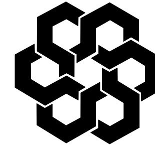

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INFORMATION FOR OBSERVERS

Board Meeting: **21 May 2008, London**

Project: **Revenue Recognition**

Subject: **Why not use an Entity-specific Measurement? (Appendix B to Agenda paper 7B)**

APPENDIX B TO CHAPTER 5 (DRAFT)

B1. As discussed in Chapter 5, the rationale for using an exit price measurement objective is that it captures only the amount to fulfil the performance obligation. However, some commentators argue that an exit or lay-off price for a performance obligation relies too much on market inputs and that the measurement instead should reflect the costs that the *entity* expects to incur in fulfilling the obligation and the margin that the *entity* would demand. In other words, they argue that the measurement should be entity-specific and that a performance obligation should be measured at the price the *entity* would charge to fulfil the performance obligation. (Note that this is not the same as arguing that the performance obligations should be measured at the entity's *sales* price of the underlying goods and services.)

B2. Some Board members have conceptual concerns about specifying the use of entity-specific measurements. This is because such measurements would not only capture economic characteristics of the item (contract asset or liability) being measured, but might also capture other characteristics of the entity. As a result, the measurement of the performance obligation in the contract would not be comparable with other entities that have the same obligations.

B3. For instance, suppose that an entity has some proprietary technology that allows it to provide goods and services at a lower cost than other entities supplying the same goods and services. If the measurement of the performance

obligation reflects the specific entity's position, then it captures characteristics of that entity's proprietary technology, ie another asset of the entity, rather than only characteristics of the performance obligation. In contrast, if the measurement excludes those aspects that would not arise for other entities, then the measurement reflects only characteristics of the performance obligation rather than the entity that holds the contract.

B4. In addition, if the entity reflects its proprietary technology in the initial measurement of a performance obligation, then the entity would reflect all of its efficiencies compared to the market at contract inception. Similarly, if the entity had no proprietary technology and was less efficient than the market, then it would reflect all of its inefficiencies at that time.

B5. To illustrate this point, consider the following example.

ManufacturingCo makes widgets using a proprietary technology not available to any other manufacturer. ManufacturingCo has an obligation to produce and deliver a widget to a customer. If the costs of obtaining a contract are ignored, most manufacturers will charge CU600 for producing and delivering a widget. This is composed of CU450 for the typical cost to produce and deliver a widget and CU150 for the required margin.

Because of its proprietary technology, ManufacturingCo can produce and deliver a widget for a cost of CU350.

On 1 January, ManufacturingCo contracts with a customer to deliver a completed widget and the customer prepays.

If ManufacturingCo measures its contract liability at CU600, then its measurement is comparable to other entities that have similar performance obligations. This measurement ignores ManufacturingCo's competitive advantage of producing and delivering widgets more efficiently than its competitors. In essence, because ManufacturingCo's competitive advantage has not yet arisen (it has not yet produced the widget) in this contract, that advantage is not reflected profit or loss.

On 30 June, ManufacturingCo completes the widget and delivers it to the customer. At that time, ManufacturerCo reports margin of CU250 as a result of satisfying its performance obligation of CU600 and recognizing its manufacturing and delivery costs of CU350. In contrast, all other manufacturers in a similar arrangement would have recognized margin of CU150. Thus manufacturingCo's comparative efficiency is recognized when it arises.

Note that had ManufacturingCo measured its liability at CU500 (ie reflecting its propriety technology), then it would have effectively recognized margin of CU100 from manufacturing and delivering prior to those activities being undertaken.

Conversely, suppose that ManufacturingCo has no proprietary technology and is inefficient relative to its competitors, producing and delivering widgets at a cost of CU550. If ManufacturingCo measured its liability at CU700 (ie reflecting its expected inefficiencies) rather than CU600, then it would have recognized a loss from manufacturing and delivering prior to those activities being undertaken. Furthermore, the margin it would report on 30 June—CU150—would suggest that it was as efficient as other entities in the market, when this is not the case.

B6. Supporters of measuring performance obligations at exit price think it is more useful to users if the effects of an entity's efficiencies and inefficiencies compared to other entities in the market are reported when they arise, ie as the goods and services are provided. This is because this is relevant information for users that provides feedback about the entity's performance relative to other entities in the market. In other words, if the entity is more efficient than the market, its profit will be greater than the market return; if it is less efficient, its profit will be less.

B7. They also think that measurements that are based on market inputs are also less subjective than those based on an entity's own inputs. And because users are typically aware of market information, the resulting measurements provide a more understandable basis for users to evaluate the entity's performance.