good even though the good no longer is an asset of the entity. For instance, in a 'genuine' bill and hold arrangement, the customer might be regarded as controlling the asset because it controls the right to use the asset, even though it does not currently have physical possession of the asset. In contrast, the entity might be regarded as having ceded control of the asset because it no longer has the ability to direct the use and benefit of the good. The entity cannot, for instance, use the good to fulfil other contracts. In effect, the entity would be providing custodial services to the customer over the *customer's* asset.

37. In the case of many contracts to provide services, an obligation will be satisfied continuously as the entity renders the services. This is because the entity is continuously transferring assets (in the form of services) to its customer.

Suppose that on 31 December 2007, Cleaning Co enters into a contract that requires it to clean a customer's offices each work day for a year.

> This contractual obligation is satisfied continuously as Cleaning Co provides the cleaning services. For instance on 31 March 2008, Cleaning Co has an obligation to provide cleaning services for nine months rather than an obligation to provide services for a year. Hence, the contractual obligation is satisfied continuously over 2008.

38. Some of the more troublesome examples in revenue recognition are contracts in which an entity is creating an asset for a customer under contract. In some cases, the entity is producing the asset (eg manufacturing a good) for *eventual* transfer to the customer. In such cases, the entity does not cede control of the asset until the asset is actually transferred to the customer. This is because the entity is largely free to direct the use and benefit of the good until it delivers the good to the customer.

> Suppose that on 1 May Engineering Co enters into a contract with a customer for the provision of a machine. The contract specifies that the machine will be transferred to the customer on 1 August, which is when payment is due. Engineering Co manufactures the machines to fulfil specific customer orders, and has partly completed the manufacturing on 30 June.
>
> On 30 June, Engineering Co has:
>
> - a *contract asset* from its remaining unperformed rights (to the customer's promise of payment) and obligations in the contract (to provide a machine)
> - an inventory asset in the process of production.
>
> Between 1 May and 1 August, there is no change in the remaining unperformed rights and obligations in the contract. This is because the output from entity's manufacturing process does not transfer to the customer and therefore satisfy the entity's obligation until 1 August.

39. The point to note in this example is that Engineering Co's production process does not in itself satisfy its contractual obligation. Therefore, when the machine is partly constructed, the obligation is *not* partly satisfied. The obligation is satisfied only when Engineering Co cedes control or otherwise ceases to direct the use and benefit of the machine by transferring it to the customer on 1 August.

40. In other cases, assets transfer to the customer throughout the production process so that the contractual obligation is satisfied continuously.

> Suppose that on 1 May Builder enters into a contract to build an extension to a building on the customer's land. The contract is expected to be completed on 30 September. The customer is required to prepay.
>
> On 30 June, Builder has:
>
> - a *contract liability* from its remaining unperformed obligations in the contract.

> In this case the outputs from Builder's production processes are transferred continuously to the customer because they become the customer's property as they are installed on its land. Therefore, the contractual obligation changes continuously. For instance, the contract liability at 30 June arises from Builder's obligation to provide the *remaining* construction materials and services.

41. The point to note in this example is that, in contrast to the previous example, Builder cedes controls of assets (construction materials and services) throughout the period of 1 May to 30 September. Hence, its obligation is satisfied continuously. It is the transfer of assets (goods or services) to the customer that signifies the satisfaction of an obligation.

42. This distinction between the two examples in paragraphs 38 and 40 is troubling to some. They argue that, in the example in paragraph 38, it might be appropriate for Engineering Co not to recognise the asset arising from its rights to the partly constructed machine, because it is being constructed to fulfil a specific contract. This is particularly the case if the asset is also constructed or adapted to the customer's specification. In other words, the partly constructed machine is deemed to be an asset of the customer rather than of Engineering Co, with Engineering Co simply providing physical custody of the machine until it is transferred to the customer on 1 August. As a result, the contractual obligation is deemed to be satisfied as Engineering Co builds the machine.

43. In addition, some observe that it is appropriate for Engineering Co not to recognise the partly constructed machine as an asset, because it has an enforceable contract. Hence, if Customer sought to breach the contract, then Engineering Co would seek monetary damages to put it in the same position as if the customer had not breached the contract. For instance, Engineering Co may use the partly constructed machine to fulfil another contract and seek compensation from the original customer to cover any loss of profit (say, because the second customer pays a lower price).

44. In response to these arguments, the following points should be noted.

    - Until 1 August, Engineering Co controls the *present* rights to the machine. It may fully intend that machine to be transferred to the customer on 1 August, but it is under no obligation to do so. It could, for instance, redirect the partly constructed machine to satisfy a contract with another customer. In extremis, it could sell the machine to another customer and breach the original contract. Hence, deeming the partly constructed machine to be the customer's asset rather than the entity's treats the transfer of the completed machine as if it were a *fait accompli*.

    - Engineering Co's present rights to the machine are apparent in other ways. For instance, it could use the work in progress as collateral for financing. It could enter into a sale and repurchase agreement with another engineering company under which that company completes the machine and sells it back to Engineering Co before 1 August.

Engineering Co would not require the permission of the customer to undertake any of these actions.

- Even if Engineering Co were obliged to transfer the particular machine on 1 August (rather than *a* machine), the machine is still its property until that date. Suppose for instance, that instead of a machine, the contract related to an item of real estate. In this case, the contract would be specifying a specific asset to be transferred. Nonetheless, until title to the asset transfers, it would remain an asset of the seller.

- The amounts that Engineering Co would seek to recover in the case of breach are to compensate it for impairments in the value of either or both the contract asset and the inventory that might arise at the time of breach.

- Even if the customer would be required to pay in full for the partly constructed machine in the event of breach and, say, could elect to take ownership of the machine, it does not follow that Engineering does not have the *present* rights to the machine before breach and that the customer has those present rights. The customer's only asset under the contract until 1 August is in the form of a call option. It is not a present right to the (partly constructed) machine itself.

- It can be very difficult to determine what *would* happen in the case of breach of contract, because it would be dependent on all of the facts and circumstances exiting at the time of breach. Developing principles around consideration of breach might be difficult to operationalise.

45. In the measurement model, the contract with the customer is considered to be an important economic phenomenon. Hence, the accounting should faithfully depict that economic phenomenon. Said another way, the accounting should not set aside the rights and obligations in the contract and account for a different set of rights and obligations. Therefore, the accounting of the contract in paragraph 38 should not portray that the obligation is being satisfied as the machine is being built and that the rights to the machine are thereby transferred continuously to the customer. Doing so would result in the statement of financial position not being a faithful depiction of the entity's assets and liabilities, which would diminish the reliability of the financial information.

Conclusion

46. The foregoing discussion section has only briefly discussed the issue of when a contractual obligation is satisfied. Nonetheless, it highlights the importance of this issue in a contract-based revenue recognition model and therefore that a prerequisite to implement this model would be guidance to assist entities in determining when contractual obligations are satisfied.

47. The tentative conclusion from this section is that in the usual situation in which an entity satisfies its obligations by providing goods and services, a contractual obligation cannot be considered satisfied until the entity cedes control of the economic resources called for in the contract. This will be when

the entity no longer has the ability to direct the use and benefit of those resources.