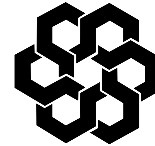

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International Accounting Standards Board

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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:	**22 July 2008, London**
Project:	**Revenue Recognition**
Subject:	**Measurement of performance obligations (Agenda paper 6B)**

INTRODUCTION

1. The purpose of this paper is twofold:

    a. to summarize the Boards' decisions in May 2008 regarding the measurement approach for a general standard on revenue recognition. The staff will ask the Boards to affirm these decisions and the rationale(s) supporting them so that they can be included in the discussion paper that will be published in the coming months.

    b. to clarify the circumstances in which the Boards would remeasure performance obligations after contract inception. The FASB expressed a preliminary view in which performance obligations would be remeasured *only* if they are deemed to be onerous. The IASB agreed that performance obligations should be remeasured if deemed to be onerous, but also suggested other circumstances in which a performance obligation might be remeasured. This paper seeks to clarify what those additional circumstances are in order to gauge how far apart the two Boards are on this issue. The information gathered in this month's meetings will help the staff determine how much time to allot for additional deliberations on this matter as the Boards move toward an exposure draft.

MEASUREMENT AT CONTRACT INCEPTION

2. From an entity's perspective, a contract represents inflows of payments from the customer (rights) and outflows of goods and services to the customer (obligations). To recognize a contract with a customer, the entity must measure those rights and obligations. The Boards have not discussed how to measure the rights in a contract, but the staff plans to ask the Boards to consider the issue in the third quarter of 2008.

3. Although the Boards have not discussed the measurement of rights, they have reached a tentative decision on the measurement of performance obligations. At contract inception (i.e., before either party has performed), performance obligations are measured equal to the transaction price in the contract.[1] This amount is often referred to as the customer consideration amount. Because both the rights and the performance obligations in the contract are measured equal to the transaction price, the contract is recognized at a net nil position at inception. Neither an asset nor a liability is recognized at the inception of the contract. Because there is no increase in a contract asset or decrease in a contract liability, no revenue is recognized at contract inception.

4. Although the Boards agreed to recognize a contract at a net nil position at inception, two different views exist as to *why.*

View A

5. Some Board members think that performance obligations (i.e. the outflows of goods and services) should be measured equal to the transaction price (i.e. the inflows of consideration) because the transaction price represents the negotiated price between a willing buyer and a willing seller. That is to say, because the transaction price represents the amount the customer is willing to pay for the goods and services to be provided in the contract, that price serves as a meaningful measure of the performance obligations in the contract.

6. These Board members also think an entity should not recognize revenue before it has provided a good or service promised in the contract—that is to say, before a performance obligation is satisfied. These Board members acknowledge that a contract with a customer may be an asset to the entity, but they do not think an entity should recognize revenue for the obtaining of a contract. The decision to measure performance obligations at the transaction price precludes revenue from being recognized for the obtaining of a contract.

View B

7. Other Board members agree that performance obligations should be measured at the transaction price in the contract, but for a different reason. Ideally, these Board members think that a performance obligation should be measured directly at the price to satisfy the performance obligations (i.e., a fulfillment price). This is because a fulfillment price (whether an exit price or an entity's

[1] The transaction price would likely be adjusted for the time value of money (if payments are made over an extended period of time) and customer credit risk. These adjustments relate to the measurement of rights, which the Boards have not yet deliberated.

own fulfillment price) measures only the remaining economic resources the entity is required to transfer to the customer. Said differently, they think that measuring the outflows in a contract should ideally be done by focusing directly on those future outflows rather than on the inflows, which they think are intended to cover both past and future outflows.

8. These Board members acknowledge that a fulfillment price measure for the performance obligations will typically lead to the recognition of a contract asset at the inception of a contract with a customer. Conceptually, this makes sense to these Board members because the focus of the proposed model is on contracts with customers. In concept, they think that revenue should be recognized when a contract asset increases (from the obtaining of a contract or the satisfaction of a performance obligation) or a contract liability decreases (from the satisfaction of a performance obligation).

9. However, although these Board members prefer a fulfillment price for these conceptual reasons, they think the costliness and complexity of estimating such a price is unjustified given that the transaction price in the contract is a relatively straightforward, observable, and reasonable proxy for a fulfillment price. Moreover, these Board members worry that any mistake in identifying and measuring performance obligations at contract inception would affect the amount of the contract asset and revenue that would be recognized. As a result, these Board members reject a fulfillment price measurement approach and conclude that at contract inception, the rights and the performance obligations should be measured equal to the transaction price in the contract.

The need to distinguish between View A and View B

10. Distinguishing between these two views is important to standard setters because the basis for this conclusion will serve as the basis for applying the resulting standard to new situations in the future. View A suggests that no matter how observable or costless to obtain a fulfillment price measurement might be, the Boards would still not favor the recognition of a contract asset and revenue at contract inception. This is because no performance obligation in the contract has been satisfied at contract inception.

11. In contrast, View B suggests that the Boards might decide at some future point that in situations in which a fulfillment price is observable and relatively inexpensive to obtain, that price would be used to measure the bundle of performance obligations—especially if the fulfillment price for those obligations materially departs from the transaction price. As a result, a contract asset would likely be recognized at contract inception in these situations with a corresponding amount of revenue also being recognized.

12. The staff is not asking the Boards to vote for one of these two views in this meeting. It is only asking whether the two views have been expressed accurately. At this point, the staff intends to include both views in the discussion paper to explain why the Boards have tentatively decided that performance obligations should be measured at the transaction price in the contract.

13. In summary, for two fundamentally different reasons, the Boards have expressed a preliminary view in favor of measuring both the rights and the performance obligation in a contract equal to the transaction price at contract inception. As a result, neither a contract asset or liability is recognized at contract inception, nor is any revenue recognized at that point.

> **Q1:** Does the Board agree with the description of the measurement approach for performance obligations at contract inception? If not, what changes need to be made?
>
> **Q2**: Does the Board agree that paragraphs 5-9 faithfully reflect the two views supporting the decision to measure performance obligations equal to the rights at contract inception? If not, what changes need to be made?
>
> **Q3:** Does the Board agree that both views should be included in the discussion paper?

SUBSEQUENT MEASUREMENT

14. After contract inception, revenue is recognized when the entity satisfies a performance obligation in the contract. This is because when a performance obligation is satisfied, either the entity's contract asset increases or its contract liability decreases (or both). Hence, after contract inception, the point at which performance obligations are satisfied determines *when* revenue is recognized. However, the *amount* of revenue recognized depends on the amount of the increase in the contract asset or the decrease in the contract liability. Effectively, this amount is determined by how much the measure of remaining performance obligations decreases when a given performance obligation is satisfied.

Allocation approach

15. The Boards have expressed a preliminary view in favor of an allocation approach to measure how much performance obligations decrease when an entity satisfies a given performance obligation. According to this view, the transaction price used to measure the bundle of performance obligations at contract inception is allocated to individual performance obligations based on the entity's separate selling prices of the promised economic resources (i.e., goods and services). The amount allocated to each performance obligation at inception is then recognized as revenue when that particular performance obligation is satisfied. This approach negates the need to remeasure the remaining performance obligations in subsequent periods to determine how much revenue to recognize in those periods.

16. The following example illustrates this approach:

On 1 February, EngineeringCo enters into a contract to provide and install a machine. The enforceable rights to the machine transfer on its delivery to the customer on 31 March. The machine is installed in the first two weeks of April. The customer pays the contract price of CU100,000 on delivery of the machine.

Suppose EngineeringCo sells the machine separately for CU95,000. It sells installation services separately for CU10,000. Based on these separate selling prices, the CU100,000 transaction price would be allocated to the two performance obligations as follows:

	Observed selling price	*Allocation of discount*	*Measurement of performance obligation*
Machine	95,000	4,524	90,476
Installation	10,000	476	9,524
	105,000	5,000	100,000

At 31 March, the remaining performance obligation would be measured at CU9,524 and revenue of CU90,476 would be recognized. When the obligation to provide installation service is satisfied, the remaining performance obligations would be measured at CU0 and revenue of CU9,524 would be recognized.

17. In this example, the entity sells both the machine and installation services separately, so the transaction price of the entire contract is allocated to the promised good and service based on the separate selling prices of each. In many situations, the entity may not actually sell a promised good or service separately. When this is the case, the entity must estimate the price at which it would sell the good or service separately so that the transaction price can be allocated to all performance obligations in the contract.

18. When estimating the price at which it would sell a good or service that it currently does not sell separately, an entity should use the price a competitor would charge separately in the same market for the identical good or service as a starting point for its own estimate. If the identical good or service is not sold separately by the entity or others, the entity must still estimate a selling price.

19. The following example illustrates an approach to estimating a separate selling price when neither the entity nor its competitors sell a particular good or service separately:

On 2 January, SoftwareCo enters into a contract to create a software program for the sole use of the customer and to provide two years of post contract support (PCS) to the customer. This software is not sold by any other competitor, nor is PCS for this particular software sold by any other competitor. The enforceable rights to the software transfer to the customer on June 30 (at the point of delivery), while the benefit of the PCS transfers to the customer over the ensuing two years. The customer pays the entire contract price of CU400,000 on delivery of the software.

Because neither SoftwareCo nor any other entity sells this particular software separately, SoftwareCo must estimate a separate selling price for the software. Similarly, because no entity sells PCS for this particular software separately, SoftwareCo must estimate a separate selling price for the PCS.

SoftwareCo decides that a reasonable approach to determine the separate selling prices of the software and the PCS is to estimate the cost-weighted labor hours needed to create the software and provide PCS. (Of course, other costs might also be included in this estimation process, but in this situation, these costs are relatively insignificant and likely would not affect the allocation of transaction price to the performance obligations.)

SoftwareCo estimates 2,000 hours of programmer time at an hourly labor cost of CU100 to create the software (for a total of CU200,000). Although the number of hours is not observable, the hourly labor cost is observable on internal records and corroborated by industry trade reports on current programmer salaries.

SoftwareCo estimates 600 hours of PCS in year one and 400 hours in year two and an hourly labor cost of CU70 to provide this support (for a total of CU42,000 in year one and CU28,000 in year two). Again, the number of hours is not observable, but the hourly labor cost for PCS is observable on internal records and corroborated by industry and trade reports on PCS personnel salaries.

Because SoftwareCo has never sold software programming separately from PCS, it has no entity-specific data to suggest that margins for software programming are different from margins for PCS. However, industry reports suggest that margins on programming and PCS are roughly the same when they are sold separately. As a result, SoftwareCo assumes that margins on its programming and PCS are the same. This leads to the following allocation of the contract transaction price across the three performance obligations in the contract:

	Estimated labor cost	*Percentage of total labor cost*	*Measurement of performance obligation*
Software	CU200,000	74	CU296,296
PCS-Year 1	42,000	16	62,222
PCS-Year 2	28,000	10	41,482
	CU270,000	100	CU400,000

At 30 June, the remaining PCS performance obligations would be measured at CU103,704 and revenue of CU296,296 would be recognized. When the obligation to provide the first year of PCS is satisfied (probably continually throughout that year), the remaining obligation of PCS would be measured at CU41,482 and revenue of CU62,222 would have been recognized. Finally, when the obligation to provide the last year of PCS support is satisfied, revenue of CU41,482 would have been recognized.

20. This example illustrates just one way in which an entity might reasonably determine separate selling prices for the individual performance obligations in a contract. Moreover, this estimation approach is necessary only when neither the entity nor its competitors sell a particular good or service separately. When the entity sells the identical good or service separately, the separate selling price of that good or service should be used as the basis on which to allocate the transaction price.

21. It is important to note that the fact that a particular good or service is not sold separately by the entity or any other entity does not preclude the allocation of transaction price to the related performance obligation in the contract. This represents a significant departure from current US literature for contracts subject to EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software Revenue Recognition*. These standards generally require vendor-specific evidence or other forms of objective evidence to substantiate the selling price of a particular good or service.

An exception to the allocation approach

22. Some Board members have suggested a limited exception to the allocation approach described above. This exception would apply when goods or services identical to those promised in a contract are traded in an active market (to which the entity has access) with pricing information available on an ongoing basis. In this situation, the promise to transfer such a good or service should be measured at the quoted price in the active market. Any remaining balance of the contract transaction price is allocated to all other performance obligations in the contract on a relative selling-price basis.

23. The staff questions the usefulness of this exception for two reasons. First, the exception appears to apply to a very limited set of circumstances—principally those in which an entity promises to transfer a commodity or a financial

instrument to a customer. Given that many of these promises are already covered by literature dealing with derivatives and financial instruments, the staff questions the usefulness of including this exception in a general standard on revenue.

24. Second, the staff thinks this exception is not likely to provide information that is any more useful than the information already provided by the allocation approach. In settings in which an entity is promising to transfer a commodity or financial instrument (or other similar resource traded on an active market), the entity typically is also promising to provide other services such as broker services. Although the broker services and the commodity or financial instrument are distinct economic resources, they transfer to the customer at the same time. As a result, they would be treated as a single performance obligation in the proposed model. Measuring the commodity or financial instrument obligation at a market quoted price and allocating any excess consideration to the broker service obligation would not provide any more useful information than simply measuring the combined obligations at the transaction price.

25. Given these arguments, the staff recommends that an exception to the allocation approach not be permitted simply because a promised good or service is traded on active markets with quoted prices that are available on an ongoing basis.

Rejected alternatives

26. The Boards considered the possibility of remeasuring the contract after each performance obligation is satisfied (using either a current selling price or exit price for the remaining bundle of goods and services) instead of using a locked-in allocation approach. Any increase in the remeasured contract asset or decrease in the remeasured contract liability would lead to the recognition of revenue. However, the Boards rejected this remeasurement approach in favor of an allocation approach for two primary reasons.

27. First, the Boards think there are few circumstances in which remeasurement would provide significantly more useful information to users than the locked-in allocation approach described in this section. In other words, the Boards do not think a remeasurement of the remaining performance obligations at each reporting date would provide significantly more useful information than a locked-in allocation that is determined at contract inception.

28. Second, remeasuring the contract as each performance obligation is satisfied would almost always require some form of estimation. Board members did not think that continually revising these estimates would be worth the cost. Although the allocation approach at contract inception sometimes requires estimation of selling prices, this estimation process is required much less frequently than would be needed to remeasure the contract at each reporting date.

29. In summary, the Boards have expressed a preliminary view in favor of an allocation approach because it provides a straightforward, cost beneficial

means of determining the change in the contract asset or liability when a performance obligation is satisfied and hence the amount of revenue to be recognized. This means that after initial recognition, the remaining performance obligations in a contract are measured at the amount of the transaction price allocated to those obligations at contract inception.

Q4: Does the Board agree with the description of the allocation approach in this section, including the recommendation not to allow any exceptions to the allocation approach? If not, what changes need to be made?

Q5: Does the Board agree that the example of estimating a separate selling price in this section is a reasonable illustration of a potential estimation process? If not, what changes need to be made?

Q6: Does the Board agree that paragraphs 26-28 faithfully reflect the basis for choosing the allocation approach? If not, what changes need to be made?

REMEASUREMENT OF PERFORMANCE OBLIGATIONS

30. The Boards rejected the approach in which the contract would be remeasured to determine by how much a contract asset has increased or a contract liability has decreased after each performance obligation is satisfied, and hence how much revenue should be recognized. Instead, the Boards selected a locked-in allocation approach as a way of determining by how much a contract asset has increased or a contract liability has decreased after a performance obligation is satisfied.

31. Although this approach is arguably less complex than a remeasurement approach, the Boards acknowledge that a locked-in allocation approach sometimes will not provide a faithful depiction of the obligation to transfer economic resources to a customer. For example, if the estimated remaining costs to satisfy a performance obligation exceed the original amount allocated to that performance obligation (i.e. the performance obligation is deemed "onerous"), the allocated amount may significantly understate the economic resources required to satisfy that obligation.

32. In the May Board meetings, both Boards decided tentatively that performance obligations that are deemed onerous should be remeasured upward with a loss recognized in the statement of comprehensive income.[2] When that performance obligation is later satisfied, the Boards decided that the original allocated amount for that performance obligation would be recognized as revenue, and the upward adjustment due to the onerousness of the obligation would be reversed and recognized as a gain in the statement of comprehensive income. In other words, remeasurement of the performance obligation due to the onerousness of that obligation affects comprehensive income, but does not affect recognized revenue.

[2] The Boards have not determined the specific details of what an onerous contract test would entail (e.g., is it based on a loss trigger or a minimum margin trigger). The Boards intend to deliberate this issue at a future point in the project.

33. Although both Boards decided tentatively to remeasure performance obligations when onerous, they differed in their willingness to remeasure performance obligations for other reasons. The FASB decided that performance obligations would be remeasured *only* if they are deemed to be onerous. The IASB noted that performance obligations *might* be remeasured for circumstances beyond the onerousness of the performance obligation. This section of the paper seeks to clarify what those additional circumstances are in order to gauge how far apart the two Boards are on this issue.

Availability of observable current exit prices

34. Some Board members have suggested that remeasurement might be justified when an observable current exit price exists for a particular performance obligation and the entity can lay off the performance obligation at that price. These Board members think that a regularly observable exit price for an identical performance obligation on the market should be used.

35. When such an exit price is observable at contract inception, some Board members have already suggested that this price should be used instead of an allocation (see paragraphs 22-25). If an observable current exit price for these same performance obligations exists after contract inception, these Board members think it should be used instead of locking in the original measurement for that obligation.

36. The staff questions how often a regularly observable current exit price would be available, even for performance obligations that have an exit price at contract inception. In fact, it is difficult to think of any examples in which an observable current exit price is available except in the case of commodities and some financial instruments. Given that current exit prices are not observable after contract inception for most performance obligations other than for commodities and some financial instruments, the staff questions whether it is worth complicating the model by including a remeasurement approach for this small set of circumstances.

Q7: Does the Board agree that there are very few (if any) performance obligations aside from promises to transfer commodities and some financial instruments that have a regularly observable exit price? If not, what other performance obligations come to mind?

Q8: Does the Board agree that the existence of observable current exit prices for performance obligation after contract inception is not sufficient cause to remeasure performance obligations?

Uncertain, long-term performance obligations

37. Another situation in which some Board members have suggested they would remeasure performance obligations rather than locking in the original measurement is when a performance obligation spans many reporting periods and the economic resources necessary to satisfy the obligation are highly uncertain or unpredictable. Some have suggested long-term insurance and

construction contracts give rise to just such performance obligations. Even if an updated measure of these performance obligations is not observable, these Board members think some form of updated measurement would be more useful than a locked-in measurement.

38. Given that the Boards have already agreed that remeasurement is required for performance obligations that are deemed onerous, the concern in measuring these uncertain, long-term performance obligations must rest on *when* a remeasurement is triggered. A number of Board members have expressed this very concern—that remeasurement for onerous obligations can lead to surprises. Supposedly, an obligation that is not yet loss making but is headed that direction is invisible to financial statement users. However, the moment that obligation becomes loss making, a loss is immediately recognized in the statement of comprehensive income because the obligation is remeasured upward.

39. One of the reasons such surprises happen is that management has some discretion in estimating expected remaining costs when comparing those costs to the locked-in measure of the performance obligation. If management decides that they want to take more losses in a particular reporting period, they can increase their estimates of remaining costs and trigger the onerous obligation adjustment. The fact that remeasurement may require that a margin be added to any remaining costs only exacerbates the potential surprise and increases the subjectivity in the remeasurement of the performance obligation.

40. Board members who suggest that uncertain, long-term performance obligations should be remeasured at each reporting date think that such an approach will decrease the number of surprises that would result under the more limited onerous-test approach. To the extent that a remeasurement approach would be applied more frequently than an onerous test approach, fewer surprises are likely to occur. That said, the staff questions whether a cost-beneficial improvement in the information provided to users would result from a remeasurement approach.

41. Another difficulty with the suggestion to remeasure long-term, uncertain performance obligations is defining what those obligations are. It is not as simple as saying that all stand-ready obligations should be remeasured because many stand-ready obligations are not long-term and their outcomes are reasonably predictable. Even some longer term stand-ready obligations, for instance some three-year warranties, are reasonably predictable. Given the difficulty of defining this class of obligations to be remeasured, the staff again questions whether such an exception can be articulated.

42. The staff recommends that a remeasurement approach not be sought for uncertain, long-term obligations. Aside from the fact that such obligations would be difficult to define and identify in a principled way, it is likely that an improved onerous test that is based on a more conservative trigger (e.g., one that requires an adjustment when, say, 50 percent of the originally anticipated margin is wiped out instead of 100 percent being wiped out) might address Board members' concerns about surprise losses related to these obligations.

43. The staff notes that this recommendation for a general standard on revenue recognition has implications for the IASB's deliberations on insurance. On that project, the IASB decided that insurance contracts, which often include long-term uncertain obligations, should be remeasured.

Staff recommendations on remeasurement

44. Given the arguments in this section and the examples that Board members have raised in the past, the staff recommends that the Boards not remeasure any performance obligations after contract inception unless the obligation is deemed onerous. In the near future, the staff will ask the Boards to consider if and how they would want to apply an onerous test to performance obligations in a general revenue recognition standard. This discussion will consider both the trigger for an onerous adjustment and the extent to which existing literature provides adequate guidance on how to remeasure obligations that are deemed onerous.

> **Q9:** Does the Board agree that the primary concern with a locked-in allocation approach for uncertain, long-term performance obligations is that the approach sometimes leads to significant, negative surprises when an onerous adjustment is triggered? If not, why do some Board members want to continuously remeasure these types of performance obligations?
>
> **Q10**: Does the Board agree that a reconsideration of onerous tests has the potential to resolve Board members' concerns about the surprises that can happen in a locked-in allocation approach?
>
> **Q11**: Is there any other circumstance not mentioned in this section for which Board members would want to remeasure performance obligations at each reporting date?
>
> **Q12**: Assuming the answer to the previous question is no, does the Board agree that performance obligations should be remeasured *only* if they are deemed onerous?

CONCLUSION

45. The purpose of this paper has been to summarize and clarify the Boards' recent decisions on measuring contracts with customers. In particular, the staff is seeking the Boards' affirmation of their decision to measure performance obligations equal to the transaction price at contract inception and then not to remeasure those performance obligations unless they are deemed onerous. The staff is also seeking clarification of the circumstances (beyond an onerous obligation) in which some of the IASB Board members would want to remeasure performance obligations. Based on an initial analysis of what the staff thinks those circumstances are, the staff is recommending that the Boards decide not to remeasure performance obligations unless they are deemed to be onerous.