Project	**Revenue Recognition**
Topic	**Recognizing revenue in a segment of a contract**

Introduction

1. Once an entity has segmented a contract (Agenda Paper 3B/Memo 122B) and allocated the transaction price to those segments (Agenda Paper 3C/Memo 122C), it must determine how much revenue to recognize as it satisfies performances obligations within each segment (this paper).

Summary of staff recommendations

2. The objective when applying the proposed model is for an entity to recognize revenue to depict the transfer of goods and services to customers in an amount that reflects the customer consideration in exchange for those goods and services.

3. This paper recommends that:

   (a) Management of an entity should exercise judgment and be able to select from various methods of measuring the goods and services transferred to a customer in a segment of a contract (e.g. units of output, units of input, or the passage of time).

   (b) For each segment of a contract, an entity should select a method that is most consistent with the objective of the proposed model and apply that method consistently both:

      (i) Throughout the contract, and

      (ii) To segments in other contracts with similar characteristics.

Background

4. The principle for when to recognize revenue in the proposed model is clear—an entity recognizes revenue to depict the transfer of goods and services to customers in an amount that reflects the customer consideration in exchange for those goods and services. With that principle, the Boards have clearly defined what constitutes an entity's performance in the proposed model.

5. Separating a contract into segments makes the proposed model more operational but it does not change the proposed revenue recognition principle and definition of performance. Hence, an entity's performance in a *segment* of a contract also refers to the transfer of goods and services to the customer.

6. Measuring an entity's performance in a segment of a contract is straightforward when all the promised goods and services are transferred at the same time. In effect, the segment would comprise a single performance obligation. The entity would use the guidance on control (e.g., the definition and indicators of control that the Boards considered in September 2009) to determine when the performance obligation is satisfied and revenue should be recognized.

7. Measuring an entity's performance is more difficult when a segment comprises more than one performance obligation—especially when performance obligations are satisfied continuously. In those cases, an entity must be able to practically determine the amount of performance obligations satisfied during the period—i.e., measure its performance. This paper considers how an entity should do that.

Structure of paper

8. This paper is organized as follows:
   - (a) Measuring performance in a segment of a contract
     - (i) Units of output
     - (ii) Units of input
     - (iii) Passage of time.
   - (b) Applying a single method consistently.

Measuring performance in a segment of a contract

9. When an entity transfers goods and services to a customer at different times (or continuously), the entity must determine how much revenue to recognize in each reporting period. The amount of revenue the entity recognizes each period depends on the performance obligations satisfied in the period.

10. The objective when measuring performance in the proposed model is clear—it is to recognize revenue to depict the transfer of goods and services to the customer in an amount that reflects the consideration promised in exchange for those goods and services. An entity can achieve that objective using various methods.

11. In some contracts, the contract's invoicing schedule might achieve the objective. That is, the customer invoicing might coincide with the entity's performance. For example, a service provider might charge a customer a specified price per labor hour. If that hourly rate represents a standalone selling price and the customer is invoiced as the services are provided, then the entity could simply recognize revenue based on customer invoicing. Recognizing revenue as invoiced in that case would meet the objective of the proposed model because the invoiced amounts would depict the transfer of services to the customer in the amount the customer pays in exchange for those services.

12. For contracts in which an entity cannot simply recognize revenue as invoiced, the entity must consider other methods. This paper considers the following methods of measuring an entity's performance in a segment:

    (a) Units of output

    (b) Units of input

    (c) Passage of time.

Units of output

13. Arguably, the methods of measuring performance that are most consistent with the objective of the proposed model are methods based on results achieved or output to the customer. Those methods include measuring performance in terms of units produced, units delivered, contract milestones, value added, or any other metric that directly measures the amount of goods and services transferred to the

customer. In U.S. GAAP, ASC 605-35-25-71, *Construction-Type and Production-Type Contracts*, states the following about output methods of measuring performance:

> Output is used to measure results directly and is generally the best measure of progress toward completion in circumstances in which a reliable measure of output can be established.

14. In IFRSs, IAS 11, *Construction Contracts*, states that an entity can measure performance (i.e., determine the stage of completion of a contract) in a variety of ways. The entity should use the method that measures reliably the work performed. Choosing a method that focuses on "work performed" arguably is consistent with focusing on results achieved or units of the entity's output.

15. Output methods of measuring performance can be based on observation and inspection by third parties such as engineers, architects, surveyors or other personnel qualified to assess performance for a particular type of contract.

16. Output methods are intuitive when performance consists of a specified number of similar acts (i.e., repetitive transfers of similar goods and services). For example, consider an entity that promises to transfer the same good or service once a month for a period of 2 years. An output method would appropriately recognize revenue in an equal amount each month as each unit of output is transferred.

17. Another common example of an output method is a road builder that contracts to build 100 miles of road over similar terrain. The builder could use miles of road built as a method of measuring performance. That is, if the builder has completed 50 miles of road, 50 percent of the revenue would be recognized.

18. A disadvantage of output methods is that sometimes they are not readily available or they are not available without incurring additional costs. For example, a manufacturer of a specialized piece of equipment might be producing an asset for a customer and continuously transferring the work in progress to the customer. The manufacturer could pay an engineer familiar with that type of equipment to attest to the completeness of the equipment. However, the manufacturer's incremental benefit of doing so might not justify the cost if the manufacturer can reliably measure its performance in another way.

Units of input

19. As noted above, output methods arguably are most consistent with the principle of the proposed model but sometimes they are not directly observable (at least not without additional costs). Hence, in many cases an entity can measure its performance in terms of units of input that serve as a proxy for the transfer of goods and services to a customer.

20. The most common input method is based on costs incurred relative to total costs expected to be incurred. Other input methods are based on labor hours, labor dollars, machine hours, quantities of materials, or any other unit of input that is considered to relate to the transfer of goods and services to a customer.

21. An example in the Boards' Discussion Paper refers to costs being used as a proxy for measuring performance in a contract. Paragraph A38 states:

> In many contracts, the actual costs incurred as a proportion of the total expected costs might be a reasonable proxy of the amount of goods and services that the customer has received.

22. The primary disadvantage of an input method of measuring performance is the potential disconnect between a unit of input and the transfer of goods and services to the customer. Often, that results from an entity's inefficiencies. For example, a service provider might have a fixed price contract for a project that is expected to incur a specified amount of costs. If the initial phase of the contract incurs more costs than expected because of employee turnover or error, those additional inputs into the contract do not necessarily transfer additional services to the customer.

23. Existing standards allow input methods of measuring performance in continuous-delivery contracts. For example, construction contract accounting guidance for both U.S. GAAP and IFRSs discuss an entity's ability to use the ratio of actual costs incurred to total expected costs as a measure of progress in a contract. However, both sets of guidance clearly warn of instances in which costs might not relate to the transfer of goods and services of the contract.

24. For example, in U.S. GAAP, ASC 605-35-25-75 states:

> Measuring progress toward completion based on the ratio of costs incurred to total estimated costs is also an input method. Some of the costs incurred, particularly in the early stages of the contract, shall

> be disregarded in applying this method because they do not relate to contract performance. These include the costs of items such as uninstalled materials not specifically produced or fabricated for the project or of subcontracts that have not been performed. For example, for construction projects, the cost of materials not unique to the project that have been purchased or accumulated at job sites but that have not been physically installed do not relate to performance. The costs of such materials should be excluded from costs incurred for the purpose of measuring the extent of progress toward completion.

25. Similarly, IAS 11, paragraph 31 states:

> When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date. Examples of contract costs which are excluded are:
>
> (a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and
>
> (b) payments made to subcontractors in advance of work performed under the subcontract.

26. The staff thinks that in many contracts, input methods (e.g., a cost to cost calculation) are the most practical way for an entity to measure performance each period. They should be allowed in the proposed model but only to the extent they are consistent with the objective of recognizing revenue to depict the transfer of goods and services in the amount of consideration the customer promises in exchange for those goods and services.

Passage of time

27. In some contracts, the passage of time might be the best measure of an entity's performance in a segment of a contract. That might be the case if an entity is not able to directly observe an output to the customer and cannot identify a unit of input that relates to the transfer of goods and services. In those cases, the entity might measure performance in terms of the passage of time.

28. Measuring performance in terms of the passage of time often is appropriate with stand-ready obligations that are satisfied over a fixed term and have an even pattern of services to be provided. For example, a warranty or maintenance

service continuously transfers the benefit of risk coverage to the customer over a fixed term. If the likelihood of a claim is even over the contract term, an entity could straight-line the revenue over time unless another measure of performance is more appropriate (e.g., if the risks to the entity are weighed more heavily to later periods).

29. That approach is consistent with existing guidance in U.S. GAAP on accounting for separately priced warranties and product maintenance contracts. ASC 605-20-25-3, *Separately Priced Extended Warranty and Product Maintenance Contracts,* states that:

> …revenue shall be recognized in income over the period in which the seller is obligated to perform. That is, revenue from separately priced extended warranty and product maintenance contracts shall be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue shall be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

30. Similar guidance also exists in U.S. GAAP for accounting for nonrefundable upfront fees for future services. SEC Topic 13 states that generally, a nonrefundable upfront fee should be deferred and recognized systematically over the periods that the fees are earned. Footnote 40 clarifies that:

> A systematic method would be on a straight-line basis, unless evidence suggests that revenue is earned or obligations are fulfilled in a different pattern, in which case that pattern should be followed.

31. The appendix to IAS 18, *Revenue,* similarly states that if an upfront entrance or membership fee entitles a customer to services provided during a membership period, it is recognized on a basis that reflects the timing, nature, and value of the benefits provided.

Staff recommendation and question for the Boards

32. The staff thinks that various methods of measuring performance are consistent with the principle of the proposed model as discussed above. The staff also thinks that the proposed model needs sufficient flexibility in measuring performance if the model is to be applied across various industries and

transactions. The *definition* of performance is not flexible—i.e., it is the transfer of goods and services to a customer. But management of an entity must be able to exercise judgment in selecting a method that best depicts the goods and services transferred to a customer.

Question 1 Methods of measuring performance in a segment
The staff recommends that management of an entity should exercise judgment and be able to select from various methods of measuring the goods and services transferred to a customer in a segment of a contract (e.g. units of output, units of input, or the passage of time). Do the Boards agree?

Applying a single method consistently

33. As discussed above, an entity could use various methods to measure performance in a segment of a contract. When considering the various methods available, the entity must select the method that is most consistent with the objective of recognizing revenue to depict the transfer of goods and services to the customer in the amount of consideration the customer promises in exchange for those goods and services.

34. Once an entity has selected a method for a segment; the staff thinks it is important for the entity to use that method consistently throughout the contract. For example, consider a company that sells a bundle of hardware, software, and services. For each of those segments, the entity might select a measure of performance as follows:

Segment	**Measure of performance**
Hardware	Unit(s) delivered
Software	Passage of time
Services	Labour hours incurred

35. Once the entity selects a measure of performance for each segment, it should apply that method consistently throughout the contract. That is, if the entity recognizes revenue for the services segment on the basis of labour hours

incurred, the staff thinks it should not change in the middle of the contract to a method of recognizing revenue on the basis of the passage of time. Using different methods of measuring performance for similar goods and services could reduce the comparability of information for users of financial statements.

Recent deliberations by the EITF

36. The EITF has recently considered a similar issue in relation to EITF Issue No. 08-1, "Revenue Recognition for a Single Unit of Accounting." In that issue, the EITF considered the instances, if any, in which it might be appropriate for an entity to use more than one method of attributing revenue to a single unit of accounting. For example, in a services arrangement an entity might receive a nonrefundable upfront fee that is recognized on a straight-line basis throughout the contract (i.e., it is recognized based on the passage of time). In addition, the entity might recognize revenue for the same services on the basis of labor hours incurred. Many people have questioned whether that practice is appropriate.

37. Another example that the EITF considered is one that occurs frequently in the biotechnology and pharmaceutical industries. In those industries, companies often license a particular technology and provide related research and development services with the aim of achieving specific milestones in a product's development. The license and the services are accounted for as a single unit of accounting (i.e., a single segment) because they fail to meet the separation criteria in existing guidance on multiple-element arrangements.

38. In those arrangements, it is common for an entity to recognize revenue on the basis of labor hours incurred (i.e., units of input). However, some companies then recognize revenue for the entire amount of a milestone payment when the milestone is achieved (i.e., a results achieved or unit of output method). Arguably, using more than one attribution method for a single unit of accounting bypasses the separation criteria in existing standards. The EITF decided to not address that issue directly in part because of its relation to the Boards' Revenue Recognition project.

Staff analysis and recommendation

39. The staff thinks that practice issues and questions similar to those considered by the EITF would continue to arise if the proposed model is not clear on the issue. Therefore, the staff thinks that an entity should select a single measure of performance per segment and apply that method consistently throughout the contract.

40. The staff thinks that requiring the use of a single measure of performance per segment will provide a clear answer to the questions raised in recent EITF discussions. In the biotechnology example in paragraphs 37 and 38, the entity would be required to use a single measure of performance (e.g., labor hours) to each segment of the contract. However, whether the license and services give rise to one or two segments depends on the entity's judgment on the basis of the staff's recommendations in Agenda Paper 3B/Memo 122B.

41. In addition to applying a single measure of performance consistently within a segment of a contract, an entity also should apply a measure of performance consistently across contracts. That consistency would enhance the comparability of revenue for users of an entity's financial statements.

Question for the Boards

Question 2 Applying a single method consistently
The staff recommends that for each segment of a contract, an entity should select a method that is most consistent with the objective of the proposed model and apply that method consistently both: (a) Throughout the contract, and (b) To segments in other contracts with similar characteristics. Do the Boards agree?