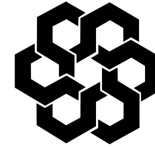

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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: **January 2008, London**

Project: **Revenue Recognition**

Subject: **Customer Consideration model – Measurement (Agenda paper 2B)**

INTRODUCTION

1. Memo 96 / Agenda Paper 4B, presented to the Boards in November, explained how the rights and obligations in a contract give rise to a contract asset or contract liability under both models being developed within this project. The next issue to consider is how that contract asset or liability should be measured. This is because the amount of revenue that is recognised, and consequently the amount of profit or loss that is reported, depends on how the contract asset or liability is measured. In November and December, measurement was considered in the Measurement model; this paper looks at measurement of the rights and obligations in the Customer Consideration model.

2. This paper begins by considering the reasons for developing a revenue recognition model in which the initial measure of the rights is allocated to the obligations (paragraphs 3–23). It next explains why the amount of customer consideration, or transaction price, has been selected as the measurement approach of this model (paragraphs 24–33). It then explains how the customer consideration amount is allocated to identified performance obligations (paragraphs 34–52). Finally, it explains that performance obligations are not re-measured subsequently, unless the contract becomes onerous (paragraphs 53–62).

MEASUREMENT AT CONTRACT INCEPTION

3. **The contract rights are measured at the amount of contract consideration stated in the contract. This amount is referred to as the customer consideration.**

4. **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 performance obligations at contract inception are measured at an amount equal to the customer consideration.**

How are rights and obligations measured initially?

5. Under the Customer Consideration model, the rights within a contract are measured at the amount of consideration promised by the customer, with adjustments for the time value of money if significant.

6. The consideration promised by the customer is typically readily observable within the contract. Because the customer consideration is typically observable, the measurement of the rights is fairly straightforward and readily verifiable.

7. *(Staff are currently considering what effect credit risk should have on the measurement of the rights. Some staff think that the initial measurement of the rights should reflect the customer's credit risk and would therefore propose that the contract rights be measured at fair value.)*

8. In contrast, the measurement of the obligations within a contract is not so straightforward. There are at least three potential bases that could be used to measure the contractual obligations:

   - the separate selling prices of each promised good or service
   - the lay-off prices of each promised good or service
   - an allocation of the customer's promised consideration.

Obligations measured at separate selling prices

9. The first potential basis on which to measure contractual obligations to a customer is the price at which the underlying goods and services sell separately (or would sell if ever sold separately). In most cases, this price is well known to the entity or could be estimated with relative ease using pricing approaches already familiar to the entity. Moreover, measuring obligations at the separate selling price of the underlying goods or services would be easily understandable to investors and other financial statement users.

10. However, measuring each promised good or service at its separate selling price is problematic because the sum of the separate selling prices for those goods and services is likely to exceed the promised consideration from the customer. This occurs because an entity typically sells a package of goods and services for less than it would sell the same goods and services separately.

Because the sum of the separate selling prices typically exceeds the customer consideration amount in the contract, a difference between the measure of the rights and the measure of the obligations would result in recognising a contract liability at inception and a related loss. To recognise a loss, on what is usually seen as a positive event, would not represent a faithful depiction of the entity's position.

Obligations measured at lay-off prices

11. Another potential basis on which to measure the obligations is the price the entity would pay another party to legally assume the obligations. For most contracts, this so-called lay-off price would be less than the promised consideration from the customer because some of the consideration received is meant to cover pre-contractual activities to obtain customers such as advertising or sales commissions—activities the third party assuming the obligations would not have to undertake.

12. The lay-off price may also be less than the consideration promised by the customer because the customer may have different information or perception of the costs or risks involved in satisfying the obligation. That is the lay-off price may be less because the customer is not actually a participant in the entity's market. Customers may also pay more than the lay-off price for irrational reasons such as the peace of mind that warranty coverage may provide. In either case, because the lay-off price of the obligations is typically less than the promised consideration, a difference between the measure of the rights and the measure of the obligations would result in recognising a contract asset and a related gain (or revenue).

13. Although obtaining a contract is usually considered a positive event for an entity, many would be uncomfortable recognising a contract asset and a gain at contract inception for a variety of reasons.

14. First, the a faithful representation of the initial contract asset and gain depend almost entirely on having accurately identified and measured of all obligations in the contract. Any error in identifying or measuring these obligations affects the asset and gain recognised at inception. Because most obligations to customers lack readily available and observable lay-off prices, the chance of error and even abuse when measuring these obligations is substantial.

15. Secondly, many would be uncomfortable recognising a contract asset and a gain at inception because the need to measure the obligations at a lay-off price implies that the obligation can actually be laid off. For many obligations, it is contractually or economically impossible to lay off the obligation. Estimating a lay-off price in such situations is an attempt to measure an attribute of the obligation that does not exist. Hence it is not clear whether investors and other financial statement users would regard this measurement as relevant.

16. Finally, some would oppose the recognition of a contract asset and a gain at contract inception because they do not think such an asset and a gain (or revenue) can arise before the entity actually satisfies an obligation required in the contract itself. That is, some think that a contract asset and a gain (or revenue) cannot arise until one or more contractual obligations are satisfied.

Although there may be many reasons to delay the *recognition* of a contract asset and its associated gain (or revenue), the contract itself could represent an asset to the entity before one or more obligations are satisfied. Consequently, this model does not rely on this argument to reject the lay-off price measurement basis for performance obligations.

Obligations measured at the customer consideration amount

17. Another potential basis on which to measure the obligations is the consideration amount promised by the customer. That is, the entire set of contractual obligations can be measured initially at the same amount as the rights are measured. The customer consideration amount would be allocated to the identified performance obligations based on some systematic approach. A pro rata allocation based on the separate selling prices of each underlying good or service would be consistent with much of the existing literature.

18. Supporters of a customer consideration measurement approach articulated a number of views in support of this basis. One view relies on the assumption that in an exchange between two willing, rational parties, each party gives and receives something of equal value. If a contract embodies the exchange between an entity and its customer, then the consideration promised by the customer would have to be equal to the value of the goods and services promised by the entity. Thus, a possible measurement basis for the obligations (in total) is the customer's promised consideration, and this total amount of consideration is allocated to performance obligations in order to identify what part of the total consideration had been exchanged for each obligation.

19. Some object to this "equal exchange" view arguing that a contract rarely embodies the *entire* exchange between an entity and its customer. That is, some of what an entity gives and the customer receives in an exchange occurs before a contract is created. For example, in an exchange with a customer, an entity provides benefits both before (for example, through knowledgeable sales demonstrations) and after a contract is formed. The price the customer is willing to pay (that is, the customer consideration amount in a contract) clearly takes into account the customer's perception of the value of these pre-contractual services. To assume that the promised consideration is somehow a representation of the value of the goods and services promised in the contract is to ignore the value the customer places on any pre-contractual services received. Those who make this argument reject the "equal exchange" assumption for using the customer consideration measurement approach.

20. Nonetheless, in developing the Customer Consideration model, these pre-contract services are excluded from the accounting because it is difficult, if not impossible, to know which pre-contract services should be included. Appliance salesmen who demonstrate their wares may provide a benefit to customers but then so would free parking and a central location. If some pre-acquisition costs and activities were included as part of the contract accounting, what criteria could be applied to decide which were included and which were excluded? It might be easy to conclude that a salesman's commission was a specific service to the customer, once the contract was agreed, but what of that effort which went into designing the sales brochure

that he used to clinch the deal or the expense of renting an adjacent parking lot for visitors to the shop?

21. There are some who would say the salesman's activities are closely enough related to the contract to attract revenue. In contrast, the effort to create the sales brochure, which might have happened months before, is not closely enough related to the contract to attract revenue. Any approach that identified pre-contract activities as suitable for attracting revenue would be likely to require prescriptive guidance to ensure a common approach to their identification. Such guidance would be inconsistent with principles-based standard setting. The arbitrary nature of any boundary that would be used to identify pre-contract activities for inclusion caused proponents not to attribute revenue to any of these activities.

22. A second view supporting the customer consideration measurement approach appeals less to the economics of contracts and more to the notions of verifiability and cost-benefit constraints. This argument accepts that explicit measurement of contractual obligations using a lay-off price makes sense in concept. However, given (a) the difficulty of completely identifying all performance obligations in a contract, (b) measuring the lay-off prices of those obligations in a way that can be reasonably verified, and (c) the questionable usefulness of lay-off prices when most obligations will not or cannot be laid off, proponents argue that a lay-off price is not worth the additional costs it would impose.

23. In the face of these difficulties, this model proposes the customer consideration amount as an understandable, readily available, cost-beneficial number that can be used to calibrate the measurement of all contractual obligations. By allocating the customer consideration amount to identified obligations based on the separate selling prices of each underlying good or service, this measurement approach avoids the incremental cost inherent in measuring lay-off prices and reduces the scope for error and abuse in measuring the obligations. In the majority of customer contracts, this will mean that the rights and the obligations are both measured equal to the customer consideration amount, with no contract asset or liability recognised at inception.

Other advantages of the Customer Consideration approach

24. There are a number of other perceived advantages in using the Customer Consideration approach, or transaction price, to calibrate the measurement of the performance obligations. For instance, using the customer consideration amount as the measurement is familiar and understandable to users. There is a long history of accounting transactions being measured at the transaction amount. Users of financial statements understand what revenue in the profit and loss represents when it equals the amount of customer consideration received or receivable. Of course, there is a downside to familiarity as well. The fact that users and preparers may be familiar with the Customer Consideration approach may make it difficult for users and preparers to grasp the conceptual emphasis on changes in assets and liabilities.

25. Another advantage is that users of financial statements are used to interpreting the amounts that are currently recognised for revenue and adjusting them for any further "what if" or trend analysis required. A transaction price is also not based on any valuation techniques that may be difficult for non-specialists to understand.

26. Another advantage (already alluded to above) is that the customer consideration amount is readily observable for each individual contract (and thus is directly measureable). This observability benefits preparers for whom the amount is readily obtainable. If the customer consideration amount is used, there is no need to make assumptions or use inputs that are not readily observable, which would be the case when dealing with a contract for which there is not an observable market – that is, in most revenue transactions. Using the Customer Consideration approach also aids compliance and eases audit verification as complex calculations or modelling approaches are required to a lesser extent (that is, only when a separate selling price must be estimated because an obligation is never sold separately).

27. As another advantage, some argue using the allocated transaction price is likely to be a more faithful representation of the entity's own specific future costs and expectations of reward than would a market based measure.

28. Finally, use of a verifiable customer consideration amount has an anti-abuse benefit in that it calibrates the measurement of the set of performance obligations to the observable contract price thereby reducing the risk of a deliberate misstatement of those obligations.

Exception for readily observed lay-off prices in active markets

29. The only exception to this transaction measurement approach would be when the good or service promised is traded on an active market with readily observable prices (such as the case with gold and other commodity-like goods).

Tensions with IAS 37

30. It is important to note that measuring performance obligations at the customer consideration amount is inconsistent with the measurement basis required for non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 requires all non-financial liabilities within its scope to be recognised at the amount required to settle or transfer the obligation at the reporting date. Although there is some ambiguity in the articulation of the measurement approach in IAS 37, its measurement is similar to a current lay-off price.

31. Proponents of the Customer Consideration model are not troubled by this inconsistency. For many non-financial liabilities under IAS 37, there is no readily available alternative basis on which to measure the liability.

32. For example, in a lawsuit against an entity, there is no observable transaction price for which the entity obligated itself to the outcome of the lawsuit. As a result, there is a limited set of measurement attributes that could be chosen—

either no recognition of the liability at all or an explicit measure of some attribute of the liability (eg the amount that would be required to settle the obligation today.)

33. In a transaction with a customer, an entity obligates itself to transfer goods and services in the future. The overall transaction price (that is, the customer consideration amount) serves as a readily available, cost-beneficial measure of these performance obligations. Proponents of this model, therefore, see no need to directly measure the performance obligations.

ALLOCATION OF CUSTOMER CONSIDERATION

34. This section describes how the customer consideration is allocated to the identified performance obligations in the contract. Note that the identification of performance obligations is discussed in Agenda Paper 2C.

35. Given the arguments in the previous section, the Customer Consideration model proposes to allocate the customer consideration amount to the identified performance obligations in the contract. This allocation is done pro rata based on the entity's own separate selling prices (observed or estimated) for the promised goods and services.

36. Note that the allocation of customer consideration could have been done pro rata based on the separate lay-off prices for each obligation. However, for the same reason that lay-off prices were rejected as the measurement for the performance obligations, this model would not allocate consideration based on lay-off prices.

37. The allocation to each obligation should be based on the most reliable selling price information available. Typically, this will be the price at which the entity currently sells the promised goods or services separately. If the entity does not sell the promised good or service separately, the entity should review the price its competitors charge for that good or service when sold separately. Finally, if neither the entity nor its competitors sell the good or service separately, the entity should estimate the price at which it would sell the good or service separately. This hierarchy of reliable selling prices is summarised as follows, from most reliable to least reliable:

    - *Level 1* - Current sales price charged by the entity itself (in an active or inactive market)
    - *Level 2* - Current sales price charged by competitors (in an active or inactive market)
    - *Level 3* - Estimate of sales price the entity would charge using its own pricing practices and internal assumptions

38. When estimating a Level 2 sales price, the entity could make use of a competitor's sales price, but re-calibrate that price to reflect the entity's own presumed sales price. For example, if the competitor is known to charge a premium compared with the entity itself, an adjustment would need to be made to remove this premium in estimating the entity's own sales price.

Similarly if the competitor's prices are at a discount compared with those of the entity, an adjustment would be required to remove the discounted effect.

39. Note that estimates of separate selling prices are allowed for purposes of allocating customer consideration. This would represent a significant departure from existing requirements in EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software Revenue Recognition*. These standards generally require objective and reliable evidence of the selling price of the good or service underlying a performance obligation for that obligation to be treated as a separate obligation.

40. Note also that the separate selling prices are not used as direct measures of the obligations, but instead are used as a basis for allocating the customer consideration amount. If the sum of the separate selling prices is more than the promised customer consideration (which will be the case in most situations), then the difference between the customer consideration and the sum of the selling prices is allocated to the obligations pro rata based on the separate selling prices determined above.

41. This method is illustrated in the following simple example.

> Outfitters is a long-established children's clothing shop. Each year they hold a special Back to School offer whereby a complete school uniform can be purchased for CU150. This package consists of two cotton shirts, a pair of woollen trousers and a blazer. These items can be purchased separately at any time for the standard price of:
>
> | | |
> |---|---|
> | Shirts (each) | CU25 |
> | Trousers | CU40 |
> | Blazer | CU90 |

42. A customer contracts with Outfitters to buy one uniform at the agreed price of CU150. Because the paper has not yet discussed how to identify separate performance obligations, assume for purposes of this example that each piece of clothing represents a separate performance obligation. How should the customer consideration be allocated to these performance obligations?

43. The sum of the separate selling prices is CU180, which exceeds the customer consideration of CU150. The difference of CU30 should therefore be allocated to the three separate goods as follows:

	Base	Allocation	Revised
Shirts [(50/180)x30]	50	-8	42
Trousers [(40/180)x30]	40	-7	33
Blazer [(90/180)x30]	90	-15	75
Total	180	-30	150

44. This means that if at the reporting date Outfitters has provided, say, the shirts and trousers to the customer, but not the blazer, it would measure its remaining obligation at the amount of customer consideration allocated to it, ie CU75.

45. Of course, the above is a very simple example in which the separate selling prices are readily observable. However, in more complex contracts, the separate sales price of the good or service underlying the performance obligation will need to be estimated. In such cases, although the total measure of the performance obligations is calibrated to the generally observable customer consideration amount, errors in the estimates of the individual obligations could affect profit or loss after initial recognition of the contract.

Caveat where the difference appears to be a premium

46. There is an important point to consider when allocating customer consideration. The expected situation, as in the above example, would be that most entities would provide a package of goods and services for an aggregate price that is *below* the price at which they would sell the goods or services separately. Otherwise, a rational customer would buy each component of the package separately. Entities commonly provide multiple goods and services, therefore, at a discount. This helps the vendor maintain market share and volume and reflects the fact that it is cheaper and more efficient to do additional work for existing customers rather than searching for new customers.

47. Given this expectation, it would be unusual for a customer to pay a premium above the sum of the separate selling prices of the promised goods and services. Therefore, if the sum of the separate selling prices is less than the customer consideration in the contract, this suggests that an unidentified service (for example, a performance obligation for contract management or a brokerage fee for access to a closed market) may have been omitted. If the difference between customer consideration and the sum of the separate selling prices represents a premium rather than a discount to the customer, care should be taken to ensure that all possible obligations have been identified.

Exception for readily observed lay-off prices in active markets

48. The allocation approach described above is the basic measurement approach for the Customer Consideration model. According to this approach, the customer consideration is allocated pro rata to all identified performance obligations based on separate selling prices of the underlying goods and services. However, there is an important exception to this approach when a promised good or service is traded in an active market with readily observable prices. In such cases, that obligation should be measured using this readily observed lay-off price and no additional amount of consideration should be allocated to it. After subtracting this lay-off price from the total consideration promised, the remaining customer consideration amount should be allocated to all other performance obligations.

49. In essence, this exception directly addresses the concern expressed by those who oppose a lay-off price measure for all performance obligations. It allows for the use of a lay-off price when the good or service is actively traded and the prices are readily observed. This exception is expected to be rare and would typically apply to commodity-like goods such as gold, oil, and some agricultural products.

Alternative allocation approach

50. Some have argued for a variation of the allocation approach described in this section. In this variation, part of the customer consideration would be recognised immediately as revenue to offset any direct contract acquisition costs (narrowly defined). This is similar to the "zero gross margin approach" permitted in SOP 81-1 *Accounting for performance of Construction-type Contracts.* As noted in paragraph 19, some of what an entity gives and the customer receives in an exchange occurs before a contract is created. In other words, some of the customer consideration could be regarded as compensation for activities undertaken before the contract exists.

51. If part of the customer consideration is allocated to such costs, the remaining amount of consideration allocated to the identified performance obligations is likely to be a more faithful representation of those identified performance obligations. Such an approach would require additional guidance to identify the permissible direct acquisition costs so that a sufficient amount of the customer consideration is allocated to the remaining performance obligations. Such guidance might be inconsistent with principles-based standard setting. It also would place greater stress on any onerous contract test at contract inception (see paragraph 60). Given these constraints, the Customer Consideration model proposes that all the customer consideration be allocated to the identified performance obligations, unless the price of the promised good or service is observable on an actively trading market (see paragraphs 48–49).

52. Having discussed the measurement approach used at contract inception, the paper next discusses how contractual rights and performance obligations are reported after contract inception.

MEASUREMENT AFTER CONTRACT INCEPTION

53. **The contract rights are measured after inception at the amount of promised consideration still to be received, adjusted for the time value of money.**

54. **The contract obligations (that is, performance obligations) are measured at the amount of customer consideration originally allocated to them at contract inception. Performance obligations are not remeasured except when the contract is judged to be onerous.**

Remeasurement of contract rights

55. The rights in a contract are remeasured at each reporting period to reflect the amount of promised consideration still to be received. This amount is adjusted to reflect the time value of money where significant. However, changes in the measure of the contractual rights do not affect the recognition of revenue. Only the satisfaction of performance obligations and the resulting decrease in the measure of total performance obligations lead to the recognition of revenue under the Customer Consideration model.

Remeasurement of performance obligations

56. As noted above, the performance obligations under the Customer Consideration model are not remeasured after contract inception unless the contract is judged to be onerous (an issue that will require attention later). Instead, the performance obligations are reported at the original amount of consideration allocated to them until the obligation is actually satisfied.

57. The Customer Consideration model could have chosen to remeasure existing performance obligations using a current measure of the amount of consideration that would be allocated to the same promised good or service in a current transaction for the same bundle of goods and services. This approach assumes that the original transaction would still have taken place at the current price, which made proponents of the Customer Consideration model uncomfortable. In the absence of current transactions for the same bundle of goods and services, the entity would also have to estimate what they would sell the same bundle for currently, assuming the customer would still have entered into the contract at the new price, and then estimate how it would allocate that estimated consideration based on the separate selling prices of those goods and services. Clearly, this would be a more complicated approach, and would probably not provide significantly more useful information to justify the increased expense.

58. As a result, the Customer Consideration model requires no remeasurement of performance obligations after contract inception (unless the contract becomes onerous). Instead, the measure of the remaining performance obligations in the contract changes only as obligations are satisfied. When such an obligation is satisfied, the measure of the remaining performance obligations decreases by the amount of consideration originally allocated to that obligation and thus increases the contract asset or decreases the contract liability. This leads to the recognition of revenue for the amount originally allocated to the obligations satisfied during the period.

59. It is worth noting at this point that the identification of performance obligations and how they are satisfied has not yet been discussed. This is a key issue because customer consideration can only be allocated to performance obligations capable of separate satisfaction. Thus, the purpose of the next paper is to describe how performance obligations are identified and how to determine when such performance obligations are satisfied.

Onerous contracts

60. Performance obligations under the Customer Consideration model will need to be remeasured upward if the economic circumstances surrounding the contract suggest that the contract as a whole will be loss making. That is, if total expected cash outflows under the contract (including prior cash outflows) exceed total expected inflows of consideration (including consideration received previously), the remaining performance obligations would be remeasured upward.

61. The particular details of this onerous contract test and the way in which performance obligations would be remeasured have not been discussed in

detail as yet. It is clear that such a test would need to be performed at inception and regularly throughout the life of the contract as is required in existing literature.

62. The obligation could be measured at the lay-off amount as required by IAS 37 or at expected future cash outflows as under other current literature. Which treatment should be recommended has not yet been agreed under this model.

CONCLUSION

63. This paper addressed the single issue of measurement in the Customer Consideration model. It explained why proponents of this model decided to measure the performance obligations in a contract at the customer consideration amount.

64. The next paper explains the importance of identifying performance obligations at contract inception under the Customer Consideration model. It provides a rationale for identifying those performance obligations and provides a number of examples to illustrate this rationale.