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International Accounting Standards Board

This document is provided as a convenience to observers at the World Standard Setters meeting, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the WSS meeting. Paragraph numbers correspond to paragraph numbers used in the WSS agenda paper.

INFORMATION FOR OBSERVERS

WSS Meeting: **September 2008, London**

Project: **Revenue Recognition**

Agenda paper 6

Project session: Revenue Recognition
Model Summary and Discussion Points

INTRODUCTION

1. Before the end of this year the IASB intends, jointly with the FASB, to issue a discussion paper on revenue recognition. This paper summarises the proposed revenue recognition model, and some of the points to be raised in that discussion paper, by considering the three steps required in the building of an asset and liability revenue recognition model:

   a) What does the model account for?

   b) How does the asset or liability accounted for change?

c) How is that asset or liability measured?

2. At the World Standard Setters meeting IASB staff will present an overview of the model based on this paper. At convenient points in this presentation, the following questions will be discussed in open forum by those attending the session:

   a) What effect will changes to unbundling have on existing practice?

   b) How will the change in recognition criteria affect current practice?

   c) How will initial measurement affect current practice?

   d) How will the use of estimated selling prices affect accounting under US GAAP?

   e) What basis should be used for triggering and for measuring onerous contracts?

   f) Under what other circumstances should performance obligations be remeasured?

STEP 1 – WHAT DOES THE PROPOSED MODEL ACCOUNT FOR?

Contracts with customers

3. The proposed model focuses on a single asset or liability—the contract with a customer.

4. The Boards decided to focus on contracts with customers for two main reasons. First, contracts to provide goods and services are important real world economic phenomena; they are the lifeblood of most companies.

5. Secondly, most of today's revenue recognition literature focuses exclusively on contracts with customers.[1] Transactions within the scope of IAS 18 *Revenue* envisage a customer, and any transaction with a customer either explicitly or implicitly involves a contract. Because the objective is to develop a model that can supplant much of the existing literature, that model needs to encompass at least as broad a scope as the existing literature.

[1] The glossary of the IASB defines a contract as: *An agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts may take a variety of forms and need not be in writing.*

Contract assets and liabilities

6. When an entity enters into a contract with a customer, the contract conveys *rights* to the entity to receive consideration from the customer and imposes *obligations* on the entity to transfer economic resources (in the form of goods and services) to the customer. These obligations are called performance obligations. The combination of the rights and obligations are treated as a single (that is, net) asset or liability, depending on the relationship between the underlying rights and obligations. A contract is treated as an asset if the measure of the remaining rights exceeds the measure of the remaining obligations. Similarly, a contract is treated as a liability if the measure of the remaining obligations exceeds the measure of the remaining rights. The contract asset or liability reflects the entity's net position in the contract with respect to its remaining rights and obligations.

STEP 2 - HOW DOES A CONTRACT ASSET OR LIABILITY CHANGE OVER THE LIFE OF A CONTRACT?

7. An entity's net position in a contract can change due to its own performance or the performance of the customer. For example, when a customer performs by paying its promised consideration, the entity's net position in the contract (whether an asset or liability before that time) decreases because the entity no longer has any remaining rights in the contract. An entity's contract asset would decrease or its contract liability would increase because the rights to the customer's payment no longer exist.

8. An entity's net position in a contract also changes when the entity provides its promised goods or services. Once these goods or services are provided, the entity no longer has this particular obligation in the contract. As a result, its net position in the contract (whether an asset or liability before that time) increases. This increase meets the conceptual framework's definition of revenue.

9. Therefore, in a contract-based model of revenue recognition, there are essentially two changes in a contract that can lead to revenue recognition. The first is the point at which an entity enters into a contract with a customer. For revenue to be recognised at this point (contract inception), the measure of the entity's rights must exceed the measure of the

entity's obligations. This would lead to revenue recognition because the recognition of such a contract position would result in the recognition of a contract asset. This outcome depends on how the rights and obligations in the contract are measured.

10. The second point at which revenue can be recognised in the life of a contract is when the entity satisfies an obligation in the contract. This would lead to revenue recognition because satisfying an obligation in the contract either leads to an increase in a contract asset or a decrease in a contract liability.

11. In adopting the customer consideration measurement approach, as discussed in step 3, the Board's preliminary view is that revenue will not be recognised at contract inception because the rights and obligations are deemed equal at inception. Under the customer consideration approach, only the satisfaction of performance obligations to the customer gives rise to revenue recognition. Therefore, the revenue recognition principle could be stated as follows:

> **Revenue is recognised when the contract asset increases, or the contract liability decreases, on the satisfaction of a performance obligation.**

What is a performance obligation?

12. In a contract between an entity and a customer, the entity promises to provide goods or services in exchange for consideration from the customer. These promises represent performance obligations of the entity and are sometimes referred to as "deliverables" or "elements" in existing literature.

13. Although the notion of a performance obligation is implicit in much of the existing literature, there is no definition of a performance obligation. Hence, the Boards have proposed the following tentative definition:

> **An entity's performance obligation is a promise in a contract between the entity and a customer to transfer an economic resource to that customer.**

14. The economic resource can be in the form of goods, services or rights to use.

Changes to unbundling – amount and timing

15. As a result of the above definition, performance obligations are unbundled whenever the resource *could* be sold separately. In adopting this model, therefore, the Board proposes eliminating the current hurdles required for unbundling, eg separate negotiation, separate rejection, etc. Hence, individual contracts are more likely to be unbundled into a greater number of performance obligations under the proposed model compared with current practice. For practical purposes, performance obligations will only be unbundled into separate performance obligations where the timing of the satisfaction of the obligations differ and where, consequently, revenue would be recognised at different times. Therefore, if a good, service or right to use *could* be sold separately and where the associated performance obligation is satisfied at a different time, it will be accounted for separately as a performance obligation from which revenue, and margin, will arise.

16. The greater separation of performance obligations that this model requires is likely to have two main effects on current practice.

Cost accruals replaced by performance obligations

17. One consequence of the greater unbundling is that some 'post delivery obligations', such as warranties and installation services, will now be recognised as separate performance obligations whereas previously they were accounted for as accrued cost obligations. Total contract revenue and margin will no longer all be recognised on delivery of the main good; some will be attributed to subsequent deliverables such as warranties, installation and commissioning services.

More granularity of reporting

18. A further consequence is that all goods, services and rights to use which arise from the contract will each represent separate performance obligations to which some revenue will be attributed. Breaking a contract down into a greater number of individual performance obligations will affect current accounting. The contract will be accounted for at a lower level by dividing the contract into smaller units, the individual performance obligations. Each contract will be accounted for, therefore, by individual service or good, and margins

will be more directly attributable to each period. At present the hurdles in IAS 11 can cause different components to be accounted for at the overall contract gross margin percentage. Under this model, performance obligations are satisfied, and accounted for, individually. The margin reflected, therefore, will be that of the individual performance obligations satisfied in the period, rather than the blended, overall contract margin.

Discussion point 1

What effect will changes to unbundling have on existing practice? Consider, in particular, the effect of transferring some cost accruals, such as warranties, from IAS 37 and attributing revenue to their satisfaction.

How are performance obligations satisfied?

19. If a performance obligation is a promise in a contract between the entity and a customer to transfer an economic resource to that customer, then satisfaction of a performance obligation depends entirely on when the promised economic resource is *transferred* to the customer. When the economic resource is transferred, the obligation to transfer the resource can no longer exist and is thus satisfied. As a result, the entity's net position in a contract (whether a contract asset or a contract liability) will increase and lead to revenue recognition.

When are performance obligations satisfied?

20. When an entity promises to transfer a good, it means that the entity is promising to transfer to the customer the enforceable right or access to that good. When an entity promises to provide a service, it means that the entity is promising to provide a service or access to a service, even though the service itself may be simultaneously consumed by the customer. Thus, to determine when a promised good has been transferred, an entity must search for indications (within the contract and the operation of law) that the enforceable rights or other access to the good have transferred from the entity to the customer. To determine when a promised service has been provided, an entity must search for indications (within the contract and the operation of law) that access to the service has been provided to the customer.

21. In essence, performance obligations are satisfied when promised economic resources are transferred to customers. This means that, in relation to performance obligations, revenue is recognised for the *output* of economic resources to customers and not for the *activity* of the entity itself.

Issue 1- When do resources transfer?

22. **Paint -** Consider the following example:

> PainterCo is a contractor that provides painting services for home owners. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3000. The price is inclusive of all paint, which PainterCo obtains. The customer is given the right to obtain its own paint, although the customer does not choose to do so in this case.
>
> All paint necessary to complete the contract is delivered to the customer's house on 31 March. PainterCo renders the painting services continuously from 1 April through 15 April. In accordance with the contract terms, the customer pays in full upon completion of the house painting.
>
> PainterCo's quarter ends on 31 March.

23. To identify performance obligations in this contract, any promise to transfer to the customer an enforceable right (or other means of access) to a good and any promise to undertake activities that will immediately benefit the customer, a service, must be identified. Typically these performance obligations are any promised goods or services that could be sold separately. Clearly, the paint itself represents a good that could be sold separately. Similarly, the efforts to paint the house represent a service that could be sold separately. Thus, according to the proposed definition of a performance obligation, both the paint and the painting services are potentially separate performance obligations.

24. In the case of goods, the satisfaction criteria need to focus on indicators that suggest when an enforceable right (or other access) to the good is relinquished by the entity and obtained by the customer. Paint is delivered before the painting service is actually undertaken.

25. What indicators would suggest that the enforceable rights (or other access) to the paint have been relinquished by PainterCo when the paint is delivered? And what indicators

would suggest that the customer obtains the enforceable rights (or other access) to the paint upon delivery? Consider the following:

a) PainterCo loses free access to the paint after delivery.

b) The customer has access to the paint and can protect that access by preventing others (including PainterCo) from coming onto its property.

c) PainterCo no longer has an enforceable right to the paint, but instead has an enforceable right to payment or the return of the paint.

d) If the customer chooses to pay for the paint, PainterCo has no enforceable right to demand the paint instead of payment.

26. On the other hand, there are indicators that would suggest that PainterCo has *not* relinquished the enforceable rights (or other access) to the paint under the contract:

a) The contract requires that PainterCo use the delivered paint in painting the house. Thus, PainterCo has the right to use the paint and has not relinquished this right by delivering the paint.

b) Under this view, the customer is acting as PainterCo's agent in holding the paint. The risks and rewards of owning paint still reside with PainterCo.

27. Many people have interpreted these opposing indicators as suggesting that PainterCo has not relinquished the enforceable rights to the paint. Given the difficulty in these types of scenarios of determining when the enforceable rights or access to goods transfer, the Boards propose a rebuttable presumption that when a good is used in a subsequent service to a customer, it does not transfer on delivery but transfers as the good is used in satisfying the service obligation.

Issue 2 - Distinguishing Between Goods and Services

28. It is also often difficult to determine whether the promise in a contract is to transfer a good or to provide the materials and services required to produce a good. The key to resolving this difficulty is found in the definition of a performance obligation—a promise to *transfer* an economic resource to the customer. To determine whether an entity is promising to transfer a good or the materials and services necessary to produce a good, an entity must determine *when* an economic resource is actually transferred to the customer.

29. In some cases, this is easy. For instance, if a customer provides a special wood to a cabinet maker together with a design for a table, then the cabinet maker is transferring services to the customer as work progresses. This is because the services being consumed are enhancing an existing resource of the customer (the wood). As another example, if a contract calls for the construction of a building on the customer's own land, then the builder is transferring services to the customer as work progresses. This is because the services (and materials) being consumed are enhancing an existing resource of the customer.

Real Estate Contracts

30. The distinction between a good and a service becomes blurred when a new resource is created. Real estate contracts are an example in which it has been difficult to determine when the obligation to transfer an economic resource is satisfied. The IFRIC's recent deliberations on whether real estate contracts should be accounted for as contracts for construction services (under IAS 11 *Construction Contracts*) or as contracts for goods (under IAS 18) highlights this difficulty. Consider the following situation:

> HomebuilderCo contracts with a customer to construct a home in accordance with the features and designs chosen by the customer. The home is to be built on the homebuilder's plot of land, and the title (that is to say, the enforceable rights or other access) to the land and house do not transfer to the customer until the house is completed. The customer cannot take possession of the house until it is completed, nor can the customer fire HomebuilderCo and have another builder complete the home. The customer pays a 10% deposit and agrees to pay the remaining price upon completion of the home or forfeit its deposit.

31. In the example above, HomebuilderCo owns the land and the house as it is being constructed. As a result, any materials and services that improve the home are simply an improvement to Homebuilder's asset. This means that the services and materials provided during the construction of the house do not actually represent resources that transfer to the customer in this contract. Instead, these economic resources attach to the work-in-progress to which HomebuilderCo has the enforceable rights. Only when the house is completed and the customer makes the final payment does any economic resource

transfer from HomebuilderCo to the customer. As a result, no performance obligation is satisfied in this contract until the completed house is transferred to the customer.

32. Now consider a different example:

> ContractorCo contracts with a customer to construct a home in accordance with the features and designs chosen by the customer. The home is to be built on the homebuilder's plot of land, however the title (that is to say, the enforceable rights or other acess) to the land and house transfers to the customer from the moment construction begins. The customer can take possession of the house at any point, and the customer can fire ContractorCo and have another builder complete the house. The customer pays a 10% deposit upfront and makes periodic payments that are sufficient to cover the costs and margins of ContractorCo's time and materials during construction.

33. In this example, ContractorCo transfers the land and house to the customer once construction begins. As a result, any materials and services that improve the house represent the transfer of economic resources (goods and services) to the customer. This means that the services and materials provided during the construction of the house each represent economic resources that transfer to the customer in this contract. As a result, ContractorCo's net position in its contract is increasing as each performance obligation is satisfied, and revenue is recognised throughout the construction process.

34. The thinking behind the above examples is similar to that in the recent interpretation IFRIC 15 *Real Estate Sales*.

Discussion point 2

The proposed performance obligation satisfaction revenue recognition principle is similar to much current practice, eg IAS 18. However, it may affect the accounting of some contracts that are currently accounted for using the percentage of completion method in IAS 11 if the goods and services do not transfer continuously to the customer as the contract progresses. Which types of contracts and industries are likely to be affected?

Are there industries in which recognising revenue as performance obligations are satisfied would not provide decision useful information about the entity's contracts?

STEP 3 – HOW IS THE CONTRACT MEASURED?

Measurement at contract inception

35. From an entity's perspective, a contract represents inflows of payments from the customer (rights) and outflows of goods and services to the customer (performance obligations). To recognise a contract with a customer, the entity must measure those rights and obligations.

36. The contract rights are measured at the amount of the transaction price in the contract.[2] This amount is referred to as the customer consideration.

37. Under the customer consideration approach, the total obligations in the contract are measured at contract inception equal to the customer consideration amount. The customer consideration is allocated to the individual performance obligations pro rata based on the separate selling prices of each underlying good or service.

38. One view supporting this measurement approach is that performance obligations (ie the outflows of goods and services) should be measured equal to the transaction price (ie the inflows of consideration) because the transaction price represents the negotiated price between a willing buyer and a willing seller. That is to say, because the transaction price

[2] The transaction price may need to be adjusted for the time value of money (if payments are made over an extended period of time) and customer credit risk. The Board has not yet deliberated these issues.

represents the amount the customer is willing to pay for the goods and services to be provided in the contract, that price serves as a meaningful measure of the performance obligations in the contract.

39. Another view which supports this measurement approach is based on performance obligations being measured, in an ideal situation, directly at the amount required to satisfy the performance obligation, ie a fulfilment price. This basis is believed to depict the future outflows required to satisfy the performance obligation more faithfully than would the transaction price because it would focus directly on the future outflows rather than the inflows. However, those Board members who hold this view think the costliness and complexity involved in estimating a fulfilment price is unjustified given that the transaction price, which is relatively straightforward and observable, is a reasonable proxy for a fulfilment price.

40. Because both the rights and the performance obligations in the contract are measured equal to the transaction price, the contract is recognised at a net nil position at inception. Neither an asset nor a liability is recognised at inception of the contract. Because there is no increase in a contract asset, or decrease in a contract liability, no revenue is recognised at contract inception.

41. The Board has discussed the treatment of costs arising from contract origination, contract acquisition costs (eg sales commissions). Their preliminary view is that these costs should be expensed as incurred.

Discussion point 3

The proposed measurement approach precludes the recognition of a contract asset, revenue or gain at contract inception. However, costs associated with originating the contract are expensed as they are incurred. Are there cases in which expensing contract origination costs at contract inception might result in an unfaithful representation of the entity's activities?

Multiple element obligations

42. The transaction price used to measure the bundle of performance obligations at contract inception is allocated to individual performance obligations based on the entity's separate

selling prices of the promised economic resources (ie goods and services). The amount allocated to each performance obligation at inception is then recognised as revenue when that particular performance obligation is satisfied.

43. The following example illustrates this approach:

> On 31 December, ComputerCo enters into a contract to provide computer hardware and a one-year service contract. The enforceable rights to the machine transfer on its delivery to the customer on 2 January. The customer pays the contract price of CU10,000 on delivery of the machine.
>
> ComputerCo sells the machine separately for CU7,000. It sells installation services separately for CU4,000. Based on these separate selling prices, the CU10,000 transaction price would be allocated to the two performance obligations as follows:

	Observed selling price	*Allocation of discount*	*Measurement of performance obligation*
Hardware	7,000	636	6,364
Service	4,000	364	3,636
	11,000	1,000	10,000

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

Use of estimated sales prices in multiple element arrangements

45. Estimating sales prices will represent a significant change compared with US GAAP, where objective evidence of a sales price is required in order to recognise separate elements. This will affect current accounting under both EITF 00-21 *Revenue Arrangements with Multiple Deliverables* and SOP 97-2 *Software Revenue Recognition*.

Under these statements the recognition of revenue from elements lacking observable evidence of a sales price is delayed as these elements are not accounted for separately.

Discussion point 4
What effect will this change, to permit the use of estimated selling prices for individual elements, have on existing practice under US GAAP? Are there any cases where estimation of selling prices may not be appropriate?

Remeasurement of performance obligations

46. The Boards have tentatively decided that, in general, performance obligations should not be remeasured. Hence, the initial allocated measurements are locked in at contract inception and are not subsequently updated. However, the Boards acknowledge that a locked-in allocation approach sometimes will not provide a faithful depiction of the obligation to transfer economic resources to a customer.

Onerous contracts

47. For example, if the estimated remaining costs to satisfy a performance obligation exceed the original amount allocated to that performance obligation (ie the performance obligation is deemed "onerous"), the allocated amount may significantly understate the economic resources required to satisfy that obligation.

48. An onerous contract is defined in paragraph 10 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as:

> A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

49. If a contract obligation is deemed onerous, it is measured at the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. Hence, the IAS 37 remeasurement of an onerous performance obligation implies the inclusion a margin, although the role of a margin in IAS 37 is still being discussed by the Board.

50. IAS 11 also provides guidance on accounting for expected loss contracts. An onerous remeasurement is *triggered* and an expected loss is recognised as an expense when it is probable that total contract costs will exceed total contract revenue. However, the *measurement* approach differs from that under IAS 37 because it does not include a margin in the remeasured performance obligation.

51. The Board has yet to discuss onerous contracts in detail but there are a range of options which could be available characterised by the answer to two fundamental questions:

    a) Should the trigger be based on whether future revenues exceed expected cash outflows or costs plus margin?

    b) Should the remeasurement basis be cost or cost plus margin?

52. Options include:

    a) Trigger and remeasurement both at an amount similar to an IAS 37 measurement, ie including a margin

    b) Trigger and remeasurement both at expected future cash outflows (similar to IAS 11)

Discussion point 5
What basis should be used for triggering and for remeasuring onerous performance obligations?

Availability of observable current exit prices

53. Some Board members have suggested that remeasurement might be justified when an observable current exit price exists for a particular performance obligation and the entity can lay off the performance obligation at that price. The obligation would be measured at a level 1 fair value measure at inception and remeasured subsequently at its observable price.

Uncertain, long-term performance obligations

54. Another situation in which some Board members have suggested they would remeasure performance obligations, rather than locking in the original measurement, is when a performance obligation spans many reporting periods and the economic resources necessary to satisfy the obligation are uncertain or unpredictable. Some have suggested long-term insurance and construction contracts give rise to just such performance obligations. These Board members think some form of updated measurement would be more useful than a locked-in measurement in order to reflect changes in measuring the underlying uncertainties.

55. This is particularly of concern where changes are adverse and the contract is in danger of becoming onerous in future. An obligation that is not yet loss making (but is headed that direction) is not highlighted at present to financial statement users. However, the moment that obligation becomes loss making, a loss is immediately recognised in the statement of comprehensive income because the obligation is remeasured upward.

Discussion point 6

Under what circumstances, other than onerous contracts, would you advocate remeasurement of performance obligations?