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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

ARG Meeting: **November 2007, London**

Project: **Revenue Recognition: Customer Consideration Model Summary**
(Agenda Paper 3A, Appendix B)

INTRODUCTION

1. In this model, revenue arises from recognising increases in specified assets and decreases in specified liabilities rather than from a separate evaluation of how much performance occurred in a period. In other words, the amount of revenue to be recognised is determined by how much assets and liabilities change in a period.

2. The specified assets and liabilities in this model are those that arise directly from enforceable contracts with customers. A contract can be either an asset or a liability to the entity, depending on the remaining unperformed rights and obligations in the contract. A contract would be an asset (a contract asset) to the entity if the remaining unperformed rights exceed the remaining unperformed obligations. A contract would be a liability (a contract liability) to the entity if the remaining unperformed obligations exceed the remaining unperformed rights.

3. To measure the contract, the underlying rights in the contract are measured at inception at the amount promised by the customer (often referred to as the customer

consideration) That amount is then allocated to the separate performance obligations identified within the contract based on the sales price of the good or service underlying each performance obligation. Therefore, the sum of the identified performance obligations always equals the customer consideration at inception. Because the model is predicated on this allocation of customer consideration to the performance obligations, it is described as the *customer consideration model*.

4. Because the customer consideration amount is allocated to the identified performance obligations, the sum of these performance obligations and the measure of the rights are equal at inception. Thus, the measure of the contract at inception is typically zero—neither an asset nor a liability arises at contract inception.

5. As each performance obligation identified in the contract is satisfied, the resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

WHAT IS REVENUE?

6. **Revenue is the decrease in contract liability, or increase in contract asset, that results from an entity satisfying its performance obligations.**

7. **Performance obligations are the enforceable promises an entity makes within a contract to provide goods and services to a customer. The change in the contract asset or liability that results from the satisfaction of these performance obligations gives rise to revenue. This satisfaction takes place when the goods and services specified by the contract are transferred to the customer.**

WHAT ASSETS AND LIABILITIES ARISE FROM AN ENFORCEABLE CONTRACT?

8. **When an entity enters into an enforceable contract with a customer, it exchanges promises with the customer. The promises convey rights to the entity and impose obligations on it.**

9. The entity's rights under the contract represent the customer's promise to pay the consideration specified in the contract. The entity's obligations under the contract represent the customer's rights to goods or services from the entity.

10. The combination of the rights and obligations gives rise to a contract asset (where the value of the remaining unperformed rights exceeds the value of the remaining unperformed obligations) or a contract liability (where the value of the remaining unperformed obligations exceed the value of the remaining unperformed rights) that reflects the entity's net position in the contract. Increases in this asset or decreases in this liability, which result from the satisfaction of performance obligations, give rise to revenue as a residual.

Identifying the performance obligations in a contract

11. **The contract with the customer should be disaggregated into its separate performance obligations based on the goods and services being transferred under the contract.**

12. A good or service represents a potentially separate performance obligation if it is sold separately or if it could be bought and sold separately. Hence, if a contract requires the provision of a number of goods, each good potentially represents a separate performance obligation if that good is, or could be, sold separately. Similarly, where a range of services or rights is provided, each service or right potentially represents a separate performance obligation if it is, or could be, sold separately.

13. This approach identifies only the deliverables explicitly defined by the contract as performance obligations. There are also further, implicit services provided to the customer, for which the customer implicitly pays, but that are not explicitly part of the contract terms. For example, services provided prior to contract, such as sales demonstrations, are not performance obligations because they are not outstanding at contract inception.

14. Each good or service agreed between the entity and its customer has the *potential* to be a separate performance obligation.

15. There are two reasons why potential performance obligations would be accounted for separately.

- The settlement of the different obligations within a contract can occur at different times over the period of the contract. Separation of the obligations allows recognition of revenue when each separate obligation is satisfied.

- It is easier to ascertain whether an obligation has been satisfied if it is considered in isolation. The identification of performance obligations is, therefore, a tool for identifying when a performance obligation is satisfied.

16. However, to be identified as a separate performance obligation, the underlying good or service must be capable of separate satisfaction within the terms of the individual contract. There will be some cases in which the potential performance obligation is not separately satisfied because the goods and services are not transferred separately.

17. For example, an entity may find a specific type of gravel for a customer and wash and grade it prior to delivery. While finding, washing, and grading the gravel are all services that will benefit the customer and could be sold separately as finding services, washing services or grading services, *in this particular example,* they do not transfer separately. They all transfer on delivering the gravel to the customer. Therefore, in this example, there is only a single performance obligation (or unit of account): delivery of special, washed and graded gravel.

Which obligations are not performance obligations?

18. One view, not reflected in this model, is that *any* obligation that arises to the customer as a result of a contract should be recognised as a performance obligation. Under this view any such obligations would be identified as performance obligations at inception and revenue attributed to them.

19. Under this model, however, performance obligations are restricted to those benefits agreed upon by the entity and its customer and included within the terms of the contract. Other obligations may be incurred at the same time as a customer contract, but are excluded from performance obligations.

20. Such ancillary obligations share several characteristics:

    a. The obligation is not specified within the customer contract. Its terms are outside of the contract with the customer.

b. The obligation arises outside the contract and is not directly related to the good or service transferred under the contract; and

   i. The obligation relates to a future, possible transaction.

   ii. The future transaction and the satisfaction of the obligation are both at the customer's instigation.

   iii. The obligation adjusts the price of these future transactions.

21. Ancillary obligations, above, include the promotional offerings that give the customer the option of transacting a future, second transaction, usually at a favourable rate. An example of this would be a discount voucher against future purchases. These are excluded for the points noted above.

22. In addition, issuing these vouchers to a customer often may create an intangible benefit. Future benefits will flow to the retailer when the discounted future sale occurs. To account for the future performance obligation while ignoring the intangible customer asset does not represent this transaction completely or, therefore, faithfully.

23. These ancillary obligations may be recognised as liabilities in accordance with IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* or FAS 5 *Accounting for Contingencies* in accordance with local practice.

24. The future customer benefits *will* represent performance obligations when the entity and its customer have entered into a separate contract covering them. For example, when a customer joins the entity's loyalty reward scheme, this represents a separate arrangement. The entity is obligated to perform this service for the customer under the terms of the loyalty agreement. All subsequent purchases made by the customer under the loyalty scheme will attract some revenue, therefore.

MEASUREMENT OF THE RIGHTS AND OBLIGATIONS

25. **The contract rights are measured at the amount of contract consideration stated in the contract. This takes into account the customer's credit risk as well as the time value of money. This amount is referred to as the customer consideration.**

26. **The contractual obligations are not measured directly. Instead, the customer consideration is allocated to the individual performance obligations pro rata based on the separate selling prices of each underlying good or service. As a**

result, the total remaining performance obligations at contract inception are measured at an amount equal to the customer consideration.

Why allocate the customer consideration amount to performance obligations?

27. In any exchange between two rational parties, it is assumed that the parties are giving and receiving items of equal value. This is the assumption with this model. However, some of what the entity gives, and the customer receives, occurs before contract inception. In the exchange with the customer, the entity provides benefits both before (for example, through knowledgeable sales demonstrations) and after contract inception. The amount of consideration promised by the customer takes into account the services received prior to contract because the selling price includes an amount to recover these costs.

28. These services provided prior to contract inception are not easily measured. Many of the performance obligations themselves are sometimes just as difficult to measure. Because of these inherent measurement difficulties, the customer consideration model takes the easily observed and immediately available customer consideration amount and allocates it only to the remaining goods and services in the exchange that are identified in the contract. The customer consideration amount is allocated only to the performance obligations in the contract simply because it is a cost-beneficial, reliable substitute for an explicit measurement of the remaining obligations.

Allocation of consideration

29. The allocation of consideration should be based on the most reliable information available of how the bargained price was calculated. These estimated sales prices are specific to the contract and specific to the time of the transaction.

30. The hierarchy of entity-specific entry prices, from most reliable to least reliable, is as follows:

- Level 1 - Current sales price charged by the entity itself in an active market
- Level 2 - Current sales price charged by the entity in an inactive market
- Level 3 - Current sales price of competitors in an active market
- Level 4 - Estimates of sales prices using entity inputs that reflect the entity’s own internal assumptions

31. Once the standalone sales price of each performance obligation is assessed, any difference between the sum of the obligations and the total contract value needs to be allocated across the obligations. This residual amount is allocated to each performance obligation pro rata based on the estimated sales price of the performance obligation as a proportion of total customer consideration.

32. In a contract with multiple elements in which a performance obligation has an observable quoted price in an active market, that performance obligation would be recorded at fair value and no part of the residual would be allocated to that obligation.

33. As the full amount of customer consideration is allocated only to the identified performance obligations, there is no initial unallocated customer consideration. Therefore, no revenue arises at contract inception under this model.

No re-measurement of performance obligations

34. **Performance obligations are subsequently measured at the amount of the customer consideration allocated to them at contract inception. They are not re-measured, except when the contract is onerous.**

35. The customer consideration amount is only observable at contract inception. After that point, the price for the remaining obligations in the contract would rarely be observable and, therefore, could not be ascertained.

Loss making contracts

36. Both at inception and where economic circumstances have changed, there would need to be an onerous contract test to ensure that the performance obligations are not understated.

Tension with IAS 37

37. IAS 37 measures all non-financial liabilities, both at initial and subsequent recognition, at the amount required to settle the obligation at the reporting date. This measurement would be similar to the current lay-off price. The customer consideration model proposed would not measure the remaining contractual obligations consistently with IAS 37. Instead, this model allocates the customer

consideration measure to the performance obligations in a contract. This will differ from the current treatment of other non-financial liabilities as stated in IAS 37.

38. Discussions during the development of the model concluded that this difference in measurement was appropriate. The liabilities that would remain in IAS 37, such as litigation obligations, have no readily available alternative measure. Measuring them at the lay-off price reflects the uncertainty inherent in their outcome. Performance obligations, on the other hand, have a fairly reliable and immediately available means of measurement using the customer consideration amount. Furthermore, in many situations, an entity would not be able to lay-off the obligations, for instance, if no other party could perform the contract or if there is no right of novation. In such cases, a lay-off price would not represent a real-world aspect of the contract.

ACCOUNTING FOR THE CONTRACT WITH THE CUSTOMER

At contract inception

39. **At contract inception the contract as a whole is measured at zero.**

40. At inception, the rights and obligations are both equal to the total customer consideration amount, so no contract asset or contract liability is recorded at contract inception unless the contract is judged to be onerous.

After contract inception

41. **Revenue is recognised when the contract liability decreases, or the contract asset increases, as a result of the entity satisfying its performance obligations.**

42. As the contract progresses, sales invoices are issued in line with the terms of the contract. The contract right is converted into a receivable or debtor, which is, in turn, converted into cash as the invoices are paid. These changes in this right do *not* give rise to revenue.

43. The performance obligations identified in the contract are satisfied individually as the contract progresses. At each reporting period, the entity will need to ascertain whether the obligations have been satisfied or not. As these obligations are satisfied, the

resulting decrease in the contract liability or increase in the contract asset results in the recognition of revenue.

Identifying when goods and services transfer

44. **The performance obligations are satisfied when goods and services transfer from the entity to the customer.**

45. The obvious, clear indicator that transfer has taken place occurs when legal title transfers. This is an absolute indicator that the rights and obligations of ownership have transferred. However, for many transactions these risks and rewards will transfer in advance of legal title.

46. To assess whether the good or service has transferred, an entity needs to consider who has the following rights and obligations:

    a. Who has physical possession
    b. Who has the ability to use
    c. Who can control or direct the benefit
    d. Who would be deemed to have control in a terminated transaction
    e. Who bears the insurance risk
    f. Who has the ability to pledge
    g. Who bears technical or obsolescence risk
    h. Who bears the risk of loss or destruction
    i. Who bears the risk of price changes

47. These rights and obligations together reflect an everyday idea of ownership or control. Where the majority of rights and obligations has transferred to the customer, the performance obligation will have been satisfied. Where the balanced view is that the majority have been retained, the benefit has not transferred and the performance obligation has not been satisfied. In this situation, no revenue is recognised.

48. ***Goods***. A principal indicator of the transfer of a good to the customer is physical delivery of the good to the customer’s premises. At this stage the customer usually acquires physical control of the good, the ability to use it, pledge it, and resell it. The entity, in turn, can be seen as having satisfied its performance obligation.

49. ***Services***. The benefit of a service provided to the customer transfers as the service is rendered by the entity.

50. Where a service is rendered on the customer's goods, the transfer of benefit is immediate and revenue is recognised as the obligation is progressively satisfied by performance. In a building construction contract on the customer's site, a small increment of the obligation is satisfied as each brick is laid. The performance obligation is not being re-measured as it is satisfied, but rather may be thought of as a series of tiny, identical obligations, each of which is measured at inception at the same amount and satisfied separately as the benefit transfers.

51. However, where the service is not performed on the customer's good or directly for the customer, the question arises—is the entity supplying *its good* to a customer or is it providing *a service* to the customer to create the customer's own asset?

52. Indications that a service is being provided, rather than a finished good delivered, would include:

- The customer controls the unfinished inventory (work in progress or WIP). Indicators that the entity has transferred control include:

    a. The asset is constructed on land owned by the customer.

    b. The customer has the right to take over the WIP.

    c. In the event of termination, the customer retains the WIP and the entity has the right to be paid for it.

    d. Title passes as the asset is built.

- Further indicators that an entity would be compensated for WIP arise from customisation. It is not customisation per se, however, that suggests the good is the customer's from the outset. It is the fact that the operation of law or an explicit statement in the contract makes the good the customer's from the beginning. In the absence of such a statement or operation of law, an entity is taking the risk that the customer could simply walk away from the contract.

53. Where a construction service is provided, it will normally be expressed as a number of separate performance obligations, representing how the service as a whole is performed. The construction of a house will include laying the foundations, building the frame, cladding the frame, and fitting the electrics and plumbing. All of these services *could* be sub-contracted or sold separately. Each is a potential separate performance obligation. As each is satisfied, revenue is recognised

54. The level of separation the entity goes to will depend on both the sensitivity of timing (for example does the contract span a year end) and on its method of control and management of the contract. Where costing structures and responsibilities are segregated, the disaggregation of performance obligations will reflect that level of separation.

55. In practice, the identification of separate performance obligations and ascertaining their satisfaction will not be burdensome for many contracts. Satisfaction takes place instantaneously in many transactions. For example, in the case of a retail transaction, the transfer of the goods and services and the satisfaction of the obligation is both simultaneous and instantaneous. The existence of the performance obligation is not noted by observers nor is it recorded separately by the retailer.