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International Accounting Standards Board

INFORMATION FOR OBSERVERS

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Subject: **Measurement of the Contract (Agenda paper 7B)**

CHAPTER 5 (DRAFT)

INTRODUCTION

1. The previous chapters introduced and explained the contract asset and contract liability—that is to say, the asset or liability arising from the rights and obligations in a contract with a customer. This chapter considers how that contract asset or liability is measured throughout the life of the contract.

2. Measurement of the contract is fundamental to the proposed model for revenue recognition for two reasons. First, the measurement approach determines whether the contract is recognized as an asset, a liability, or a net nil position (in effect, not recognized). Hence, it determines whether revenue, a contract loss, or nothing is recognized in profit or loss at inception of the contract. If the contract is initially recognized as an asset, revenue is recognized in accordance with the revenue recognition principle introduced in Chapter 2:

> In a contract with a customer to deliver or produce goods, render services, or other activities that constitute the entity's ongoing major or central operations, revenue is recognized when a contract asset *increases* or a contract liability *decreases* (or some combination of the two).

3. Secondly, after contract inception, the measurement approach determines the amount of revenue that is recognized over the remaining life of the contract as performance obligations are satisfied. This is because when the entity satisfies

its performance obligations, either the contract asset increases or the contract liability decreases. The *amount* of that increase or decrease depends on how the contract asset or liability is measured.

4. In developing a measurement approach for the proposed revenue recognition model, two main questions arise. First, how is a contract measured at inception (initial measurement)? Secondly, how is a contract measured after contract inception (subsequent measurement)? More specifically, should the initial measurement be (a) updated in subsequent reporting periods to reflect current information or (b) locked in at contract inception?

5. This chapter is therefore organised as follows:

   (a) *initial measurement*: an explanation of two alternative measurement objectives (ie an exit price and a sales price) and their consequences at contract inception (paragraphs 7–44);

   (b) *subsequent measurement*: an explanation of how the initial measurement could be updated after contract inception using either of the two alternative measurement objectives and the consequences if the initial measurement is *not* updated but is instead locked in at contract inception (paragraphs 45–66);

   (c) *evaluation*: an explanation of the main strengths and weaknesses of (i) each of the two alternative measurement objectives and (ii) updating the initial measurement (paragraphs 67–76).

6. Based on the evaluation, paragraphs 77–84 of the chapter explain two potential measurement approaches that have been developed by the Boards for the proposed revenue recognition model. These two measurement approaches arise from the four possible permutations of (a) using either of the two alternative measurement objectives discussed in paragraphs 7–44 and (b) either updating or locking in the initial measurement as discussed in paragraphs 45–66.

INITIAL MEASUREMENT OF THE CONTRACT

7. Chapter 2 proposed that an entity recognize a contract once the entity and a customer have made an agreement that creates obligations that are enforceable or otherwise recognizable at law. To recognize such a contract, the rights and performance obligations in that contract need to be measured.

8. In many cases, measuring the rights is relatively straightforward. This is because their measurement depends on the consideration specified in the contract and this is typically a *cash* inflow that is determinable from the contract. In other cases, measuring the rights is not straightforward. For instance, the promised consideration may be variable rather than fixed or may be uncertain because it is contingent on a specified event. In addition, the contract may specify non-cash consideration.

9. This paper does not discuss these latter cases. Instead it is assumed that the consideration is fixed and due either at contract inception (ie the customer prepays) or at other determinable points throughout the life of the contract. Hence, the rights can be measured at the amount of the consideration specified in the contract and adjusted (if necessary) to reflect the time value of money and the customer's credit risk (ie the risk that the customer may default).[1] The Boards plan to address non-cash, variable and contingent consideration later in the project.

10. This chapter therefore focuses on measuring the performance obligations. A performance obligation is essentially a promise to provide a good or service. Hence, satisfying a performance obligation typically results in a transfer of *non-monetary* resources to the customer (ie the good or service). Putting a number on this promise can be difficult, but is a necessary step to represent these obligations in the financial statements. The issue is how best to do this.

11. In the project to date, the Boards have discussed two different objectives for measuring performance obligations: exit price and sales price. The next sections therefore discuss:

    (a) how performance obligations would be measured using an exit price objective (paragraphs 12–18);

    (b) the consequences of measuring performance obligations at exit price (paragraphs 19–30);

    (c) how performance obligations would be measured using a sales price objective (paragraphs 31–34);

    (d) the consequences of measuring performance obligations at sale price (paragraphs 35–44).

[1] For simplicity, all of the examples in this chapter ignore the time value of money and the customer's credit risk.

Measuring performance obligations at exit price

12. One way to measure an entity's performance obligations at contract inception is to determine the price that an independent third party[2] would charge to fulfil those performance obligations. In other words, the performance obligations would be measured at the price the entity would have to pay to transfer (or lay off) all of the performance obligations in the contract to a third party. This measurement objective is referred to as an exit price.

13. An exit price reflects three main components:

    (a) *expected costs*. These include the direct costs (such as the raw materials and labour) that a third party would expect to incur in providing the promised goods and services. They also include the indirect costs (such as administrative costs and the use of plant and equipment) that a third party would expect to incur in providing the promised goods and services.

    (b) *time value of money*. This is because an obligation that will be fulfilled in a year's time is, all other things being equal, less burdensome than an obligation to be fulfilled tomorrow. Therefore, two otherwise identical obligations should not be reported as being equivalent if they will be fulfilled at different times.[3]

    (c) *margin*. This is the return or profit required by the third party for providing the promised goods and services and bearing the risks and uncertainties associated with the obligation (such as the risk that the raw material and labour costs turn out to be higher than expected).[4] An exit price includes a margin because entities not only price their contract to recover their expected costs of providing goods and services and to reflect the timing of when those costs will be incurred, but they also require a return for providing those goods and services. Ultimately, profit-orientated entities need to make returns for their owners.

14. It is also important to describe what an exit price does *not* reflect. An exit price does not reflect any direct or indirect costs that a third party incurs (or would expect to incur) to *obtain* a contract with a customer. These costs, such as advertising overhead and sales commissions, have already been incurred by the time a contract is obtained, so they are excluded from the exit price or the price that a third party would require to fulfil the performance obligations. Similarly, an exit price does not reflect any margin associated with obtaining the contract that a third party would require. In other words, once a contract

[2] The independent third party is a peer or competitor to the entity and is sometimes described as a market participant.

[3] For simplicity, all of the examples in this chapter ignore the time value of money component of an exit price.

[4] The amount required for a return or profit margin is not solely determined by the third party. Instead, this amount is affected by what customers are willing to pay and what other entities are willing to accept for the promised goods and services. In fact, fluctuations in demand and supply can sometimes lead to negative returns on a contract if a third party agrees to accept less consideration than it needs to cover the direct and indirect costs of providing the promised good or service.

exists, the costs and margin associated with obtaining that contract are irrelevant to the measurement of the *remaining* performance obligations.

15. An exit price based on what a third party would require to assume the remaining performance obligations may be indistinguishable from the price the entity itself would require to *fulfil* those remaining obligations. In fact, if an entity estimated its own entity-specific 'fulfilment' price—the price it would charge a competitor to assume and fulfil identical performance obligations—the entity would have to determine its own direct and indirect costs and a required return for the promised goods and services. It would not include in this estimate any costs and margin associated with obtaining a contract with a customer.

16. The only difference between a third-party exit price and an entity's own fulfilment price is that the fulfilment price is based on the entity's own expected direct and indirect costs and required margins, rather than a third party's expected direct and indirect costs and required margins. However, both the entity-specific fulfilment price and the third-party exit price exclude the costs and margin associated with obtaining a contract with a customer because the contract has already been obtained.[5]

17. In summary, the exit price measurement objective can be stated as follows:

> Measure the performance obligations at the amount that the entity would be required to pay to transfer those obligations to an independent third party.

18. Measuring performance obligations by estimating the price to transfer them to another party does not mean that the entity will in fact transfer them. Indeed, in most cases the entity will either choose not to transfer them or will not be able to do so (for instance, because the customer would not agree to the transfer, or the entity cannot identify a third party that is willing and able to assume the contract). Rather, an exit price measurement provides an unambiguous objective for measuring performance obligations based on the market's perception of them.

Consequences of measuring performance obligations at exit price

19. There are three main consequences of measuring performance obligations at exit price:

    (a) a contract asset and revenue can be recognized at contract inception;

    (b) a contract liability and loss can be recognized at contract inception;

    (c) measurements of performance obligations will often need to be estimated.

[5] Board members who support an exit price approach favour the use of a third-party exit price over an entity-specific fulfilment price. The reasons behind this are discussed in Appendix B to this chapter.

Recognizing a contract asset and revenue at contract inception

20. If performance obligations are measured at exit price, they are measured independently of the sales price in the contract. Thus the sales price may be useful as a reasonableness check of the measurement, but it is not used directly in measuring the performance obligations.

21. Paragraphs 12–18 highlighted the fact that the exit price of a performance obligation includes the costs and margin that a third party requires to *fulfil* a performance obligation, but excludes the amount it would require to obtain the contract. However, entities need to recover the costs of obtaining a contract in their pricing to customers. Given this, the sales price to the customer—which affects the measurement of the *rights* at contract inception—may include components that do not relate to the remaining *obligations* that exist once the contract is formed. Accordingly, the value of the rights at contract inception is typically greater than the value of the remaining performance obligations.

22. This means that at contract inception, a contract *asset* will typically be recognized. Applying the revenue recognition principle in paragraph 2, the corresponding increase in that asset qualifies for recognition as revenue.

23. The following example illustrates this.

FlooringCo is a company that installs wooden floors. FlooringCo does not have any retail outlets; instead it advertises extensively in newspapers and magazines. FlooringCo has its own sales team and administers the contracts itself. However, the installation is undertaken by subcontractors. FlooringCo obtains the wood from a supplier that delivers it directly to the customer's house.

On 30 June, after various visits from a salesman to discuss the available options, a customer enters into a contract with FlooringCo for a new floor.

For this contract, FlooringCo will buy wood at a price of CU500 and will pay the subcontractor CU1,000 for installation. It also requires CU50 to cover its costs and to provide a margin for managing this contract, ie for making all the necessary arrangements to fulfil the contract (including purchasing the wood and arranging for the subcontractor to install the floor) and dealing with the customer. It has no evidence to suggest that these amounts differ from those of others in the industry.

FlooringCo will pay its salesman a commission of CU200 for obtaining the contract and decides that it requires CU250 as a contribution towards recovery of costs incurred in the past (eg product development, advertising, costs of sales force). The CU250 also includes a contribution towards a reasonable return on those costs.

FlooringCo 's sales price is therefore CU2,000 (ie CU500 + CU1,000 + CU50 + CU200 + CU250), payable on completion of installation.

For simplicity, ignore the time value of money, risk of non-payment and performance guarantees.

The exit price of Flooring Co's performance obligations on 30 June would be expected to be about CU1,550 (ie price of wood of CU500 plus price of installation of CU1,000 plus price to manage the contract of CU50). As the rights are measured at CU2,000, a contract asset and revenue of CU450 is recognized on 30 June (ie CU2,000 – CU1,550), as well as an expense of CU200 for commission.

24. In this example, FlooringCo would demand about CU450 to transfer the contract that it has obtained to a third party. Furthermore, the third party would be prepared to pay CU450. This is because it would require only CU1,550 to fulfil the performance obligations (for its expected costs and required margin) and on fulfilment will be entitled to collect CU2,000 under the contract from the customer. In a competitive market in which entities are providing goods and services at about the same price, the exit price of the contract asset would represent the market price for obtaining contracts with customers.

25. Because the performance obligations are measured independently of the entity's sales price, the measurement of the contract asset will also reflect the extent to which the entity has been able to charge its customer a higher price than other entities. This may be possible because the entity may have superior negotiating skills. For instance, suppose that in the above example FlooringCo was able to charge its customer CU2,200. In this case, all other things being equal, the contract asset would increase by CU200. This is because the performance obligations would still be measured at the price the third party would charge to fulfil those obligations (ie CU1,550) but the measurement of the rights would increase by CU200. That premium would be recognized as revenue at contract inception reflecting that the entity, compared to other entities, was more successful in contracting.

26. An important point to note is that recognizing revenue at contract inception does *not* mean that the *entire* profit expected from the contract is recognized at that point. This is because the exit price measurement of the performance obligations includes the margin that a third party would require for providing the goods and services (ie fulfilling the contract). Hence, this margin has *not* been recognized in profit or loss at contract inception.[6]

27. It also follows that *net* profit is reported only if any revenue recognized is greater than any expenses recognised at the same point for direct or indirect costs incurred in obtaining the contract.

Recognizing a contract liability and loss at contract inception

28. Just as a contract asset and revenue are recognized at contract inception if the measurement of the rights is greater than the measurement of the performance obligations, a contract liability and a loss are recognized at contract inception if the measurement of the performance obligations is greater than the measurement of the rights. For instance, suppose that in the example in paragraph 23 FlooringCo charges its customer only CU1,500. In this case, FlooringCo would recognize a contract *liability* of CU50 on 30 June and the

[6] After contract inception, in addition to the margin, an entity would also recognize expense for the time value of money component.

corresponding increase in that liability would be recognized as a contract loss. This is because a third party would still require CU1,550 to fulfil the contract but would collect only CU1,500 from the customer on fulfilment of the contract.

Measurements will often need to be estimated

29. Measuring performance obligations at exit price would have an important practical consequence: the entity often would have to estimate that price. This is because in many situations there will not be an observable exit price for a particular bundle of performance obligations.

30. The inputs used to estimate an exit price would need to be consistent with the objective of estimating the price an independent third party would charge to fulfil the performance obligations. However, it is worth emphasising that an entity generally would use its own inputs when pricing the performance obligation. It would not need to conduct an exhaustive search for market data that does not exist. However, if there is evidence to suggest that an independent third party would use different inputs, the entity should adjust its own inputs so that they are consistent with the entity's estimate of what third parties would use in pricing the performance obligation.

Measuring performance obligations at sales price

31. Another way to measure an entity's performance obligations at contract inception is to determine the price that the entity charges its customer to provide the promised bundle of goods and services in the contract. This paper uses the term *sales price* to refer to this measurement objective. At contract inception, this means that the performance obligations are measured at the price specified in the contract for the bundle of goods and services to be provided (ie the contract price) adjusted, as necessary, for the time value of money and the customer's credit risk.

32. If the sales price is used to measure performance obligations, typically their measurement implicitly reflects the direct and indirect costs that the entity expects to incur in providing the goods and services (eg raw materials, labour costs, etc) and the margin that the entity requires for providing those goods and services.

33. However, in addition (and in contrast to an exit price), the sales price also implicitly reflects any amounts that the entity charges its customer to recover its direct and indirect costs of obtaining a contract with a customer (such as advertising, sales commissions, etc) together with any margin associated with obtaining the contract.

34. In summary, the measurement objective of this second approach can be stated as follows:

> Measure the performance obligations at the price for which the entity sells to customers the bundle of goods and services underlying those performance obligations.

Consequences of measuring performance obligations at sales price

35. There are four main consequences of measuring the performance obligations at sales price:

    (a) no contract asset or revenue is recognized at contract inception;

    (b) there is a need for an onerous contract test at contract inception;

    (c) a *net* loss is possible at contract inception;

    (d) initial measurement of performance obligations is observable.

No recognition of contract asset or revenue at contract inception

36. At contract inception, the entity's rights and its performance obligations are both measured at the contract price. Hence, neither a contract asset nor revenue is recognized.[7]

37. Consider again the example in paragraph 23.

> FlooringCo measures the bundle of the performance obligations at the sales price of the bundle of the underlying goods and services, ie CU2,000. As the rights are also measured at CU2,000, neither a contract asset nor revenue is recognized.

Need for an onerous contract test

38. There may be occasions when the sales price is less than the cost the entity expects to incur in satisfying its performance obligation. When this occurs, a different measurement objective may be required. For instance, suppose that in the example in paragraph 23 FlooringCo charges its customer CU1,400. In this case, measuring the performance obligations at that sales price will not inform users that the entity expects to incur costs of CU1,500 in fulfilling its performance obligations.

39. In other words, there may be occasions when an entity has an onerous contract and so the performance obligations need to be measured at more than the entity's sales price of the underlying goods and services. In such cases, the entity will recognize a contract liability and a contract loss at contract inception.

40. Thus, if an entity measures the performance obligations at the sales price of the underlying goods and services, it recognizes no contract asset and revenue at contract inception, but does recognize at inception a contract liability and loss if the sales price does not at least cover the entity's expected costs to fulfil the obligations.

41. The above discussion is not intended to imply that a performance obligation would be onerous only if the sales price is less than the expected costs to fulfil

[7] Revenue might be recognized immediately after contract inception if the entity satisfies a performance obligation at that point.

that obligation. However, because it typically would be rare that performance obligations would be deemed onerous at contract inception, onerous contracts are discussed more fully below in the context of subsequent measurement (see paragraphs 63–65).

Net loss possible at contract inception

42. Paragraph 21 highlighted the fact that entities attempt to set sales prices that cover not just the costs of fulfilling the performance obligations but also their costs of obtaining a contract. If performance obligations are measured at the sales price of the underlying goods and services, the initial measurement of the performance obligations includes the part of the sales price that recovers the costs of obtaining the contract. As a result, no revenue is recognized at contract inception. However, to the extent that an entity incurs any costs in obtaining a contract, those costs are expensed. As a result, the entity will report a *net* loss at contract inception. For instance, consider again the example in paragraph 23:

> FlooringCo measures its rights and performance obligations at 30 June at the sales price of CU2,000, so it recognizes neither a contract asset nor revenue.
>
> However, on that day it will also recognize an expense of CU200 for the salesman's commission. Hence, on 30 June it will recognize a *net loss* of at least CU200 (because it may have also recognized other expenses for indirect costs associated with obtaining this contract).

Initial measurement is observable

43. Unless the performance obligations are deemed to be onerous, the bundle of performance obligations is measured at the entity's sales price for the underlying goods and services. Because the entity actually entered into a transaction for the goods and services, this price can be observed and verified.

Comparing exit price and sale price at contract inception

44. The following table summarises the consequences of measuring performance obligations at contract inception at exit price and sales price.

Table 5.1 Comparison of the two measurement objectives at contract inception

	Exit price	**Sales price**
Measurement objective for the bundle of performance obligations	Measure at exit price, ie the price to transfer the obligations to an independent third party. This is the price a third party would charge to *fulfil* the performance obligations.	Measure at *sales* price, ie the price specified in the contract between the entity and its customer for the goods and services that the contract obliges the entity to provide.

Table 5.1 Comparison of the two measurement objectives at contract inception		
	Exit price	**Sales price**
Need for an onerous contract test?	No (is in effect done automatically).	Yes (to test the adequacy of the sales price measurement for the performance obligations).
Can revenue *be recognized?*	Yes (if exit price of rights obtained > exit price of obligations incurred).	No.
Can a contract loss *be recognized?*	Yes (if exit price of obligations incurred > exit price of rights obtained).	No, unless performance obligations are deemed onerous.
Can net profit *be reported?*	Yes (if exit price of rights obtained less exit price of obligations incurred > contract origination expenses).	No.
Can net loss *be reported?*	Yes (if the contract origination expenses > exit price of rights obtained less exit price of obligations incurred.	Yes, for any contract origination expenses. Also, a loss will be reported if the contract is deemed to be onerous.
Use of estimate in measurements	Required unless there is an observable lay off price.	Not required at contract inception unless performance obligations deemed onerous and there is no other observable price for the obligations.

SUBSEQUENT MEASUREMENT OF THE CONTRACT

45. Chapter 2 explained that, after contract inception, revenue is recognized as the entity satisfies its performance obligations in the contract. This is because as each performance obligation is satisfied, either the entity's contract asset will increase or its contract liability will decrease (or both, with a contract liability becoming a contract asset).

46. Therefore, 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 decrease in the contract liability, and this will depend on how that asset or liability is subsequently measured.

47. Accordingly, regardless of whether the Boards choose to measure performance obligations initially at exit price or sales price, they also have to determine whether those initial measurements should be updated at subsequent financial statement dates to reflect current information (ie the prices and circumstances existing on those dates), or whether the initial measurements should be locked in. This paper refers to this process of updating the measurements for changes other than those that result from satisfying the performance obligation as *remeasurement*.

48. The next section therefore discusses:

    (a) what remeasuring the performance obligations would mean whether using an exit price objective (paragraphs 49 and 50) or a sales price objective (paragraphs 51 and 52); and

    (b) the consequences of not remeasuring the performance obligations, but instead locking in the initial measurements (paragraphs 53–66).

Remeasuring the performance obligations at exit price

49. When using an exit price objective, the bundle of performance obligations is initially measured at the amount that the entity would be required to pay to transfer those obligations to an independent third party. The exit price measurement objective can also be applied to subsequent measurements of the performance obligations. That is to say, after contract inception, the remaining bundle of performance obligations can be remeasured at the amount that the entity would be required to pay *on that date* to transfer those performance obligations *on that date*. In other words, they are remeasured at a *current* exit price.

50. This means that the subsequent measurement reflects what a third party would charge *on the financial statement* date to fulfil the bundle of remaining performance obligations, not what it would have charged at contract inception to fulfil those obligations. On the financial statement date, this price therefore reflects the costs a third party *then* expects to incur in providing the remaining goods and services and the margin it requires. Consider the following example:

> On 2 January DistributorCo enters into a contract to provide three different widgets A, B and C. The widgets take a long time to manufacture and will be delivered separately over 18 months. On 2 January, suppose DistributorCo would have to pay CU10,000 to transfer all of its obligations to a third party. At that same date, a third party would charge CU6,000 to assume the obligations to provide only widgets B and C.
>
> On 30 June, the enforceable rights to widget A transfer to the customer and therefore part of the bundle of obligations is satisfied. If the performance obligations are remeasured, the remaining bundle of performance obligations (ie to provide widgets B and C) on 30 June is measured at the amount DistributorCo would have to pay *on 30 June* to transfer those obligations. Suppose this amount has increased to CU6,500.

If the performance obligations are remeasured at current exit price, the remaining bundle of obligations is measured at CU6,500.[8]

Remeasuring the performance obligations at sales price

51. When using a sales price objective, the bundle of performance obligations is initially measured at the price for which the entity sells to customer the bundle of goods and services underlying those performance obligations. The sales price measurement objective can also be applied to subsequent measurements of the performance obligations. That is to say, after contract inception, the *remaining* bundle of performance obligations can be remeasured at the price that the entity would charge a customer *on that date* for the remaining underlying goods and services. In other words, the remaining performance obligations are remeasured at the *current* sales price of the underlying goods and services.

52. As at contract inception, this amount implicitly includes any amounts that the entity would charge its customer to recover its direct and indirect costs of obtaining a contract to provide those remaining goods and services, as well as a margin. Consider again the example in paragraph 50:

Suppose on 2 January DistributorCo would sell widgets A, B and C for CU11,000 and would sell widgets B and C for CU6,600.

On 30 June, the enforceable rights to widget A transfer to the customer and therefore part of the bundle of obligations satisfied. If the performance obligations are remeasured, the remaining bundle of performance obligations (ie to provide widgets B and C) on 30 June is measured at the amount DistributorCo would charge a customer for widgets B and C *on 30 June*. Suppose this amount has increased to CU7,150.

If the performance obligations are remeasured at current sales price, the remaining bundle of obligations is measured at CU7,150.

Consequences of locking in the initial measurements

53. Instead of remeasuring the bundle of remaining performance obligations at a current exit price or a current sales price, the initial measurement of the performance obligations could be locked in. There are two main consequences of locking in the initial measurements of the performance obligations:

    (a) the initial measurement of the bundle of performance obligations must be *allocated* to individual performance obligations;

    (b) there is a need for an onerous contract test.

[8] Chapter 6 discusses how the remeasurement should be reported and its potential effect on the amount of revenue subsequently recognized.

Initial measurement allocated to individual performance obligations

54. If the remaining performance obligations are not remeasured at each financial statement date, then the initial measurement of the bundle of performance obligations is locked in. However, as individual performance obligations are satisfied, an entity needs to reflect the reduction in the remaining performance obligations. Otherwise, no revenue will be recognized until *all* the performance obligations are satisfied and this would clearly not faithfully represent the entity's transfer of economic resources under the contract.

55. To reflect the reduction in the remaining performance obligations when an individual performance obligation is satisfied, the initial measurement of the bundle of performance obligations must be allocated at contract inception to the individual performance obligations. This is the case regardless of whether an exit price objective or a sales price objective is used to measure the bundle initially. Allocation is necessary because the sum of the measurements of individual performance obligations will almost always exceed the measurement of the bundle of performance obligations.

56. For instance, if individual performance obligations are measured at their separate exit price, the sum of those prices will typically exceed the price a third party would charge to assume the bundle of those performance obligations. This is because third parties generally charge less to assume a bundle of performance obligations than they charge to assume the same performance obligations on a separate basis.

57. Similarly, if individual performance obligation are measured at the separate sales prices for the underlying goods or services, the sum of those sales prices will typically exceed the price the entity would charge a customer for that bundle of goods and services. This is because entities generally sell a bundle of goods and services for less than they sell the same goods and services separately.

58. To be consistent with the basic measurement objective, the allocation could be pro rata based on:

    (a) the exit price of each separate performance obligation if the initial measurement objective is exit price;

    (b) the sale price of the good or service underlying each separate performance obligation if the initial measurement objective is sales price.

59. The following example illustrates the allocation approach when the measurement objective is an exit price.

On 1 February, EngineeringCo enters into a contract to provide, install and maintain 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 and the maintenance agreement commences on 15 April. The customer pays the contract price of CU100,000 on delivery of the machine. (For simplicity, ignore any performance obligations that result from contract management and performance guarantees.)

At initial contract recognition, EngineeringCo could transfer the bundle of performance obligations for CU85,000. On an individual basis, EngineeringCo could transfer the machine obligation for CU75,000, the installation obligation for CU8,000 and the maintenance service obligation for CU6,500.

How should the remaining performance obligations be measured on 31 March, after the machine obligation is satisfied?

The original exit price of the bundle of obligations (CU85,000) could be allocated to each performance obligation as follows:

	Individual exit price	*Allocation of discount*	*Measurement of performance obligation*
Machine	75,000	3,771	71,229
Installation	8,000	402	7,598
Maintenance	6,500	327	6,173
	89,500	4,500	85,000

At 31 March, the remaining performance obligations would be measured at CU13,771 (ie CU7,598 + CU6,173).

60. The following example illustrates the allocation approach when the measurement objective is the entity's sales price.

Consider again the example in paragraph 59.

Suppose EngineeringCo sells the machine separately for CU85,000. It also sells installation and maintenance services separately for similar machines for CU10,000 and CU8,000 respectively.

How should the remaining performance obligations be measured on 31 March?

The original sales price of the bundle of promised goods and services could be allocated to each performance obligation as follows:

	Individual selling price	*Allocation of discount*	*Measurement of performance obligation*
Machine	85,000	2,476	82,524
Installation	10,000	291	9,709
Maintenance	8,000	233	7,767
	103,000	3,000	100,000

At 31 March, the remaining performance obligations would be measured at CU17,476 (ie CU9,709 + C7,767).

61. One of the consequences of allocation under either measurement objective is that a separate exit price or sales price must be determined for each individual performance obligation, or at least each bundle of performance obligations that is satisfied at the same time. If the measurement objective is exit price, because such prices are observable in only limited circumstances, the entity will often have to estimate the price a third party would require to take on each individual performance obligation.

62. Similarly, if the measurement objective is sales price, the entity will have to look to the price it charges for each promised good or service as a basis for allocating the overall contract price. If the entity does not sell the good or service separately, but only as part of a bundle, the entity will have to estimate the price for which the corresponding good or service would be sold separately. Such an approach would be different from that taken in the US in SOP 97-2 *Software Revenue Recognition* and EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables*. These generally preclude a good or service being treated as a separate performance obligation if there is no observable price (either from the entity or other entities). However, such an approach can result in a satisfied performance obligation being treated as an unsatisfied obligation.

Need for onerous contract test

63. Paragraphs 38-41 highlight the fact that if performance obligations are initially measured at sales price, they need to be subject to an onerous contract test to determine whether their carrying amounts should be increased. If the initial measurements of performance obligations are locked in, then regardless of the initial measurement objective, there will also need to be a similar onerous contract test after contract inception.

64. The rationale behind the onerous contract test after contract inception is to ensure that the carrying amount of a performance obligation, which is based on prices and circumstances existing at contract inception, is not understated to the extent that it is no longer faithfully represents the obligation. If the carrying amount is determined to be understated, it is adjusted upwards to some specified current value. In effect, an onerous contract test is the mirror image of the asset impairment test that is required in IFRSs and US GAAP for many assets that are not carried at a current value.

65. Other than acknowledging the need for such a test if performance obligations are not remeasured, the Boards have not discussed how such a test would operate. They plan to address this topic later in the project, including the following specific issues:

(a) At what level should the onerous test operate? Should it apply to an individual performance obligation, the bundle of remaining obligations in a single contract or a portfolio of similar performance obligations? The higher the level at which the test operates, the greater the possibility that losses on individual performance obligations would be offset by gains from other performance obligations, either in the same contract or other contracts.

(b) To what current amount would the carrying amount of the performance obligation be compared? For instance, would a performance obligation be determined to be onerous only if the expected cost to discharge that obligation is more than its carrying amount? If so, what costs are included in this determination—indirect costs as well as direct costs?

(c) What would be the measurement objective if the performance obligation was deemed to be onerous? For instance, would the revised carrying amount include a margin or would it equal only the expected cost to discharge the obligation? If it includes a margin, how would the margin be determined?

(d) If a performance obligation is remeasured upwards, could that remeasurement be reversed if the circumstances causing that remeasurement reversed?

Comparing remeasuring and locking in

66. The following table summarises the consequences of (a) updating the initial measurements of the performance obligations (ie remeasuring) and (b) locking in the initial measurements at contract inception.

Table 5.2: Comparing the subsequent measurements

Initial measurement of performance obligations	*Remeasured*	*Locked in*
Is subsequent measurement consistent with initial measurement?	Yes	No. Subsequent measurement is an *allocation* of the initial measurement rather than a direct *measurement* of the remaining performance obligations.
Need for an onerous contract test?	No	Yes
Are adverse changes in circumstances reported in profit or loss when they occur?	Yes	No, unless the change in circumstances causes the contract or individual performance obligations to be deemed onerous.

Are favourable changes in circumstances reported in profit or loss when they occur?	Yes	No, unless they are implicitly recognized because they prevent the contract from otherwise being deemed onerous.
Does the measurement of the performance obligations at the financial statement date include a margin?	Yes	It depends. If there has been no change, yes. If there has been an adverse change in circumstances but the contract is not deemed onerous, the margin is used to absorb that adverse change.

EVALUATION

Objectives for a measurement approach

67. The foregoing discussion in this chapter has suggested that there are two main decisions that the Boards will ultimately need to make to arrive at a measurement approach for a general revenue recognition standard:

    (a) which measurement objective would result in the most decision-useful information for performance obligations;

    (b) whether performance obligations should be remeasured.

68. How should the Boards choose between the various possible alternatives? Clearly, the objective of a measurement approach is to provide decision-useful information in the financial statements about the entity's contract at the financial statement date. This information should help users assess the amounts, timing and uncertainty of the future cash inflows and outflows from the rights and obligations in the contract. In the Boards' view, measurements will be most useful to users if they:

    - provide a faithful representation of the contract on the financial statement date;
    - represent in an understandable manner something that is meaningful and useful to users;
    - are verifiable, ie different observers would reach general consensus about those measurements;
    - are neutral;
    - are comparable, so that they assist users in identifying similarities and differences between different performance obligations.

69. However, any measurement approach is subject to a cost-benefit constraint. In selecting one particular approach over another, for instance because it is considered to provide a more faithful representation of the contract, the benefits of that approach must justify the costs of implementing that approach compared with other potential approaches.

70. In view of these objectives, the following sections consider the strengths and weaknesses of the two measurement objectives and the strengths and weakness of remeasuring.

Strengths and weaknesses of the two measurement objectives

71. The strengths of an exit price objective are as follows:

(a) *More faithful representation of the performance obligation*. An exit price measurement is the (market) price to *fulfil* the obligation. It excludes amounts that relate to obtaining the contract with the customer, an event that has already occurred. In other words, because the exit price objective is a direct measurement of the performance obligation, it focuses precisely on the obligation being measured. The resulting measurement is therefore a faithful representation of the obligation that the entity has at the financial statement date.

(b) *More faithful representation of the economics of the contract*. If an entity creates value by obtaining a contract with a customer, that value is recognized at contract inception rather than delayed until the entity starts to provide goods and services. Reporting that value when it arises gives a more faithful representation of the entity's activities between obtaining contracts (ie selling activities) and providing goods and services to customers.

(c) *No need to consider treatment of contract origination costs*. Because an exit price objective does not preclude the recognition of revenue at contract inception, there is no need to determine which contract origination costs should be expensed or deferred. All contract origination costs are simply expensed.

(d) *Greater comparability*. If performance obligations are measured at exit price, an entity will measure similar obligations at similar amounts regardless of how those obligations were incurred and the amount the entity was paid to assume those obligations. For instance, when an entity sells warranties to its own retail customers and also assumes identical warranties from other retailers for less money, it measures those identical warranties at identical amounts. In addition, different entities will in principle measure similar obligations at similar amounts even if they sell the underlying good or service for different prices. Hence, using exit prices assists a user to understand the differences and similarities between entities' performance obligations because it portrays like items similarly and conversely does not portray unlike items similarly.

(e) *Neutral reporting of the contract*. Using an exit price objective, an entity recognizes revenue at contract inception if the rights exceed the performance obligations. Conversely if the obligations exceed the rights, at contract inception an entity recognizes a contract loss. In this way, an exit price objective is not biased towards recognition of losses.

72. The weaknesses of an exit price objective are as follows:

(a) *Measurement may not be verifiable and may be costly*. The exit price of the remaining performance obligations will often have to be estimated, even at contract inception. This is because there may be no observable lay-off prices. Therefore although the measurement is described as market based, in reality some of the inputs will not be derived from the market. In addition, the lack of observable prices increases the difficulties and costs of implementing the measurement approach for preparers.

(b) *Risk of measurement error*. A faithful representation of the performance obligations depends on accurate identification and measurement of all the obligations in the contract. If an obligation is either inadvertently or deliberately not identified or is mismeasured (either through inadvertent or deliberate use of inappropriate assumptions), then those errors immediately affect reported profit or loss.

(c) *Depicting an extinguishment option that may not exist.* Measuring the exit price of a performance obligation is not intended to suggest that the entity will extinguish that performance obligation by laying it off. Nonetheless, if the entity is not able to lay off the performance obligation, some argue that an exit price measurement is an attempt to measure an attribute of the obligation that does not exist.

73. The strengths of a sales price objective are as follows:

(a) *Initial measurement of performance obligations verifiable*. In many cases the only verifiable price for a revenue contract is the contract price—the price agreed between the entity and its customer. If that contract price is used as the measure of the bundle of performance obligations, the measurement can be verified easily.

(b) *More understandable estimates*. If estimates of sales prices are required (for example to allocate the contract price to individual performance obligations), the objective is to determine the price at which an entity would sell its goods and services to customers. Because entities routinely determine sales prices for their goods and services to customers, this would be a relatively easy price for preparers to estimate and would be easily understood by users.

74. The weaknesses of a sales price objective are as follows:

(a) *Indirect measurement of performance obligations*. The sales price at contract inception is directly relevant to the measurement of the *rights* in the contract because it relates to the *inflow* of resources from the customer. However, the economic phenomena being measured are the performance obligations in the contract, that is to say, the promises that are expected to result in an *outflow* of resources from the entity. Hence, the sales price objective is an *indirect* measurement of a performance obligation. Because the rights and performance obligations are, in fact, different economic phenomena—only by chance might they be equal—this indirect measurement of the performance obligations

inevitably results in a less faithful representation of those obligations than a direct measurement.

(b) *Overstates the measurement of performance obligations*. A sales price typically includes components to recover the direct and indirect costs of obtaining a contract. Because these components do not relate to the remaining performance obligations, a performance obligation measured at sales price will often be overstated. In effect, the measurement of the performance obligations at sales price includes deferred credits that are not obligations and results in the possibility of an entity having 'secret' or 'hidden reserves' on which profits can be generated at any time by laying the obligations off to third parties. This undermines the relevance and understandability of the financial statements. Furthermore, although subsequent events may result in the measurement of a performance obligation having to be increased, it is more transparent to users and more representationally faithful to report those events when they occur rather than offsetting them against amounts that were deferred at contract inception.

(c) *Verifiability of the measurements is indirect*. Because a sales price measurement of the performance obligations is an indirect measurement, the fact that that sales price is directly verifiable provides little evidence that the measurement of the performance obligations itself faithfully represents those performance obligations.

(d) *Subsequent measurements may not be verifiable and may be costly*. If a sales price objective is used for subsequent measurement, the current sales price of the remaining goods and services may not be observable. This is because an entity may not sell the bundle of goods and services underlying the *remaining* performance obligations. Hence, there may be no observable sales price so that it needs to be estimated. This lack of readily accessible and observable prices increases the cost of the measurements for preparers.

(e) *Less comparability*. Because performance obligations are measured at the entity's sales prices, similar obligations may be measured at different amounts depending on how the obligation is incurred (for example, which may stem from differences in bargains struck between the entity and different customers). The history of a particular obligation can therefore affect its current measurement.

(f) *Need to consider treatment of contract origination costs*. Because a sales price objective precludes the recognition of revenue before any obligations are satisfied, any contract origination costs that are recognized as expenses at contract inception will result in the reporting of net losses. This may result in a desire to defer the recognition of at least some contract origination costs, particularly in industries that incur significant direct origination costs. This would result in the recognition of deferred debits that are not assets, which would undermine the representational faithfulness of the statement of financial position. Whilst some might argue that such a deferred debit is a proxy for a contract asset, in the proposed revenue recognition

model a contract asset arises when the entity has remaining rights that exceed its obligations, not when it has incurred a cost to obtain a contract.

(g) *Biased reporting of the contract*. Although the measurement precludes recognizing the value that is created by obtaining a contract, it nonetheless requires the recognition of a loss if the contract is deemed onerous. Recognizing losses at contract inception but precluding recognition of income introduces bias into the financial statements.

(h) *Measurement error*. At contract inception, the measurement of the bundle of performance obligations is typically set equal to the contract price (unless the contract is onerous), so there is little chance that an error in using a sales price objective would affect profit or loss at contract inception. Nonetheless, a sales price measurement of the remaining performance obligations *after contract inception* depends on accurate identification and measurement all of the remaining obligations in the contract. If an obligation is either inadvertently or deliberately not identified or is mismeasured (either through inadvertent or deliberate use of inappropriate assumptions), then those errors affect profit or loss subsequently.

Strengths and weaknesses of remeasuring

75. The strengths of remeasuring are as follows

(a) *Consistent objective for measuring performance obligations over the life of the contract.* Having a consistent objective provides a coherent framework to account for the performance obligations over the life of the contract and hence to determine the *amount* of revenue to be recognized in any period. This is because the measurement of the change in the contract position in an accounting period is derived from explicit and consistent *measurements* of the contract position. Hence, performance under the contract is determined by explicitly measuring the change in the contract asset or liability. This may be particularly useful in more complex contracts in which the pattern of the transfer of resources to the customer in the contract is not straightforward (for example, long-term stand ready obligations).

(b) *Up-to-date depiction of the contract over its life*. Because the measurements are updated, they correspond to the economic conditions existing at each financial statement date rather than only at contract inception. This is because they reflect the *current* price to fulfil the remaining performance obligations or the *current* sales price for the remaining goods and services. Consequently, the measurement will faithfully represent the performance obligations that the entity is a party to at the financial statement date (for instance, it will provide more up to date and hence relevant information about the exit price or sales price of the economic resources that remain to be transferred in the contract). In contrast, if measurements are locked in at contract inception, the resulting allocated measurements are not explicit

measurements of the performance obligations and do not mean anything—they can be understood only in terms of their calculations.

(c) *Neutral reporting of subsequent changes in circumstances*. If measurements are updated, both favourable and adverse changes in prices and circumstances are reported as and when they arise. In contrast, relying on an onerous contract test introduces bias into the subsequent measurements because it treats changes in prices and circumstances differently. An unfavourable change of prices or circumstances that causes a contract to become onerous would be treated differently from either (i) an unfavourable change that does not cause the contract to be deemed onerous or (ii) favourable changes in prices or circumstances. That is because the first would be recognized, but the other two would not. In addition, a favourable change of circumstances would be implicitly recognized if it is offset against an unfavourable change in circumstances that would otherwise have caused the contract to be deemed onerous.

(d) *More timely reporting of subsequent changes in circumstances*. If remeasurement is required only by exception, adverse changes in circumstances that do not cause the contract to be deemed onerous may not be reported. This can result in large remeasurements eventually being required to be recognized. For users, such losses can come as surprises. Reporting changes as they arise also provides more feedback to users about changes in prices and circumstances (ie past real economic events) that have occurred after contract inception. In addition, if remeasurement is required only by exception, there is a risk of a required remeasurement being overlooked.

(e) *Better reporting of margins.* The measurement of a performance obligation at any financial statement date would include the margin required for providing the remaining goods or services (a market margin if exit price is used or the entity's margin if sales price is used). This ensures that profit (or loss) is recognized over the life of the contract. In contrast, if a performance obligation is not remeasured, the margin initially included in the measurement of the performance obligation will be used to absorb any adverse change in prices until such time as the contract is deemed onerous and is remeasured. This can result in the measurement no longer including a margin as illustrated in the following example.

ServiceCo enters into a two-year contract on 2 January 2008 to provide maintenance services on a new product. ServiceCo and third parties expect that their direct and indirect costs to provide these services will be CU8,000. For simplicity, assume that the costs are expected to arise evenly over the two years. ServiceCo and third parties also require a margin of CU2,000 for providing these services. Assume that there are no contract origination costs so that the contract price and the exit price is CU10,000. The customer prepays.

During 2008, it becomes apparent that the machine requires more maintenance than was originally expected. ServiceCo and third parties therefore increase their prices on new maintenance contracts.

Suppose that at 31 December 2008 the maintenance servicing costs expected to be incurred in 2009 are CU5,000.

If the contract is not deemed onerous at 31 December 2008, the measurement of the performance obligation would not be updated and would be CU5,000, ie the amount of the initial measurement attributed to the second year of the contract (on the basis that the maintenance services were expected to be provided evenly over the two years).

In effect, this means that CU1,000 of the initial margin that was included in the pricing of the second year of the contract has been used to absorb the change in circumstances that occurred in 2008. Had the change in circumstances not occurred, ServiceCo would have reported the margin of CU1,000 for the second year (included in the initial measurement of the performance obligation) in profit or loss when the services were provided in 2009.

Therefore, because the measurement of the performance obligation is not updated when the change in circumstances occurs in the 2008, some of the remaining margin in the contract is implicitly recognized at that point to absorb the change in circumstances. At the end of 2008, ServiceCo expects to report no margin in 2009, even though it originally required a margin of CU1,000 to provide services in the second year. Said another way, not recognizing the effect of the change in circumstances arguably results in accelerating or 'front loading' the reporting of the original margin in the contract.

The above example is somewhat extreme. However, it illustrates how not remeasuring the performance obligation could mean that the measurements no longer include *any* margin (if a performance obligation is not deemed to be onerous until its carrying amount is less than the expected costs of providing the goods and services). Since entities do not willingly provide goods and services to their customers without recovering a margin, a measurement of a performance obligation to provide goods and services that excludes a margin would typically not faithfully represent the entity's obligation to provide goods and services. Even if not all of the margin is eroded by a change in price and circumstance, the remaining margin might be significantly less than would be required if a new contract was entered into to provide the remaining goods and services.

(f) *Consistency with IAS 37*. Remeasurement would be consistent with the approach currently required in IAS 37, which is an accounting model for liabilities that are not financial instruments or employee benefit obligations. Even though IAS 37 does not currently generally apply to liabilities arising in revenue transactions, conceptually there is no reason why it could not. IAS 37 requires a liability to be measured at the amount to either transfer or settle (presumably with the counterparty) the obligation *on the financial statement date*, ie it is a *current* measurement. Hence, if the amount to either transfer or settle the liability changes from one period to the next, the carrying amount of the liability is adjusted. The amount to transfer a performance

obligation at contract inception would be its exit price. The amount to settle a performance obligation at contract inception would equal the sales price of the underlying goods and services. Hence, to be consistent with IAS 37, the subsequent measurement of a performance obligation would need to be updated to reflect either the current exit or current sales price.

76. The weakness of remeasuring are as follows:

(a) *Burdensome and costly subsequent accounting for preparers*. It could be burdensome to remeasure. Remeasuring by exception (with an onerous contract test) reduces the need for costly remeasurement. For many simple contracts, particularly those for goods or for services provided over a short period, the benefits of remeasurement are unlikely to yield much additional information to users. This is because prices and circumstances are unlikely to change much, and because all of the profit or loss from the contract is recognized in a relatively short period. Said simply, for such contracts, the benefits of remeasuring will not justify the costs. In addition, if prices and circumstances change significantly for the worse, an onerous contract test will update the measurement. Hence, performance obligations will not be measured at less than the entity's expected cost to fulfil that obligation (and may be measured at a greater amount depending on how the onerous contract test operates).

(b) *Subsequent measurements will typically not be verifiable*. Remeasuring is likely to introduce more subjective estimates into the measurement approach because it will require entities to explicitly measure smaller bundles of performance obligations than originally included in the contract. Therefore, there is less likely to be observable information to use in measuring those obligations, whether for an exit price or a sales price measurement objective.

(c) *Counter-intuitive accounting*. If an entity remeasures a performance obligation upwards, it recognizes an expense at that time and then more income[9] when that performance obligation is subsequently satisfied. In effect, the additional income reflects the additional consideration the entity would have required had the entity been able to reprice the contract. However, since there is no additional consideration from the customer, some find that counter-intuitive. For example:

> DistributorCo enters into a fixed-price contract on 1 June to provide a widget on 1 September for CU1,000. For this illustration, assume that the exit price of the performance obligation on 1 June is CU1,000. Hence for both measurement objectives, the performance obligation is measured at CU1,000. Suppose that on 31 July, the exit price of the performance obligation has increased to CU1,100 and DistributorCo is also entering into similar contracts with a new sales price of CU1,100.

[9] Chapter 6 discusses how the remeasurement should be reported and its potential effect on the amount of revenue subsequently recognized.

If the performance obligation is remeasured to CU1,100 on 31 July, an expense of CU100 is recognized in profit or loss on that day. In addition, when the obligation is satisfied on 1 September, income of CU1,100 will be recognized. However, there is no additional consideration from the customer.

(d) *Accounting mismatches introduced into profit or loss.* Remeasurement is likely to introduce accounting mismatches into profit or loss, ie mismatches that do not reflect genuine economic mismatches of the entity. This is because many other assets and liabilities that are related to revenue contracts are not typically measured at current value. In particular, the resources that will be transferred to the customer in the contract may be accounted for at cost. In other words, remeasuring only the performance obligation may result in an incomplete and potentially misleading depiction of how the change in circumstances giving rise to the remeasurement has affected all the entity's assets and liabilities. For example:

Oil Co enters a fixed-price contract on 1 January with a customer to deliver 1,000 gallons of oil in four equal quarterly instalments starting on 31 March. Suppose that the customer pays CU3 per gallon in full in advance and, therefore, Oil Co recognizes a contract liability of CU3,000. Oil Co purchased all of the oil required to fulfil this contract on 1 January and measures its oil inventory at cost.

On 1 March 2007, the price of oil increases by 10 per cent. This increase in the price of oil results in Oil Co increasing its prices to customers on oil supply contracts and the price a third party would charge to assume the performance obligations. If Oil Co remeasures its performance obligation on 1 March to CU3,300, it recognizes a loss of CU300.

However, if Oil Co does not reflect any increase in the carrying amount of its oil inventory in March when it remeasures its contract liability, profit or loss depicts Oil Co as if it was economically identical to an entity that had not obtained any oil to fulfil the contract. In other words, it depicts Oil Co as if it was fully exposed in its contract to changes in market prices of oil, whereas it has effectively hedged its position in the contract.

TWO MEASUREMENT APPROACHES DEVELOPED BY THE BOARDS

77. Given the strengths and weaknesses noted in the previous section, the Boards have developed two potential measurement approaches from the four possible permutations of using either an exit price or sales price objective and subsequently either updating the measurements or locking them in at inception. The first approach is referred to as the current exit price approach and the second is referred to as the customer consideration approach.

Current exit price approach

78. Some Board members think that the most conceptually coherent way of determining the appropriate recognition of profit or loss over the entire life of a contract is to explicitly measure the performance obligations both at contract inception and subsequently. Thus, these Board members favour the remeasurement of contracts using the same measurement objective used at contract inception.

79. In choosing a measurement objective, these Board members emphasise the need to faithfully represent the performance obligations. In their view, an exit price objective more faithfully represents performance obligations because it does not take into account the activities needed to obtain the contract. In contrast, a sales price objective does take into account the activities needed to obtain the contract, even though the contract has already been obtained.

80. These Board members acknowledge that an exit price will often be unobservable for most revenue contracts, both at contract inception and subsequently. However, these Boards members point out that a sales price is typically available only at contract inception. As a result, even a sales price will often be unobservable (and thus will need to be estimated) after contract inception. Given the preference for remeasurement, the more faithful representation of an exit price objective and the likely need to estimate under either measurement objective after contract inception, these Board members think that the most appropriate measurement approach is to use *exit price* at contract inception and subsequently. This approach is described as a *current exit price approach* and is summarised as follows:

> At the financial statement date, the contract asset or contract liability (ie the combination of the remaining rights and performance obligations) is measured at the amount that the entity would expect to receive *on that date* or would be required to pay *on that date* to transfer that asset or liability to an independent third party.

Customer consideration approach

81. Some Board members think that the measurement approach in the proposed model should result in measurements that are verifiable. These Board members note that one of the key strengths of measuring performance obligations at sales price is that the measurements would be verifiable at contract inception. They note that any other measurement is likely to have to be estimated.

82. These Board members acknowledge that a sales price is typically verifiable only at contract inception for the original bundle of performance obligations. At any point after contract inception, if the performance obligations were to be measured at the current sales price, that price might need to be estimated. This is not particularly troubling to these Board members because they think there are few, if any, situations in which the benefits of updating measurements after contract inception would justify the costs. Hence, they think that the most appropriate measurement approach is to use a *sales price* objective at contract inception and not remeasure subsequently.

83. Accordingly, these Board members would measure performance obligations by allocating the contract price to the individual performance obligations based on the sales price at contract inception of the underlying goods and services. In this way, the initial measurement is verifiable and the subsequent measurement is derived directly from the contract price (being an allocation of the contract price). This approach is described as a *customer consideration measurement approach* and is summarised as follows.

> At contract inception the rights are measured at the contract price (ie the consideration).[10] The bundle of performance obligations is also measured at the contract price. This is accomplished by allocating the contract price to individual performance obligations based on the entity's observed or estimated selling prices of the individual goods or services underlying those performance obligations at contract inception.
>
> After contract inception, the remaining rights are measured at the amount of the consideration still to be received. The remaining performance obligations are measured at the amount of the contract price that was allocated to those obligations at contract inception.
>
> Hence, at the financial statement date, the contract asset or liability is measured at the amount of the remaining consideration to be received less the amount of the total contract price that was allocated to the remaining performance obligations at contract inception.
>
> Performance obligations are subject to an onerous contract test both at contract inception and subsequently.

[10] As noted in paragraph 31, this amount is adjusted, as necessary, for the time value of money and the customer's credit risk.

Summary and comparison

84. The following table compares the two measurement approaches:

Table 5.3: Comparing current exit price and customer consideration		
	Current exit price	**Customer consideration**
At contract inception		
Measurement of contract	Measure the remaining rights and performance obligations in the contract at their current exit price.	Measure the rights in the contract at the amount of consideration received or receivable (ie contract price). This amount is then allocated to the performance obligations based on the separate selling price of the goods or services underlying those obligations.
Need for onerous contract test?	No.	Yes.
Use of estimates in measuring performance obligations	The exit price of the bundle of remaining performance obligations will need to be estimated if there are no observable exit prices.	The standalone selling price of a good or service will need to be estimated if the entity does not sell that good or service separately.
After contract inception		
Measurement of contract	Measure remaining rights and obligations in the contract at their current exit price.	Measure remaining rights at the amount of remaining consideration receivable. Measure remaining obligations at the amount of the contract price that was allocated to those obligations at contract inception.
Need for onerous contract test?	No	Yes

Table 5.3: Comparing current exit price and customer consideration		
	Current exit price	**Customer consideration**
If there is a change in price for goods and services still to be provided, does the carrying amount of the performance obligations change?	Yes, if there is a change in the current exit price of the performance obligations.	No, unless a performance obligation is deemed onerous.
Use of estimates in measuring performance obligations	The current exit price will need to be estimated if there are no observable market prices.	When a performance obligation is satisfied over time, estimates are required to determine how much of the consideration should be allocated to the remaining obligation. The measurement of a performance obligation may need to be estimated if it is deemed onerous.

The Boards' tentative decision

85. The majority of Board members favour the [***to be determined by vote in May 2008***] measurement approach when presented with the two measurement approaches in this section. Consistent with the arguments already described in this chapter, these Board members think the [***to be determined by vote in May 2008***] measurement approach is more… These Board members also think this measurement approach is…

86. The Boards invite constituents to comment on the two measurement approaches presented in this section. However, the Boards also invite constituents to suggest other measurement approaches that build on the measurement framework outlined in this chapter—that is to say, a measurement approach that clearly states a measurement objective for the contract (both the rights and performance obligations) at contract inception and whether that measurement would be locked in or remeasured subsequently.

87. In asking for suggestions of an alternative measurement approach, the Boards acknowledge that both measurement approaches presented in this chapter have strengths and weaknesses. The Boards welcome any suggestions on how the perceived strengths of each approach might be combined into a single measurement approach. In that regard, Appendix A to this chapter briefly explains such an approach.

CONCLUSIONS

88. This chapter has presented a framework of issues that any measurement approach must consider in a contract-based revenue recognition model. Specifically, this chapter proposes that a measurement approach must determine a measurement objective for the rights and obligations in a contract, and whether that measurement objective will be used at contract inception and subsequently, or only at contract inception.

89. Based on this framework for a measurement approach, this chapter discussed two measurement approaches developed by the Boards—a current exit price approach and a customer consideration approach. Only the current exit price approach calls for remeasurement of the contract on an ongoing basis (for reasons other than an onerous contract outcome). Remeasurement has important implications for the amount of revenue that is recognized subsequently when performance obligations are satisfied. The next chapter examines this issue in more detail.