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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**16 September 2008, London**
Project:	**Revenue Recognition**
Subject:	**Subsequent measurement of performance obligations (Agenda paper 10)**

INTRODUCTION AND OBJECTIVE OF PAPER

1. In May, the Boards expressed a preliminary view in favour of the customer consideration approach to measuring performance obligations. At contract inception, that approach allocates the transaction price (customer consideration) to identified performance obligations, thus precluding revenue recognition at contract inception. That approach then locks in (ie it does not update) the initial measurement of a performance obligation unless that performance obligation is deemed onerous.

2. In July, the Boards considered whether performance obligations should be remeasured in circumstances other than when deemed onerous. For example the Boards considered whether uncertain, long-term performance obligations should be remeasured even if not deemed onerous.

3. The FASB concluded that an allocated customer consideration approach, with an onerous test, would provide decision useful information about most

contracts with customers, and would therefore be suitable as the single measurement approach in a general revenue recognition standard. The FASB noted that the transactions for which the approach may not work so well are likely to be subject to other standards (eg financial instruments and insurance contracts).

4. The IASB did not reach a conclusion for, the staff thinks, two main reasons. First, it was unclear what an onerous test would entail. Secondly, some Board members appeared uncomfortable with locking-in the initial measurements of all performance obligations until they are deemed onerous. In other words, they seemed to indicate that another measurement approach might be necessary for some performance obligations in the general revenue recognition standard.

5. Both Boards seem to acknowledge, although in different ways, that more than one measurement approach is necessary to accommodate the various types of obligations that give rise to revenue.

6. There are therefore two issues for the Boards to consider. First, what form should the onerous test take? Secondly, is the allocated customer consideration measurement approach, with an onerous test, suitable as the single measurement approach in a general revenue recognition standard? These questions assume that the scope of a general revenue recognition standard will not include some obligations that are subject to other measurement guidance (eg financial instruments) or some obligations that are the subject of ongoing Board projects (eg insurance contracts).

7. Hence, this paper:

   a. considers the main issues associated with an onerous test (paragraphs 10–39),

   b. explores some Board members' concerns about remeasuring performance obligation only if deemed onerous (paragraphs 40–46),

   c. highlights possible courses of action to address those concerns (paragraphs 47–57),

d. recommends a course of action (paragraphs 58–62).

8. The Boards do not necessarily need to reach preliminary views on these issues. Rather, the critical point is to ensure that the staff has captured the main views on subsequent measurement of performance obligations for inclusion in the discussion paper.

9. Subject to sweep issues, the staff does not plan to bring the topic of subsequent measurement back to the Boards before issuing the Discussion Paper (planned for November 2008).

ONEROUS TEST

10. The intent of this part of the paper is not to consider *all* of the issues associated with an onerous test. Instead, the staff is focusing on those issues that we think are fundamental to the Boards deciding on the suitability of the customer consideration allocation approach, with an onerous test, as the single measurement approach in a general revenue recognition standard. In the staff's view, these issues are:

   a. when should a performance obligation be deemed onerous, ie what is the trigger for remeasurement?

   b. how should a performance obligation be remeasured if deemed onerous?

Is an onerous test necessary?

11. Before turning to these questions, the staff notes that some have questioned whether an onerous test is necessary. If the relevant measure of a performance obligation is the amount the customer promises to pay in exchange for the entity assuming that obligation, then that amount should arguably remain relevant regardless of changes in expectations of the amount of economic resources required to settle that obligation. In other words, in a *pure* customer consideration model, there seems to be no reason why any losses could not simply emerge as the revenue is recognised.

12. However, the staff thinks that most Board members think it is important for the measurement of a performance obligation to faithfully represent the

outflow of economic resources required to satisfy that obligation. An allocated customer consideration amount is, in many cases, a reasonable reflection of those outflows. But in some contracts, circumstances can change such that the initial allocation no longer provides a faithful representation of the outflows. Hence, the initial measurement needs to be updated, ie the performance obligation remeasured. The onerous test is a means of identifying those performance obligations that need to be remeasured, albeit only in one direction.

When should a performance obligation be deemed onerous (trigger for remeasurement)?

Cost trigger

13. One option would be to specify that a performance obligation is onerous when the expected costs to satisfy that performance obligation exceed its carrying amount.

14. A cost trigger is currently used for construction contracts in SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and IAS 11 *Construction Contracts*. These standards, in effect, deem a contract onerous[1] when the current total expected contract costs exceed the expected inflows under the contract (ie when the total contract is expected to generate a cash loss). When the loss becomes apparent, the contract is remeasured and the loss recognised.

15. The main consequence of a cost trigger is that any margin implicit in the initial carrying amount of the performance obligation is used as a buffer to absorb adverse changes in the performance obligation. That is to say, the measurement of the performance obligation remains unchanged until its margin is exhausted. Only then is remeasurement triggered. This results in any adverse change in expected costs first reducing *future* profits—because it reduces the remaining margin implicit in the carrying amount of the performance obligation—rather than *current* profits.

[1] Although they do not use the term onerous. SOP 81-1 refers to anticipated losses and IAS 11 expected losses.

16. To illustrate this point, consider the following example:

> On 1 January 2008, ConstructorCo enters into a two-year construction contract. For simplicity, assume that the customer prepays the contract price of CU100,000 and that the construction services and materials transfer to the customer evenly over the two years. Hence, the amount of the customer consideration allocated to the performance obligations satisfied in 2008 and 2009 is the same, CU50,000.
>
> At contract inception, the expected costs to fulfil the contract are CU80,000, so the margin implied by the transaction price is CU20,000. Suppose that on 31 December 2008, due to increase in labour and material costs, the expected costs to fulfil the remaining part of the contract increase from CU40,000 to CU48,000. Because the costs to fulfil the remaining performance obligation (CU48,000) do not exceed the carrying amount of the remaining performance obligation (CU50,000), the contract is not deemed onerous.

17. As a result of using the margin as a buffer, a cost trigger can report adverse changes in circumstances in periods after the period in which the change occurs. In the above example, the effect of using the margin as a buffer to absorb the changes in circumstances is that margin of CU8,000 that would otherwise have been reported in 2009 has in effect been reported in 2008.

18. Another consequence of using a cost trigger is that it may require guidance regarding what costs to include when conducting the onerous test. This is because those costs could vary depending on how the entity intends to settle the performance obligation, for instance they might be the expected costs to perform under the contract, the costs to lay off the obligation, or the costs to breach the contract and settle with the customer. In addition, if the costs are those to perform under the contract, should they include only the direct costs of providing goods and services or should they also include administrative costs for managing the contract? These, of course, are not new issues and the Boards could adopt guidance similar to that in IAS 11 and SOP 81-1 for determining whether a construction contract is loss-making (ie onerous).

Trigger with a margin

19. Another option for the trigger would be to use a current price (which includes a margin) to determine when a performance obligation is onerous. The obvious trigger under IFRS would be to use the measurement in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This trigger is already used in IFRS 4 *Insurance Contracts* if an insurer's accounting policies

do not require an onerous test[2] that meets specified minimum requirements. Using the IAS 37 measurement as a trigger would mean that a performance obligation is onerous if its measurement applying IAS 37 exceeds its carrying amount.

20. The IASB is currently debating the existing measurement requirements in IAS 37. However, one interpretation is that they require a performance obligation to be measured at the financial statement date at the lower of (a) the amount to transfer the obligation to a third party at the financial statement date and (b) the amount to settle with the customer at that date. The former measure appears to be similar to a current exit price and the latter consistent with a current sales price (ie consistent with the customer consideration measurement approach).[3] In contrast with a cost trigger, both measures include a margin.

21. Consider again the example in paragraph 16.

> Suppose that there has been a general increase in labour and material costs. Further suppose that the IAS 37 measurement of the remaining performance obligation is CU56,000.[4] Because this amount exceeds the carrying amount of the remaining performance obligation (CU50,000), the contract is deemed onerous.

22. Compared with an expected cost trigger, a trigger with a margin would typically reduce the margin buffer that absorbs adverse changes in circumstances. A trigger with a margin should therefore provide more timely information to users about adverse changes in circumstances because they are recognised as they arise.

23. However, a trigger with a margin is likely to increase the frequency of remeasurement. It therefore more closely resembles a measurement approach in which performance obligation are remeasured at each financial statement date (what the staff describes as an explicit measurement approach). The Boards rejected such an approach in May for most performance obligations because of concerns about the added cost and complexity without sufficient offsetting benefit of decision usefulness. This complexity is mitigated by the

[2] In IFRS 4, the term *liability adequacy test* is used rather than onerous.
[3] The initial measurement in the customer consideration approach would very likely be the amount to settle with the customer at contract inception.
[4] For simplicity, the staff has assumed that the amount to transfer and settle are the same.

fact that the onerous remeasurement only recognises adverse changes (and not favourable ones).

Level at which test should be undertaken

24. An important issue that the Boards will eventually need to consider is at what level the onerous test should apply. For instance, should the test apply to an individual performance obligation, the combination of the remaining performance obligations in the contract, or a portfolio of homogenous performance obligations that are managed as a portfolio?

25. Arguably this issue is more critical if a cost trigger is selected. For instance, if the test is at the level of all of the remaining performance obligations in the contract, *all* of the margin implicit in the carrying amount of other performance obligations in the same contract would be used as a buffer to absorb losses on a single performance obligation. This may prevent a performance obligation from being deemed onerous when, if tested on its own, it would be onerous. The staff notes that it would be relatively straightforward to apply the test to separate performance obligations in a contract with discrete deliverables, such as a contract for the delivery of a machine together with a servicing contract. However, in the case of continuous delivery contracts, such as construction services, each contract is in essence an endless number of performance obligations. Hence, it may only be practical to apply the test to the remaining performing obligations.

How should a performance obligation be remeasured if deemed onerous?

26. Once a performance obligation is deemed onerous, it is remeasured. That remeasurement could be consistent with the trigger. Hence, if the trigger is when the expected costs exceed the carrying amount, then the performance obligation would be remeasured upwards to the revised expected costs. If the trigger is a current price such as IAS 37, then the performance obligation would be remeasured upwards to that price.

27. As with the trigger, the main difference between remeasuring a performance obligation to the expected cost of performance and to an IAS 37 measure relates to whether a margin is included in the remeasurement.

28. Consider again the example in paragraph 16.

Suppose that at 31 December 2008 the expected costs have increased by CU11,000, so that the performance obligation is deemed onerous both under a cost trigger and an IAS 37 trigger. Further suppose that at 31 December 2008, the IAS 37 measure would be CU59,000.

	Remeasured to cost		*Remeasured to IAS 37*	
	2008	2009	2008	2009
Revenue	50	50	50	50
Remeasurement gains/(losses)	(1)	1	(9)	9
Expenses	(40)	(51)	(40)	(51)
Margin	9	-	1	8
Carrying amount of performance obligation	51	-	59	-

29. After the performance obligation is remeasured to the revised expected costs, the margin over the remainder of the contract is nil (assuming it does not become more onerous). If the performance obligation is remeasured in accordance with IAS 37, then the margin included in the remeasurement is reported over the remainder of the contract.

Appropriateness of including a margin in the remeasurement

30. The staff acknowledges that if the remeasurement includes a margin, some find the accounting counterintuitive, in particular the ‘seesaw’ effect on the performance reporting. This effect arises because the performance obligation is remeasured with a margin and a corresponding expense recognised, and then that additional margin is subsequently recognised when the obligation is satisfied. For instance, in the above example income of CU9 is recognised and margin of CU8 reported in 2009 but there is no additional consideration from the customer. However, note that in accordance with the Boards’ decision in May the remeasurement has no effect on the amount of revenue reported. The amount by which the performance obligation is measured upwards is reversed as another component of profit or loss.

31. Although remeasuring with a margin differs from current practice in IAS 11 and SOP 81-1, it would (at least in theory) be consistent with the present measurement requirements for an onerous contract in IAS 37. Conceptually, if

the objective of the measurement is to provide a faithful representation of a performance obligation, then the measurement should include a margin over its life. This is because an entity would not willingly promise to provide goods and services without demanding a margin, so a cost measure would be an incomplete depiction of the performance obligation.

32. As to the counterintuitive nature of the performance statement, this can be viewed as similar to the income statement effect of an asset impairment (the onerous test on a performance obligation essentially being the mirror image of an asset impairment test). On impairment, the asset is written down to a present value measurement (fair value or value-in-use) and a loss is reported. The present value measurement reduces the expected future cash flows embedded in the asset for, amongst other things, uncertainty. Hence, the entity typically reports a margin as it recovers those future cash flows after recognising the impairment. (However, because the margin is reported through various line items, it is not as visible as the reversal of an onerous obligation remeasurement.)

33. Although remeasurement of a performance obligation arguably should include a margin, the staff acknowledges the difficulty of determining what that margin should be. As noted, determining what costs should be included in a cost measurement itself raises questions, although the guidance in SOP 81-1 and IAS 11 seems workable in practice. But determining a current margin raises more difficult estimation issues, in particular when determining a current margin on a partially satisfied performance obligation. This is because entities typically neither sell nor transfer partially completed goods and services so there are often no observable prices. Some are therefore concerned about the additional subjectivity of a remeasurement with a margin.

34. The Boards should also note that the IASB has not resolved the role of margins in IAS 37.

Summary of options for an onerous test

35. The preceding discussion suggests that there are two main options for an onerous test for performance obligations.

	Option A (Cost)	**Option B (Margin)**
Remeasurement trigger	When the entity's cost of performance exceeds the carrying amount of the performance obligation.	When the measurement of the performance obligation in accordance with IAS 37[5] exceeds the carrying amount of the performance obligation.
Remeasurement	Remeasure the performance obligation to the entity's expected cost of performance.	Remeasure the performance obligation to the amount in accordance with IAS 37.

36. Option A can be viewed as a 'safety net' to ensure that the carrying amount of a performance obligation does not fall below the entity's expected cost of performance. It would capture unexpected events (eg the effect of recent unexpected doubling of oil prices on an airline's performance obligations). The advantage of the approach is that it limits the occasions for remeasurement, thereby preserving the relatively straightforward nature of the allocated customer consideration model. The main disadvantage of the approach is that it delays the recognition of some adverse changes.

37. Option B is a more sensitive test because it includes a margin. Therefore it reduces the surprises to users by reporting all adverse circumstances in a timelier fashion. The main disadvantage of this approach is that it is more complex and burdensome, particularly in requiring the estimate of a current margin. In addition, having more reversals of remeasurements potentially makes it harder for users to understand profit or loss.

38. The staff notes that there could be a hybrid approach, ie the remeasurement trigger is as for Option A but the remeasurement itself is as for Option B. This two-step approach would be similar to the asset impairment test in FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets,* but would be inconsistent with the asset impairment test in IAS 36 *Impairment of Assets*.

[5] Or another similar current price.

However, for consistency and simplicity, the staff thinks that the trigger and the remeasurement should be consistent.

39. This section of the paper has considered the main issues associated with an onerous test. As noted in the introduction, some think that an onerous test can determine when all performance obligations in a general revenue recognition standard should be remeasured. Others, however, seem concerned about relying solely on an onerous test to determine when performance obligations should be remeasured. Therefore, before concluding on how an onerous test should work for the allocated customer consideration measurement approach, the next section of the paper considers why some are concerned about locking in the initial measurements of some performance obligations until they are deemed onerous.

CONCERNS ABOUT REMEASURING PERFORMANCE OBLIGATIONS ONLY WHEN DEEMED ONEROUS

40. As a reminder, the staff has written this section primarily for the IASB, because in its July meeting it did not reach a conclusion on remeasurement beyond an onerous test (whereas the FASB did).

41. As noted above, the allocated customer consideration approach locks in the initial measurement of a performance obligation and does not update it unless the performance obligation is deemed onerous. So, in effect, the measurement approach assumes that the initial assessment of those outflows will not change. If the initial assessment does change, that change is ignored until the performance obligation is deemed onerous (however defined).

42. In many cases, ignoring changes in the expected outflows until the obligation is deemed onerous is unlikely to result in financial information that is not decision useful. One reason for this is that in many cases the amount of those outflows is fairly certain (eg if uncertainty is not a significant inherent characteristic of the contract, the prices of the underlying goods and services are not volatile, or the contract is of a such short duration that it is unlikely circumstances will change significantly). In such cases, the initial measurement of the performance obligation is reasonably correlated with the final outflow of resources required to satisfy the performance obligation.

Hence, the initial measure continues to provide decision useful information about the performance obligation—ie the expected outflows required to satisfy that obligation—after initial recognition until it is satisfied.

43. However, if the expected outflows are highly uncertain, then there is a risk that the initial measurement may not continue to provide decision useful information about the performance obligation after contract inception. This may be the case if either uncertainty is a significant inherent characteristic of the contract, or prices of the underlying goods and services are volatile, or the contract is of such duration that changes in circumstances are highly likely.

44. Arguably even if the expected outflows are uncertain, then locking in the initial measurements does not matter because the onerous test captures significant adverse changes in the expected outflows. Furthermore, an onerous test with a margin (eg Option B) is relatively sensitive, so that adverse changes are reported on a reasonably timely basis.

45. However, there are weaknesses about relying on an onerous test to determine when to remeasure:

   a. Remeasuring only when a contract is deemed onerous is remeasurement by exception. Such an approach creates the risk that an entity may not identify changes in circumstances, particularly if the initial locked-in measurement is considered to contain a significant implicit buffer.

   b. It is a one-way test. Hence it can be arbitrary whether changes in circumstances are reflected in profit or loss. For instance, adverse changes that do not cause a contract to become onerous are ignored and many favourable changes are ignored. But favourable changes that prevent the contract from otherwise being deemed onerous are implicitly reflected. In contracts in which circumstances can change, failing to report all changes as they arise diminishes the decision usefulness of the financial information.

   c. In more complex contracts in which the pattern of the transfer of resources to the customer in the contract is not straightforward, the allocation of the initial transaction price to the remaining performance obligations can become somewhat arbitrary.

46. Another point that concerns some IASB members is the inconsistency of the locked-in approach with IAS 37. As noted, the IASB has yet to conclude on the measurement requirements of IAS 37. However whilst there is debate about what margin is required by an IAS 37 measure, the staff does not think that there is any debate that an IAS 37 measure involves the use of current estimates of cash flows rather than locked-in estimates. The staff notes that the proposed revenue recognition model will result in some transactions being moved from the scope of IAS37 into the new model. This is because in some cases, under current IFRS, even though all the revenue has been recognised, the entity still has remaining ‘tail’ performance obligations. These are presently accounted for under IAS 37. Examples include some warranties and refunds. Hence such obligations are currently measured not under a locked-in approach but based on current estimates of future cash flows, ie explicitly measured. Whilst warranties could be dealt with in any insurance standard, and some of the other performance obligations in IAS 37 could reasonably be accounted for under a locked-in approach, some Board members may be concerned that in moving performance obligations from IAS 37 into a locked-in measurement approach they would actually makes the resulting financial information less decision useful.

HOW COULD CONCERNS ABOUT REMEASURING PERFORMANCE OBLIGATIONS ONLY WHEN DEEMED ONEROUS BE ADDRESSED?

Could the scope of the general revenue recognition standard mitigate the concerns?

47. Some Board members have noted that other standards may address many of the performance obligations for which an allocated customer consideration approach (with an onerous test) might not provide decision useful information (eg financial instruments including derivative contracts for non-financial items). If these contracts are initially and subsequently measured at fair value, then *any* changes in circumstances that affect their fair value are reported in the period in which they arise. The Boards could choose to scope these obligations out of a general revenue recognition standard.

48. Some insurance contracts are another example of performance obligations for which the allocated customer consideration approach may not provide decision useful information. The resources required to satisfy an insurance contract can be highly uncertain because uncertainty is an inherent characteristic of insurance contracts and those contracts often cover many reporting periods. For these reasons, the IASB rejected a locked-in measurement approach with an onerous (liability adequacy) test in its 2007 Discussion Paper on Insurance Contracts. The IASB acknowledged, however, that a locked-in approach might be appropriate for many short-duration insurance contracts. Since the IASB has a long-term project in progress on insurance, insurance contracts, (like financial instruments), could be outside the scope of the general revenue recognition standard.

49. However, some think that a locked-in approach might not provide decision useful information for some performance obligations beyond financial instruments and insurance contracts. For instance:

   a. Long-term, fixed-price contracts for items having volatile prices (eg a take or pay contract for power or commodity).

   b. Contracts in which the eventual outcome depends on specified uncertain future events, eg many guarantees, warranties, contracts with customer options and other stand ready obligations particular if longer-term.

   c. Long-term contracts involving big-ticket items, such as large construction projects. With such contracts, some argue that although the expected outflows of resources are not highly uncertain or volatile, the sheer materiality of these contracts means that relatively small variations in cash flows are material and should be reported as they arise and not just absorbed into the margin.

Is there a need for another measurement approach?

50. Given the Boards' preliminary view on measurement of performance obligations and the concerns with applying that view to some uncertain, volatile contracts, the Boards need to consider whether scoping decisions (ie

scoping out financial instruments and insurance) can adequately address those concerns. If not, then the Boards could address them through disclosures or through another measurement approach in a general revenue recognition standard.

51. Those in favour of disclosure think that the advantages of having a single, straightforward, measurement approach outweigh the disadvantages of that approach providing less decision useful information in limited circumstances. In those limited circumstances, the Boards could require disclosures to enhance the decision usefulness of the information provided by the single measurement approach.

52. Those supporting another measurement approach note that the scope of a *general* revenue recognition standard is very broad (covering the most simple transactions to the most complex). Hence they think that more than one measurement approach is required for different types of transactions, unless a single measurement approach is adopted that can handle the most complex transactions (which the Boards' proposed approach cannot).

53. If the Boards were to specify another measurement approach for some performance obligations, they would need to specify to which types of performance obligations the second approach should be applied. It will be difficult to draw the line between two measurement approaches—any line is bound to be somewhat arbitrary and inconsistent with a principles-based approach.

54. However, the Boards should note that if they adopt the allocated customer consideration approach for the general revenue recognition standard and the IASB continues in its present direction in the insurance project, they already have a form of bright line. This is because an insurance contract contains service elements that would otherwise be accounted for in the general revenue recognition standard.

55. Therefore, instead of having an explicit measurement approach only for insurance contracts, the Boards could develop a second measurement approach that would be suitable for contracts with specified characteristics (eg highly

uncertain, volatile goods and services, etc). This second approach could also capture some insurance contracts. More simple insurance contracts could then be accounted for under the customer consideration allocation approach.

56. Indeed, if the two approaches were consistent in their initial measurement, then having two approaches for subsequent measurement need not necessarily be viewed as inconsistent. Rather, if the line between the two approaches was carefully drawn, the use of the allocated customer consideration approach could be viewed as a less burdensome way of entities to arrive generally at a reasonable approximation of the second explicit measurement approach.

57. Possible explicit measurement approaches that the staff has discussed with the Boards in recent meetings are discussed in the Appendix.

CONCLUSIONS AND STAFF RECOMMENDATIONS

58. This paper discusses two main issues: the nature of an onerous test for the allocated customer consideration approach, and possible limitations of that approach for some performance obligations. The objective of considering the two issues has been to identify whether the Boards think:

    a. the allocated customer consideration approach with an onerous test is suitable as the single measurement approach in a general revenue recognition standard, or

    b. the general revenue recognition standard should accommodate an alternative measurement approach for some performance obligations.

59. With respect to the onerous test, the staff recommends Option A, ie the trigger and remeasurement are the entity's expected cost to perform, for various reasons. Some prefer Option A because it preserves the straightforward nature of the allocated customer consideration approach and avoids the complexity of introducing a margin. Others prefer Option A because they think the Boards should develop a second measurement approach for the uncertain performance obligations outlined in this paper. Although they think that in principle an onerous test should be similar to Option B, they think Option A would provide a cost-effective safety net for the obligations that would be subject to the test. Performance obligations for which changes in circumstances are more likely

to occur, and hence for which a more sensitive onerous test such as Option B may be necessary, would be subject to the second, explicit measurement approach.

60. With respect to a second measurement approach, some staff think that the Boards should develop such an approach. This is because they think that the characteristics that caused the IASB to reject an allocated customer consideration approach for insurance contracts are not just limited to insurance contracts.

61. Nonetheless, the staff notes that developing two measurement approaches would impede progress on the revenue recognition project. Therefore, the staff thinks that the Boards need to focus first on developing the allocated customer consideration approach, since this approach will be applied to most transactions. In addition, the staff notes that the insurance project team is currently developing alternative explicit measurement approaches. Therefore, they seem best placed to develop any second measurement approach that could be applied more generally to obligations beyond insurance.

62. In the Discussion Paper, the staff recommends that the Boards:

   a. highlight the types of contracts which an allocated customer consideration approach may not handle so well,

   b. seek input as to whether the Boards should develop a second measurement approach in a general revenue recognition standard and, if so,

   c. ask where the line between the two approaches should be drawn, and whether the Boards should first focus on developing the allocated customer consideration approach.

Q1: Does the Board think that an allocated customer consideration approach with an onerous test (either Option A or B) would be suitable as the single measurement approach in the general revenue recognition standard?

Q2: If yes to Q1, do you think that the onerous test should be similar to Option A, ie an expected cost trigger and remeasurement, or Option B, ie a trigger and remeasurement with a margin?

Q3: If no to Q1, do you think that the Boards should develop a second measurement approach for some performance obligations as part of the general revenue recognition standard?

Q4: If yes to Q3, do you agree that on cost/benefit grounds, an onerous test similar to Option A would be acceptable for most performance obligations if the problematic obligations noted in this paper are measured under a second approach?

APPENDIX

Alternative approaches to subsequent measurement other than relying on an onerous test

A1. Some Board members have suggested that some performance obligations could initially be measured at fair value rather than at an allocated customer consideration amount. However, there seems to be an appetite for using fair value measures for revenue contracts only if there are Level 1 measures of the performance obligations (or contract) as contemplated by FAS 157 *Fair Value Measurements*. Despite comments at the July Board meeting, the staff thinks that outside financial instruments such measures are very rare. With respect to a performance obligation, there would have to be a quoted price in an active market for an identical *performance obligation* (ie for the *promise* to provide the good or service and for the good or service itself). Therefore, because Level 1 fair value measures will rarely be available, using fair value as an alternative measurement approach when they are observable, is unlikely to address concerns about measuring all other performance obligations at an allocated customer consideration amount.

A2. Hence, any alternative subsequent measurement approach would need to be consistent with the Boards' preliminary view that the performance obligations in the general revenue recognition standard should initially be measured equal to the transaction price in the contract.

A3. In the staff's view, the Board's decision about initial measurement implies two broad approaches for subsequently measuring the remaining performance obligations.

A4. The first approach is the approach that the Boards have adopted for at least the majority of performance obligations, ie the subsequent measurements are allocations of the transactions price.

A5. The other approach is that the subsequent measurement aims to replicate either elements implicit in the transaction price or at least some of those elements for the remaining performance obligations at each financial statement date.

A6. The Boards considered one version of the latter approach in May. In that version, the remaining performance obligations at the financial statement date were measured at the entity's then (estimated) current sales price of the goods and services underlying the remaining performance obligations. Another way of updating the initial measurement would be to view the transaction price as a proxy of the settlement price with the customer. Hence, the remaining performance obligations could subsequently be measured at the current settlement price with the customer.

A7. However, both of these approaches have the same main problem as when estimating an exit price, namely estimating the current margin after contract inception.

A8. It was because of this difficulty of estimating current margins that the staff gave the Boards a simplified explicit measurement approach in Appendix A to the May 2008 Board papers. In that approach, the measurement of a performance obligation is thought of in terms of components or 'building blocks'. Ignoring the time value of money (which the Boards have not yet considered), the two components are the expected costs (ie expected cash flows) and the margin. In the simplified measurement approach the cost component is continually updated, so that the measurement always consists of a current estimate of the cash flows required to satisfy the performance obligation. The margin component was initially derived directly from the transaction price (by deducting the cost component from the transaction price). Only this margin component was locked in at contract inception. Hence, this approach does not require entities to make a current estimate of margin. Such a measurement approach cannot be expressed as an attribute of the performance obligation. But some think that updating at least some components in the measurement results in a better measure than locking in *all* the components.

A9. The point the staff wants to emphasise is that there are alternatives to a locked-in allocated customer consideration measurement approach other than a current exit price measurement giving rise to revenue (and possibly profit) at contract inception and introducing significant complexity after contract inception. These alternatives may serve as a basis for remeasuring those obligations that the Boards think are not handled well by the allocated customer consideration measurement approach.