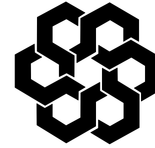

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**21 May 2008, London**
Project:	**Revenue Recognition**
Subject:	**Another Possible Measurement Approach (Appendix A to Agenda paper 7B)**

APPENDIX A TO CHAPTER 5 (DRAFT)

A1. The discussion in Chapter 5 explains the principal issues surrounding the two measurement approaches that have been developed by the Boards. The two approaches represent two different ways to measure a revenue contract both at inception and subsequently. It is likely that as the Boards move to the next phase of the project they will need to find a compromise between these approaches.

A2. The Boards have not yet discussed how to do this, but there are potentially a number of ways to achieve a compromise. For instance, some might argue that the customer consideration approach would be suitable for the majority of revenue contracts, but that in a limited set of cases it would be more appropriate to use current exit price (or another similar direct measurement approach). It would then be necessary to identify the characteristics of the revenue contract, or performance obligations, that would call for a current exit price measurement approach. For example, some have argued that the customer consideration approach would not work well for so-called stand ready performance obligations (for example a warranty contract). This is because these types of obligations typically contain significant uncertainty over the life of the contract. Some argue that it is possible to represent that uncertainty faithfully only by remeasuring the obligation over its life.

A3. Another way of finding a compromise between the two approaches is to develop a measurement approach that combines features of both approaches.

To assist respondents in considering the measurement of revenue contracts and the strengths and weakness of the two approaches discussed in Chapter 5, this Appendix briefly explains one way in which features of the two measurement approaches could be combined.

Calibrating the measurements to the contract price

A4. Chapter 5 highlights that one of the strengths of using a sales price objective is that the initial measurement of the performance obligations is derived directly from an observable price—the contract price. However, the chapter also highlights that, after contract inception, there may be no similarly observable sales price for the bundle of the *remaining* performance obligations in the contract. In other words, the only observable price over the life of a revenue contract is often the contract price. Therefore, of the two measurement approaches discussed in Chapter 5, some prefer the customer consideration approach. This is because even though this measurement approach may require the use of unobservable prices in measuring the *individual* performance obligations, the *total* initial measurement of the performance obligations is calibrated to the observable contract price.

A5. Despite this strength of the customer consideration approach, some dislike the approach because it does not update any aspect of the measurement of a performance obligation after contract inception to reflect current information. Said differently, although some prefer measurements to be based on an observable price, they nonetheless think that remeasurement of performance obligations might be necessary in at least some cases. As a result, they might want to use a measurement approach that uses the observable contract price as an input both for the initial measurements of performance obligations and when it is necessary to subsequently update those measurements.

A6. Chapter 5 highlights that, ignoring the time value of money, a direct measurement of a performance obligation can be viewed as consisting of two components: the indirect and direct costs that will be incurred in fulfilling that obligation and the margin required for providing the promised good or service. Arguably, the most difficult task in measuring a performance obligation is to estimate the required margin. In contrast, it should be easier to estimate the costs that would be required to fulfil the performance obligation.

A7. Accordingly, at contract inception, instead of estimating the margin component, it would be possible to derive it from the observable contract price by estimating the cost component of the performance obligation and deducting that amount from the contract price. On measuring a performance obligation after contract inception, the cost component of the performance obligation could be updated to reflect current information. However, the margin component could be based on the margin implied at inception by the contract price. In other words, the contract price could be used to calibrate the overall measurement at contract inception, but some of the components in that measurement could be updated after contract inception.[1]

[1] The rationale for the approach is similar to Implementation A of the current exit value measurement model discussed in paragraphs 78–86 of the IASB's discussion paper *Preliminary Views on Insurance Contracts* (May 2007).

A8. The following example shows how such an approach might work:

> ConstructorCo has a performance obligation to provide construction services for a contract price of CU100,000.
>
> The initial measurement of the performance obligation of CU100,000 can be viewed as consisting of two components: the costs expected to be incurred in fulfilling the obligation and the required margin.
>
> Suppose that the costs are estimated to be CU75,000.[2] The margin that is implied by the contract price is therefore CU25,000 (ie CU100,000 – CU75,000).
>
> Subsequently, ConstructorCo measures the performance obligation by updating the estimated costs required to fulfil the performance obligation and then using the margin that was implied by the contract price at contract inception. For instance, suppose that after three months ConstructorCo estimates that the costs required to fulfil the remaining obligation are now CU50,000. The performance obligation is measured at CU66,667 (ie CU50,000 x 100,000/75,000).

A9. The main difference from the customer consideration approach described in Chapter 5 is that the initial measurement of the performance obligation is not locked in its entirety. The cost component is updated to reflect current information. Only the total margin is locked in at inception and allocated over the life of the contract (ie the subsequent margin does not capture any change in either the amount or price of the margin that is required).

A10. The above approach could also be modified to exclude from the initial measurement of the performance obligation any amounts in the contract price that relate to obtaining the contract. The resulting measurement would then be closer to those that would be obtained with a current exit price objective.

> Suppose in the above example ConstructorCo incurred contract origination costs of CU5,000.
>
> Assuming that the contract price was set so as to recover these costs, the performance obligation could initially be measured at the contract price *less* the contract origination costs, ie CU95,000.
>
> If the costs are estimated to be CU75,000, the margin that is implied by the contract price is therefore CU20,000 (ie CU95,000 – CU75,000).
>
> If after three months, as in the above example, ConstructorCo estimates that the costs required to fulfil the obligation are now CU50,000, the performance obligation is measured at CU63,333 (ie CU50,000 x 95,000/75,000).

[2] Consideration of whether these costs are the entity's costs or a third party's costs is outside the scope of this Appendix.