Project **Revenue Recognition**

Topic **Subsequent measurement of performance obligations**

Purpose

1. This paper considers whether and, if so, when performance obligations should be remeasured after contract inception.

2. In this paper, *remeasurement* refers to a change in the initial measurement of a performance obligation for a change in the price or quantity of the resources required to satisfy that performance obligation. Remeasurement is therefore different from *reallocation*, which is a change in the amount initially allocated to the performance obligation because of a change in the transaction price (for instance, because of a change in the estimated amount of uncertain consideration).

Summary of recommendations

3. The staff recommends:

   (a) that the Boards reaffirm their preliminary view that performance obligations should be remeasured after contract inception only when they are onerous (paragraphs 9–16).

   (b) the approach of remeasuring performance obligations only when they are onerous should be applied to all performance obligations in the scope of the revenue recognition standard (paragraphs 17–25).

4. Agenda Paper 6C/Memo 123C discusses when performance obligations are onerous and, if they are onerous, how they are remeasured.

This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

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Background

5. The Discussion Paper proposed that:

   (a) after contract inception, the initial measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous.

   (b) a performance obligation is onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation

   (c) an entity would remeasure an onerous performance obligation to its expected cost of satisfying the performance obligation and recognise a corresponding contract loss.

6. Accordingly, the effect of the proposals in the Discussion Paper is that:

   (a) the initial measurement of a performance obligation is 'locked in' and updated by exception only for adverse changes in circumstances, rather than remeasured at each period end for both adverse and favourable changes in circumstances.

   (b) any margin implicit in the initial measurement of a performance obligation is used as a buffer to absorb adverse changes in circumstances until that margin is exhausted.

   (c) the basis of remeasurement is different from the initial measurement: the former excludes a margin, while the latter implicitly includes a margin.

   These effects are illustrated in the example in the Appendix to this paper.

7. The Discussion Paper highlighted that some are concerned that the proposed measurement approach might not result in decision-useful information for some contracts, particularly for those with highly variable outcomes. Such contracts include those in which:

   (a) uncertainty is a significant inherent characteristic of the contract;

   (b) the prices of the underlying goods and services are volatile; or

(c) the duration of the contract is such that significant changes in circumstances are likely.

8. The Boards therefore sought views from respondents on:

   (a) whether the proposed measurement approach would not provide decision-useful information at each financial statement date; and

   (b) whether some performance obligations should be subject to another measurement approach.

Remeasurement by exception

Feedback from respondents

9. Most respondents agree that performance obligations should be remeasured by exception when they are onerous. For instance:

> we agree that, for many contracts, the approach proposed by the Discussion Paper of 'freezing' the original allocation is both cost-effective and decision-useful. (Deloitte)

10. Even some of the (very few) respondents who did not agree with the initial allocated measurement approach supported remeasuring performance obligations only when they are onerous:

> We support the restriction of re-measurement of performance obligations to onerous contracts. Although we support the fair value approach that would suggest the symmetrical recognition of gains and losses, we would be comfortable if any resulting gain is delayed until specified criteria are met. (CFA Institute)

11. Very few respondents think that performance obligations should never be remeasured, and that any loss in the contract should emerge over time as the performance obligations are satisfied (in the same way as any profit emerges as revenue is recognised):

> We believe that performance obligations should not be re-measured even for so-called 'onerous contract' situations. It is no more relevant to re-measure an obligation that has become onerous than it is to re-measure one that has become excessively favorable. Furthermore, it singles out 'loss contracts' for special treatment while leaving break-even or marginally profitable contracts to work their way through future reporting periods. We believe bad business

> decisions that impact future periods' transactions and financial performance should be allowed to do just that. (Illinois CPA Society)

12. A few insurance-related entities think that the Boards should have specified that performance obligations be remeasured consistently with their initial measurement at each financial statement date. They think that that would have provided more decision-useful information to users.

> The value of the liability at the balance sheet date is a key piece of information for users … We do not believe it is appropriate that this is determined by reference to the historic transaction price. (European Insurance CFO Forum)

> We believe that a single principle which requires mandatory re-measurement when the changes in the outcome are expected to be significant would be preferable to two approaches. (FirstRand Banking Group)

13. These respondents argue that the Boards could have retained many of the proposals in the Discussion Paper as implementation guidance for simple contracts. That is because in such contracts allocating the consideration would typically be an appropriate proxy for measuring performance obligations.

Analysis

14. Most respondents agree with the proposed approach for subsequent measurement and, hence, that performance obligations should be remeasured only when they are onerous.

15. In response to the suggestion from insurers that the principle should be to remeasure at each financial statement date, the staff notes that:

    (a) Updating the measurement of the performance obligations at each financial statement date would represent a very significant change to the proposed model.

    (b) Outside the insurance sector, the notion of remeasuring performance obligations over the life of the contract has gained very little support. For instance, no comments were received on Appendix B to the Discussion Paper, which set out a simplified measurement approach

derived from the measurement candidates in the Insurance Contracts project. Furthermore, staff outreach has highlighted that the Boards would face a huge challenge to persuade most constituents to move from an allocation model to a measurement model.

16. In response to the suggestion that performance obligations should never be remeasured, the staff notes that:

    (a) At present both US GAAP and IFRSs include the notion of an onerous test for loss-making contracts, ie that the amount allocated to the performance obligations must at least equal the expected costs.[1] Not having such a test would therefore be a major change to current practice.

    (b) Although the onerous test might seem to reflect the traditional conservative bias in accounting, it can also be viewed as the mirror image of an asset impairment test for liabilities, ie a test to ensure that the carrying amount of performance obligations is not understated.[2] It is therefore a necessary component of a revenue recognition model in which the initial measurements are not routinely updated.

Staff recommendation and question

Question 1 Remeasurement by exception
The staff recommends that the Boards reaffirm their preliminary view that performance obligations should be remeasured after contract inception only when they are onerous. Do the Boards agree?

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[1] An onerous contract in IAS 37; a loss contingency in FASB Accounting Standards Codification (ASC) Topic 450 *Contingencies;* a provision for anticipated/expected losses in ASC Subtopic 605-35 *Construction-Type and Production-Type Contracts* and IAS 11 *Construction Contracts.*

[2] Note that on impairment, an asset is written down to a present value measurement (fair value or value-in-use). 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. That is different from the Boards' proposed onerous test.

Should some performance obligations be subject to another measurement approach?

Feedback from respondents

17. Most insurers who responded to the Discussion Paper think that insurance performance obligations should be remeasured at each financial statement date (ie subject to another measurement approach) rather than being remeasured by exception when they are onerous.

> …the uncertainty related to insurance contracts as well as the long term nature of insurance contracts means that many of the principles described in the discussion paper may not be appropriate for insurance contracts, for example the inability to remeasure performance obligations unless onerous would not provide decision useful information to the user's of insurer's financial statements. (FirstRand Banking Group)

18. Insurers also highlight examples of other types of performance obligations that they think should be remeasured at each financial statement date, including guarantees, take or pay contracts for power and commodities, and long-term construction contracts.

19. Other than insurers, only a few respondents highlight examples for which they think performance obligations should be remeasured at each financial statement date, namely:

    (a) warranties and similar maintenance contracts;

    (b) stand-ready and conditional performance obligations more generally; and

    (c) long-term and large service contracts in which relatively small changes in circumstances can have significant effects.

20. A few respondents discuss the concerns noted in the Discussion Paper with respect to the appropriateness of the proposed measurement approach for performance obligations with highly variable outcomes. However, they are not convinced that the concerns justify the use of a different measurement approach to that proposed in the Discussion Paper. They read the Discussion Paper as implying that performance obligations that are financial instruments, insurance

contracts and lease contracts would not be in the scope of the revenue recognition standard. Given that context, they think that the performance obligations in the revenue recognition standard should all be subject to the same measurement approach.

> The inability to remeasure the performance obligation(s) may result in an original estimate that is no longer relevant …For the sake of consistency, we think that all performance obligations should be subject to the same measurement approach. (Intel)

Analysis

21. The Boards will consider the scope of the revenue recognition standard at a future meeting. However, the staff's working premise is that performance obligations that meet the definitions of a financial instrument, an insurance contract and a lease contract will not be in the scope of the revenue recognition standard. Given that, the respondents' concerns relate to:

    (a) warranties and similar maintenance contracts;

    (b) other stand-ready obligations; and

    (c) long-term service contracts.

Warranties

22. A warranty meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*. In the Insurance Contracts project, the IASB have decided tentatively that pre-claims liabilities for short-duration insurance contracts should be accounted for in accordance with the unearned premium model. That model is potentially very similar to the allocated measurement approach in the revenue project. Hence, concerns about the measurement of warranty performance obligations must primarily relate to longer-duration warranties. But because warranties are insurance contracts, they will be in the scope of the insurance contracts standard, and will be subject to the measurement model for insurance contracts, unless the Boards decide to exclude them from the scope of the insurance contracts standard. Hence, respondents' concerns about

warranties can be addressed when considering the scopes of the insurance contracts and revenue recognition standards.

Other stand ready obligations

23. The staff agrees that many long-duration stand ready obligations would be better accounted for in accordance with the measurement models under consideration in the Insurance Contracts project. That is because those models would better capture the likely changes in circumstances that are inherent in those contracts. In other words, the staff does not think that the characteristics of an insurance contract that caused the Boards to reject an allocated transaction price measurement approach for some insurance contracts are unique to those insurance contracts. However, the staff notes that:

    (a) the most common type of stand-ready obligation other than a warranty is a guarantee contract. These obligations typically meet the definition of a financial instrument or an insurance contract. When considering the scope of the revenue recognition standard, the Boards may choose to keep such contracts in the scope of other standards.

    (b) the remaining types of stand-ready obligations are at present measured using an allocated transaction price approach, rather than being measured directly. Consequently, although some might argue that the Boards have not enhanced the decision-usefulness of the measurement of these obligations, the Boards have not made it less decision-useful. That may be of particular relevance to some IASB members who have previously expressed concern about moving performance obligations from the scope of IAS 37 into a locked-in measurement approach, and thereby, in their view, making the resulting financial information less decision useful.

Long-term service contracts

24. Unlike the examples discussed above, these contracts will be in the scope of the revenue recognition standard. The staff acknowledges the view that the accounting for long-term big-ticket service contracts (such as construction

contracts) could be enhanced if the performance obligations in those contracts were measured directly using a measurement model similar to those under consideration in the Insurance Contracts project. However, the staff notes that:

(a) The view that long-term big-ticket service contracts should be measured at each financial statement date is held by only a very small number of respondents to the Discussion Paper.

(b) Appendix B to the Discussion Paper, which set out a simplified measurement approach derived from the measurement candidates in the Insurance Contracts project, attracted virtually no comments. Furthermore, when the staff raised Appendix B in discussion with constituents during outreach, it received no support.

(c) The FASB has not yet decided in the Insurance Contracts project whether changes in the future cash flows should be recognised in profit or loss or as an adjustment to a composite/residual part of the margin (in other words, whether the composite/residual margin should be used as a buffer). If the FASB were to conclude that the changes should be recognised as an adjustment to the composite/residual margin, the FASB's measurement model for insurance contracts would arguably be similar to the measurement model in the Revenue Recognition project.

(d) Developing another measurement model for long-term service contracts, let alone gaining acceptance for such a model, would not be achievable within the Boards' timetable for the project.

Conclusion

25. The staff thinks that the Boards should not develop a second measurement approach for the revenue recognition standard. All performance obligations in the scope of the revenue recognition standard should be subject to the same measurement approach. Concerns raised by respondents should be revisited when considering the scope of the revenue recognition standard.

Staff recommendation and question

Question 2 Another measurement approach
The staff recommends that the approach of remeasuring performance obligations only when they are onerous should be applied to all performance obligations in the scope of the revenue recognition standard. Do the Boards agree?

Appendix

A1. The purpose of this Appendix is to illustrate the effects of Boards' preliminary views in the Discussion Paper.

> Henry enters into a contract with Kenny to paint the outside of Kenny's house. The contract is for a fixed price of CU3,450 and all materials are to be provided by Henry.
>
> In pricing the contract Henry budgets for:
>
> - 10 cans of paint @ CU20 per can = 200
> - 50 hours of labour @ CU50 per hour = 2,500
>
> resulting in a budgeted profit margin of CU750.
>
> Suppose that after completing 20 per cent of the painting, Henry:
>
> - has used 2.5 cans of paint (ie 25 per cent more than expected)
> - has incurred 12.5 hours of labour (ie 25 per cent more than expected) because Kenny's walls are more porous than expected
> - estimates that he will use a further 10 cans of paint and 50 hours of labour (ie 25 per cent more paint and labour than originally expected) to complete the painting.
>
> Further suppose that the price of paint has increased so that the remaining paint will cost CU25 per can.
>
> Assume the contract consists of one segment.

A2. After completing 20 per cent of the painting, using an output measure of performance, the amount of the transaction price allocated to the remaining performance obligations would be CU2,760 (ie CU3,450 x 80%).

A3. The remaining costs are CU2,750 (ie paint: 10 cans @ CU25 = CU250 plus labour: 50 hours @ CU50 = CU2,500).

A4. Because the expected costs of CU2,750 do not exceed the amount allocated to the performance obligations (CU2,760), the performance obligations are not onerous. Therefore they are not remeasured for either:

(a) the increase in the *price* of some of the assets required to settle the performance obligations; or

(b) the increase in the *quantity* of assets required to settle the performance obligations.

A5. Note that the initial measurement of the performance obligations, CU3,450, implicitly includes a margin of CU750 (ie transaction price of CU3,450 less costs of CU2,700). The measurement of the performance obligations after 20 per cent of the work has been done is CU2,760 and implicitly includes a margin of CU10 (ie amount of transaction price allocated to those obligations of CU2,760 less revised costs of CU2,750). Accordingly, assuming no further changes in circumstances, Henry reports a margin of CU10 over the remaining 80 per cent of the painting.