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Purpose of this paper

- The objective of this paper is to consider possible refinements and clarifications to the requirements on measuring progress towards complete satisfaction of a performance obligation that an entity satisfies over time, which were proposed in paragraphs 38-48 of the 2011 revised exposure draft *Revenue from Contracts with Customers* (the 2011 ED).

Staff recommendations

- In this paper, the staff recommend that the Boards:
 - Add as a practical expedient, the use of ‘units of delivery’ in contracts for manufacturing large volumes of homogeneous goods that have a short production cycle;
 - Explain more clearly in the standard that the adjustment to the input method proposed by paragraph 46 is to ensure that the input method meets the objective of measuring progress that is specified in paragraph 38 of the 2011

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ED—that is, to depict the entity’s performance and refine the fact pattern in Illustrative example 8 to help clarify the scope of the proposal.

- (c) Emphasise the objective of measuring progress in paragraph 38 of the 2011 ED and acknowledge that, if an input method such as cost-to-cost is used to measure progress, an entity would need to adjust the cost-to-cost calculation if some of the costs incurred (eg inefficiency or waste) do not contribute to the progress in the contract.

Overview of the proposed requirements for measuring progress

3. Paragraph 38 of the 2011 ED added an explicit objective that an entity should consider when measuring progress towards complete satisfaction of a performance obligation satisfied over time. Paragraph 38 states that “the objective when measuring progress towards complete satisfaction of a performance obligation that an entity satisfies over time is to depict the transfer of control of goods or services to the customer—that is, to depict an entity’s performance”. This does not allow an entity a free choice of methods, but requires that the method chosen reflects the entity’s best depiction of its performance in order to achieve the objective.
4. To meet that objective, the 2011 ED explains that appropriate methods for measuring progress include both input methods, such as costs incurred, and output methods, such as surveys of performance completed to date. The 2011 ED also includes specific guidance on the application of an input method when:
 - (a) There are inefficiencies in the entity’s performance (ie the proposals on wasted materials in paragraph 45 of the ED); and
 - (b) The customer obtains control of goods significantly before the related services (ie the proposals on uninstalled materials in paragraph 46 of the ED).
5. Paragraphs 47 and 48 of the 2011 ED address reasonable measures of progress. The Boards clarified that when selecting a method to measure progress and determining when to recognise revenue, an entity should recognise revenue for its performance only if it can reasonably measure its progress towards complete satisfaction of the

performance obligation, but in cases where this is not possible, the entity should recognise revenue only to the extent of the costs incurred. This proposal is consistent with existing requirements in both IFRSs and US GAAP.

Summary of feedback

6. In the 2011 ED, the Boards did not ask a specific question on the proposals related to measuring progress. However, several respondents commented on aspects of those proposals.
7. The main themes of the feedback received are outlined below. This paper is structured to address each of these themes separately.
 - (a) General comments on the measuring progress proposal, in particular, the selection of output or input methods for measuring progress (see paragraphs 8-11)
 - (b) The suitability of ‘units of delivery’ or ‘units produced’ (see paragraphs 12-40) as output methods to measure progress in:
 - (i) long-term manufacturing contracts (see paragraphs 15-26)
 - (ii) contract manufacturing arrangements (see paragraphs 27-40);
 - (c) Accounting for uninstalled materials (paragraphs 41-51); and
 - (d) Accounting for wasted materials and inefficiencies (paragraphs 52-56).

General comments – selection of input or output methods

8. Paragraph 40 of the 2011 ED explains that an entity should select a measure of progress to achieve the objective of depicting the entity’s performance in the contract. Additionally, the entity should apply that method consistently to similar performance obligations and in similar circumstances. The 2011 ED states that appropriate methods for measuring progress include input and output methods. In contrast to the 2010 ED, which indicated a preference for the use of output methods to measure progress, the 2011 ED does not indicate a preferred method. Instead, in response to feedback, the

Boards acknowledged in paragraph BC120 of the 2011 ED that output methods may sometimes be unnecessarily costly to apply, in which case an input method could be used if it provides a reliable proxy of the outputs to the customer.

9. The main points raised by respondents who commented on the proposal for selecting input or output methods to measure progress were as follows:
 - (a) A few respondents (mainly standard-setters) suggested that the revenue standard should specify that an entity should use an output method to measure progress unless the ‘value of the output to date cannot be measured reliably’ (CL#157 AASB). That is because, in the view of that respondent, input methods are inconsistent with the objective of measuring progress because there may not be a direct relationship between the entity’s efforts or inputs consumed in satisfying the performance obligation and the transfer of control of goods or services to the customer.
 - (b) Some other respondents suggested that an entity should be permitted to use a mixture of both input and output methods to measure progress in satisfying a single performance obligation if this would better reflect the pattern of the entity’s performance. In their view, using different methods to measure progress in completing different parts of the production cycle could provide a more accurate depiction of the entity’s performance in satisfying its performance obligation.

Staff analysis and recommendation

10. The staff do not recommend any changes to the proposals in the 2011 ED on the selection of output or input methods to measure progress. The staff think that the 2011 ED appropriately outlines a clear objective (see paragraph 3 above) for measuring progress that an entity should consider when selecting an appropriate method for measuring progress. The staff acknowledge that it will depend on the individual facts and circumstances as to whether an input method would provide the best depiction of the transfer of goods or services to the customer. Consequently, an entity should not assume that an input method should be used to measure progress. Equally, an entity

should not be required to use an output method if an input method is less costly to use and it provides a reasonable proxy for measuring progress.

11. Additionally, the staff think that an entity should not be permitted to use a mixture of methods to measure its performance in satisfying a single performance obligation. The staff note that, if an entity were to use a mixture of methods (eg labour hours, time and costs) to measure its performance, the entity would have to separate the components of a performance obligation that would be measured using different methods and then allocate a portion of the transaction price to those components in order to recognise revenue in an amount to reflect the entity's performance. Consequently, that approach would bypass the discipline that has been proposed for identifying separate performance obligations and allocating the transaction price to those performance obligations on the basis of standalone selling prices. Consistent with the 2011 ED proposals, the staff think that a single method for measuring progress should be chosen and that method should be applied consistently to similar performance obligations and in similar circumstances.

Units of delivery and units produced as output methods

12. Paragraph 41 of the 2011 ED mentioned *units produced* as an example of an output method used to measure progress. Furthermore, paragraph BC118 stated that “a ‘units of delivery’ method may be an appropriate method for a long-term manufacturing contract of standard items that individually transfer an equal amount of value to the customer”.
13. Respondents from industries engaged in long-term manufacturing (predominantly the aerospace and defence industry) and contract manufacturing sought clarification on whether a units of delivery method could be used to measure progress in a production contract which has a single (or separate) performance obligation that is satisfied over time.
14. This section of the paper separately addresses the comments from preparers in the long-term manufacturing industry and the contract manufacturing industry.

Long-term manufacturing

15. Some respondents from the aerospace and defence industry commented that, in their view, the units of delivery method best depicts the transfer of goods or services to the customer for their contracts. For example, one respondent from that industry commented:

...prior to the official transfer of title, acceptance is required from the Defense Contract Management Agency in the form of a signed DD250 form. Currently, we recognize revenue using the units-of-delivery method upon customer acceptance for our fixed price helicopter and military engine contracts as we believe this method best reflects the transfer of control and the underlying economics of these transactions. This is consistent with a number of other companies in the Aerospace & Defense industry. ...We believe output measures, such as units-of-delivery, faithfully depict the measurement of progress towards complete satisfaction of certain performance obligations subject to continuous transfer of control. However, because the units-of-delivery method results in the capitalization of costs until a unit is delivered, we are requesting the Boards clarify and allow for the acceptability of the units- of-delivery method in contracts with continuous transfer of control such as those more fully described above. We believe the guidance should provide flexibility in application to long-term contracts such that either the cost-to-cost or units-of-delivery method can be applied based on the method that best depicts the earnings process, and is most faithful to the economics and substance of the underlying transaction. (CL#112 UTC)

16. However, other respondents in the industry expressed a different view. For example:

If an input-based measure similar to the percentage-of-completion (POC), cost-to-cost method, is selected for recognizing revenue, we believe it is clear that costs would be recognized as incurred. However, if any other measurement method (e.g., units of delivery, milestones) is selected for

recognizing revenue, we do not believe the guidance provided will adequately allow for the determination of the amount of costs to be recognized at each revenue recognition event (CL#4A Aerospace Industries Association)

17. The following issues can be identified from those comments:
- (a) Are the performance obligations in those contracts performance obligations that are satisfied over time or at a point in time?
 - (b) Would either a *units of delivery* or a *units produced* measure of progress faithfully depict the entity's performance in satisfying those performance obligations that are satisfied over time?
 - (c) What would be the consequential effects on contract margin if the entity has a performance obligation satisfied over time?

Assessing whether the performance obligation is satisfied over time

18. The proposals for measuring progress only apply to performance obligations that are satisfied over time in accordance with the criteria proposed in paragraph 35 of the 2011 ED. Those criteria (as revised by the Boards at their July 2012 meeting and subject to further drafting improvements) are:

- 35 An entity satisfies a performance obligation and recognises revenue over time if one of the following criteria are met:
- (a) the customer receives and consumes the benefits of the entity's performance as the entity performs;
 - (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or
 - (c) the entity's performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed

to date and it expects to fulfil the contract as promised.

19. Determining whether a performance obligation is satisfied at a point in time or over time depends on the facts and circumstances of each contract. The staff understand that, for defence contracts in some jurisdictions, the paragraph 35 criteria would be met because the customer (ie the government) controls the assets as they are created or enhanced. For those contracts, the performance obligations identified would be performance obligations that are satisfied over time and the entity would need to select the measure of progress that best depicts the entity's performance in satisfying those performance obligations.
20. In contrast, performance obligations that fail the criteria in paragraph 35 would be performance obligations that are satisfied at a point in time and, consequently, a measure of progress would not be necessary—the asset under construction belongs to the entity, not the customer, and therefore an entity would need to determine the point in time when control of the asset transfers to the customer. That determination would be made considering the requirements in paragraph 37 of the 2011 ED.

Suitability of units of delivery or units produced to measure progress

21. Methods for measuring progress that focus on the production of units or the delivery of units are output methods in the sense that they measure the entity's performance in completing an activity associated with each unit—whereby the activity is deemed to be complete either when the unit is produced or when the unit is delivered to the customer. However, by focusing the measurement of performance on the completion of those activities, those methods disregard that portion of the entity's performance that has resulted in part-completed units at the end of the reporting period. In other words, those methods ignore the work in progress that belongs to the customer. For that reason, units produced and units delivered methods may not faithfully depict *all* of the entity's performance if the value of the work in progress at the end of the reporting period is material.

22. Hence, for contracts to produce units that have a long production cycle (eg large and specialised equipment items), a ‘units produced’ or ‘units delivered’ method would be unlikely to provide a good proxy for depicting the entity’s performance in that contract.
23. The staff note that a consequence of this conclusion is that the 2011 ED proposals could lead to changes in the timing of revenue recognition for some entities in the long-term manufacturing industry. For example, as one respondent commented:

In our opinion, it is important that the guidance continue to allow companies to utilize the units-of- delivery method for long-term contracts and an average cost basis for production lots as we believe this best depicts the economics of many long-term production contracts. We are concerned that the application of the principles set forth in the Exposure Draft may prevent companies from utilizing this method in the future which would accelerate revenue and profit recognition, would not reflect the true economics of the contract and would not provide decision-useful information for financial statement users. (CL#93 Textron)

Consequential effects on contract margin

24. Entities that operate in the construction or production industries primarily focus on margin recognition, which means that both the pattern of revenue recognition and cost accounting are important. One respondent explained that their current practice in accounting for revenue and costs associated with their production activities is as follows:

The margin we recognize on each delivered unit is based on the overall profit margin for the contract, which we believe is most appropriate since the overall contract margin is negotiated as a combined bundle of goods/services, rather than based on the individual performance/delivery of a single unit. For example, for a contract that calls for the production of 100 aircraft over a period of three years, we would recognize a portion of the total contract revenue upon delivery of each aircraft and would allocate costs to each aircraft based on an average-per-unit cost. We are concerned that under the Exposure Draft, it could

be interpreted that each aircraft would represent a single performance obligation if it is not considered to be highly interrelated with the other aircraft under the contract and does not require significant integration services with the other items under the contract. (CL#93 Textron)

25. Because margin recognition is important to many long-term manufacturers, some respondents requested the Boards to include additional guidance related to how production costs would be recognised in measuring their progress using a units-of-delivery method. In their view, it would be more appropriate to recognise their costs on the basis of an average cost per unit, which is currently required by ASC Subtopic 605-35 *Revenue Recognition – Construction-Type and Production-Type Contracts*.
26. The staff note that the Board has already decided that accounting for those costs are out of scope of this project. Furthermore, the staff note that, if an entity has a performance obligation that is satisfied over time in accordance with the criteria in paragraph 35 of the 2011 ED, the costs the entity incurs in satisfying that performance obligation are costs attributable to the provision of that production service promised to the customer and those costs should be recognised as expenses. Consequently, those costs cannot be regarded as the cost of the asset being constructed by the entity (ie as inventory) because that asset is controlled by the customer.

Contract manufacturing

27. In contrast to long-term manufacturing arrangements in which an entity produces highly-specialized products that require a long-production cycle (eg a year), some contract manufacturing arrangements require an entity to produce a significant number of homogeneous products over a short production cycle (eg a week).
28. Feedback was received from some contract manufacturers regarding the potential for their contracts to be identified as resulting in performance obligations satisfied over time (because the criteria in paragraph 35 of the 2011 ED would be met) and whether it would be appropriate to use a units of delivery output method to measure progress in satisfying those performance obligations. The following comment summarises the concerns of those contract manufacturers:

The objective of measuring revenue over time per paragraph 38 is to depict transfer of control of goods to the customer. This method of revenue recognition really does not achieve this objective for situations where the production cycle is very short. The stage of completion of a unit at any given time does not reflect the transfer of control of such goods to the customer at that point since, if we are to stop production and transfer the work in progress to the customer, we would not be able to do so until the unfinished unit is at a stage where another manufacturer can continue production efficiently. Accordingly, we believe the consequences from paragraph 38 are unintended because recognizing revenue over the period of performance of obligations for short-term manufacturing processes does not accurately depict the pattern in which control of such goods are ultimately transferred to the customer. (CL#56 Flextronics)

29. The staff understand that, under current practice, contract manufacturers recognise revenue at the point in time at which delivery of the contracted goods to the customer occurs, because ‘delivery is the point at which [the] customer takes title to the product, assumes significant risks and rewards of ownership of the product, and incurs an unconditional obligation to pay for the product’ (CL# 98 Sanmina-Sci).
30. However, in applying the proposed revenue model, there may be circumstances in which an entity would be required to recognise revenue over time because the criteria in paragraph 35 of the 2011 ED specifies that the entity’s performance obligation is a performance obligation that is satisfied over time. That conclusion could be reached either because:
- (a) The customer controls the assets as they are being manufactured; or
 - (b) If it is unclear which party controls the assets being manufactured, the entity determines that its performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised. Feedback from outreach suggests that those criteria could be met for some contract manufacturing arrangements. For example, one respondent commented:

A strict interpretation of Paragraphs 35(b) and 35(b)(iii) could lead to the conclusion that our performance obligations are satisfied over time. For example, at some point during the manufacturing cycle, an asset will no longer have an alternative use to us either because it includes customer-specific materials or has been configured to a customer's unique specifications. The point during the manufacturing cycle at which this occurs will vary based on the product being manufactured. Additionally, purchase orders placed by our customers generally require payment for work performed to date (including a reasonable profit margin) in the event of order cancellation. Based on this, the criteria in Paragraphs 35(b) and 35(b)(iii) appear to be met, thus indicating that revenue should be recognized over time. (CL#98 Sanmina-Sci)

31. Respondents from the contract manufacturing industry expressed concerns that the paragraph 35 criteria would require their contracts to be accounted for as performance obligations satisfied over time. Those respondents suggested that it would be difficult to measure the level of completion at an individual unit level at any given time and that it would be costly to change the systems in place at present. They were also concerned that comparability within the industry would be impaired because entities may use different methods to measure progress.
32. For those reasons, those respondents requested the Boards to consider introducing an exception or a practical expedient to allow the use of a 'units of production' or 'units of delivery' method to measure progress for their performance obligations.

Staff analysis

33. In accordance with the proposed revenue model, contract manufacturing arrangements such as those raised above by respondents would first need to be assessed as to whether or not the revised criteria in paragraph 35 (for performance obligations satisfied over time) would be met. That assessment would need to consider all relevant facts and circumstances relating to the arrangement. If those criteria are met, that means that (among other things):

- (a) The entity is contractually or practically prevented from redirecting the assets to other customers; and
 - (b) If the customer were to terminate the contract, the entity would have a right to payment for the work completed to date, which would include payment for both completed assets and any part completed assets.
34. For an entity's contract manufacturing arrangements that would be accounted for as performance obligations satisfied over time, the entity would need to determine a measure of progress that best depicts their performance in those contracts. As mentioned earlier in the paper, contract manufacturing arrangements are typified by the following characteristics:
- (a) The manufacture of homogenous assets;
 - (b) The manufacture of large volumes of those homogeneous assets; and
 - (c) A short-term production cycle for the manufacture of each asset (whereby an asset might be manufactured in a matter of hours or days).
35. In determining whether an output method such as units produced or units delivered would faithfully depict an entity's performance in a typical contract manufacturing arrangement, the staff think that:
- (a) A units produced method could provide a reasonable proxy for the entity's performance in the contract if the value of any work in progress at the end of the reporting period is immaterial; and
 - (b) A units delivered method could also provide a reasonable proxy for the entity's performance in the contract if:
 - (i) The value of any work in progress at the end of the reporting period is immaterial; and
 - (ii) The value of any units produced but not yet delivered to the customer at the end of the reporting period is immaterial.
36. Hence, in accordance with the proposals in the 2011 ED, the staff considers that it is possible for an entity to use a units produced or units delivered measure of progress if

those methods provide a reasonable proxy for the entity's performance, which might occur in the circumstances described in the above paragraph.

Add a practical expedient?

37. The staff acknowledge that materiality considerations would not always enable an entity to conclude that a units of delivery (or units produced) method provides a reasonable proxy of the entity's performance in contract manufacturing arrangements.
38. For that reason, the Boards could consider to allow, as a practical expedient, the use of a 'units of delivery' method in contracts for the manufacture of large volumes of homogenous goods that have a short production cycle. A practical expedient could be justified on the basis that a units of delivery method would be a reasonable proxy for the entity's performance if the production cycle is short and the duration between the completion of production and when the units are delivered to the customer is typically short (noting that in some cases the units might be considered to be delivered to the customer while the units are still held by the entity because the entity is also providing a custodial service). Like the practical expedient for the time value of money, this practical expedient would apply such that an entity need not assess whether, as at each reporting date, the value of work in progress and completed units not yet delivered are material.
39. Other reasons for allowing a practical expedient in those cases are:
- (a) A units delivered method would provide an objective—and readily verifiable—basis for measuring performance in the contract;
 - (b) The practical expedient would avoid the risk that an entity might need to change its measure of progress from period to period depending on depending on whether, at the reporting date, the value of work in progress and completed units not yet delivered are material; and
 - (c) The practical expedient would have the effect of delaying revenue recognition relative to other possible methods of measures of progress (eg cost-to-cost) but because the contract manufacturing arrangements typically involve the manufacture of large volumes of goods, the overall effect on the revenue recognised for a particular period is unlikely to be significant.

40. For the reasons identified in the paragraphs above, the staff recommend adding a practical expedient for those contract manufacturing arrangements.

Question 1 – use of ‘units of delivery’ output method

Do the Boards agree with the staff recommendation to:

Add, as a practical expedient, the use of ‘units of delivery’ in contracts for manufacturing large volumes of homogeneous goods that have a short production cycle.

If not, what do the Boards recommend?

Input methods

Uninstalled materials

41. To ensure that a cost-to-cost method for measuring progress properly depicts the entity’s performance in satisfying a performance obligation, paragraph 46 of the 2011 ED was added to require an adjustment to the cost-to-cost calculation in specified circumstances in which the customer obtains control of goods significantly before receiving the services related to those goods (ie uninstalled materials).

42. Paragraph 46 of the 2011 ED states:

When applying an input method to a separate performance obligation that includes goods that the customer obtains control of significantly before receiving services related to those goods, the best depiction of the entity’s performance may be for the entity to recognise revenue for the transferred goods in an amount equal to the costs of those goods if both of the following conditions are present at contract inception:

- a) the cost of the transferred goods is significant relative to the total expected costs to completely satisfy the performance obligation; and
- b) the entity procures the goods from another entity

and is not significantly involved in designing and manufacturing the goods (but the entity is acting as a principal in accordance with paragraphs B16–B19).

43. The adjustment to the cost-to-cost measure of progress for uninstalled materials is intended to apply only to a subset of goods in a construction contract—that is, only to those goods that have a significant cost relative to the contract and only if the entity is essentially providing a procurement service to the customer. That is because, for that subset of goods, recognising revenue at a contract-wide profit margin for the transfer of those uninstalled materials would overstate the entity’s performance in the contract, and therefore revenue would also be overstated.
44. For those goods that meet the criteria in paragraph 46, recognising revenue to the extent of the costs of those goods ensures that the entity’s performance in the contract is similar to the profit (or margin) that the entity would recognise if the customer has supplied those goods themselves for the entity to install or use in the construction activity. The following example illustrates how paragraph 46 can ensure that an entity properly depicts their performance satisfying a performance obligation.

In November 2012, an entity contracts with a customer to refurbish a 3-story building, including installing elevators. The cost of the elevators is CU 1 500 000. The customer obtains control of the elevators when they are delivered to the site in December 2012, although the elevators will not be installed until June 2013. At year end, the only other costs incurred total CU 500 000. The entity is not significantly involved in designing and manufacturing the elevators.

	Scenarios A and B – entity procures elevators	Scenario C – customer procures elevators
Transaction Price	5 000 000	3 500 000
Cost of elevators	1 500 000	0
Other costs	2 500 000	2 500 000
Total expected costs	4 000 000	2 500 000
Costs incurred as of year end (excluding elevators)	500 000	500 000
Scenario A (entity procures elevators and applies paragraph 46) 31 December, 2012 <u>CU 500 000</u> CU 2 500 000 = 20% complete	Scenario B (entity procures elevators and does not apply paragraph 46) 31 December, 2012 <u>CU 2 000 000</u> CU 4 000 000 = 50% complete	Scenario C (customer procures elevators) 31 December, 2012 <u>CU 500 000</u> CU 2 500 000 = 20% complete
Revenue 2 200 000	Revenue 2 500 000	Revenue 700 000
COGS <u>2 000 000</u>	COGS <u>2 000 000</u>	COGS <u>500 000</u>
Profit 200 000	Profit 500 000	Profit 200 000

45. The main comments from respondents on the proposals related to:

- (a) The scope of the proposals in paragraph 46 seemed to be too broad; and

- (b) A disagreement with recognising a nil profit margin on the transfer of the ‘uninstalled materials’.

Scope of paragraph 46

46. Respondents requested additional guidance or clarifications to assist an entity to determine whether its contracts with customers include uninstalled materials within the scope of paragraph 46. For instance:

- (a) Additional guidance was requested to assess ‘significance’ with respect to whether “the cost of the transferred goods is *significant* relative to the total expected costs to completely satisfy the performance obligation” and “the entity procures the goods from another entity and is not *significantly* involved in designing and manufacturing the goods”.
- (b) Refinements to Example 8 of the Illustrative Examples (see Appendix B) were requested because of a concern that the example implies that specialised equipment would never attract a profit margin, regardless of whether it is installed or not.
- (c) A respondent was concerned that the condition in paragraph 46 (b) about the entity not being significantly ‘involved in designing and manufacturing the goods’ could be interpreted too literally. They commented that:

Misrepresentation of the contract's economics: Customers often order turn-key solutions which involve several subsuppliers. The decision on what to outsource and what to produce in-house is with the seller. The value provided to the customer includes more than only the costs of the externally purchased parts but also the overall project management, subsupplier selection and management, procurement processes, related risks of the resold parts and integration of these parts in the overall project. This should also be considered when allocating gross margins to individual components of a single performance obligation. The margins for own work performed might be overstated if a zero margin is allocated to procurement of goods from another entity.
(CL#34 ABB)

Disagreement with a nil profit margin

47. Some respondents disagreed with the proposal requiring an entity to recognise a profit margin of zero on the transfer of the ‘uninstalled materials’ to the customer. In their view, recognising different profit margins for different parts of a single performance obligation is inconsistent with the principle of identifying separate performance obligations.
48. Some other respondents disagreed with recognising revenue for uninstalled materials at a zero profit margin because it might not properly depict the economics underlying the contract. For instance, one commentator explained that, if a customer terminates the contract, the contract might specify that the entity is entitled to payment at an amount that reflects the contract-wide margin for all of the work performed in the contract including the transfer of uninstalled materials to the customer.

Staff analysis and recommendation

49. The staff understand that there is some diversity in current practice in accounting for uninstalled materials – some entities recognise no margin, some recognise a small margin and some recognise the contract-wide margin. The staff thinks that the proposals in the 2011 ED should help to address that diversity. Furthermore, the proposals make clear that an entity should only recognise revenue attributable to uninstalled materials when the customer has obtained control of those materials.
50. To address the concerns raised with respect to the scope and application of paragraph 46, the staff recommend explaining more clearly in the standard that the adjustment to the input method proposed by paragraph 46 is to ensure that the input method meets the objective of measuring progress that is specified in paragraph 38 of the 2011 ED—that is, to depict the entity’s performance. The staff thinks that, as written, the scope of the uninstalled materials requirements is appropriate but some of the concerns raised by respondents indicate that it has been interpreted more broadly than intended. Accordingly, the staff also recommends refining the fact pattern in Illustrative example 8 to help clarify the scope of the proposal.
51. The staff does not agree with the concern raised by some respondents that paragraph 46 is inconsistent with the principle of identifying separate performance obligations.

Although, the outcome of applying paragraph 46 is that some goods or services that are part of a single performance obligation attract a margin and any uninstalled materials attract a zero margin, that difference arises only as a consequence of the need to adjust the cost-to-cost calculation in order for that input method to faithfully depict the entity's performance in the contract.

Question 2 – uninstalled materials clarifications

The staff recommend explaining more clearly in the standard that the adjustment to the input method proposed by paragraph 46 is to ensure that the input method meets the objective of measuring progress that is specified in paragraph 38 of the 2011 ED—that is, to depict the entity's performance.

Additionally, the staff recommends refining the fact pattern in Illustrative example 8 to help clarify the scope of the proposal.

Do the Boards agree?

Wasted materials and inefficiencies

52. Paragraph 45 of the 2011 ED acknowledges that a shortcoming of input methods is that there may not be a direct relationship between the entity's inputs and the transfer of control of goods or services to the customer because of inefficiencies in the entity's performance or other factors. Consequently, the 2011 ED proposed that when an input method is used, an entity should exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer (eg the costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract).
53. In that regard, the proposals in paragraph 45 can be viewed as a reminder that a cost-to-cost method might not provide a faithful depiction of the entity's performance—and, therefore, might not be consistent with the objective of measuring progress that is proposed in paragraph 38 of the 2011 ED—if the cost-to-cost method includes costs attributable to wasted materials or other inefficiencies that do not contribute to the satisfaction of the performance obligation.

54. The main comments on the proposal in paragraph 45 of the 2011 ED were as follows:

- (a) The definitions of ‘inefficiency’ and ‘wasted materials’ are unclear. For instance, one respondent sought clarification on “whether the assessment should focus on entity specific inefficiencies or also those that might be market driven” (CL#61 AICPA). Another respondent commented that “a clearer explanation of the accounting for normal, expected wasted materials versus the accounting for abnormal wasted materials is also needed” (CL#11 PCFRC).
- (b) The scope of paragraph 45 should be narrowed to inefficiencies arising from “costs related to excess / idle capacity or similar costs that provide no utility to contract performance, or infrequent / non-recurring costs such as those related to work stoppages, natural disasters, or other force majeure incidents not anticipated in the normal course of business / reflected in pricing across an entity’s portfolio of contracts” (CL#49 Raytheon).
- (c) Identifying and tracking the costs of wasted materials or other inefficiencies could be difficult. For instance, many respondents in the construction industry said that the estimate of normal rework and/or inefficiencies is often bid into contracts, making it difficult to determine if a cost is an incremental waste or inefficiency or if it has already been factored into the initial estimate of the contract price. Consider the comment from a respondent:
- In the construction industry, wasted materials are not considered as a separate item but rather are assessed regularly and are an adjustment of job cost. Therefore, the cost of wasted materials is not considered as overhead but remains as part of the job cost, forcing a lower gross margin.
- It is unclear how one determines if a cost represents waste or inefficiency when the concept of rework is priced into a company’s bids across a portfolio of contracts with the knowledge that rework will vary from contract to contract’ (CL#49 Raytheon).

Staff analysis and recommendation

55. As noted above, paragraph 45 of the 2011 ED was added to ensure that a cost-to-cost method meets the objective for measuring of progress—that is, to depict the entity’s performance in the contract. However, the feedback on paragraph 45 suggests that, if that proposal is retained in the revenue standard, the Boards may need to provide specific guidance on identifying those inefficiencies and wasted materials and how those costs should be adjusted when measuring progress.
56. The staff agrees with many of the concerns raised and, furthermore, the staff thinks it would not be possible to develop additional guidance that clearly and consistently identifies the costs of inefficiencies and wasted materials that should be excluded from a costs-to-cost measure of progress. Instead, the staff recommend that the revenue standard should instead emphasise the objective of measuring progress in paragraph 38 of the 2011 ED and acknowledge that, if an input method such as cost-to-cost is used to measure progress, an entity would need to adjust the cost-to-cost calculation if some of the costs incurred do not contribute to the progress in the contract.

Question 3

The staff recommend that the revenue standard should emphasise the objective of measuring progress in paragraph 38 of the 2011 ED and acknowledge that, if an input method such as cost-to-cost is used to measure progress, an entity would need to adjust the cost-to-cost calculation if some of the costs incurred do not contribute to the progress in the contract.

Do the Boards agree?

Appendix A

A1. The following table lists the proposed requirements from the 2011 ED that relate to the identification of separate performance obligations and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 exposure draft	Anticipated change?
<p>Measuring progress towards complete satisfaction of a performance obligation (see paragraph IE7)</p> <p>38 For each separate performance obligation that an entity satisfies over time in accordance with paragraphs 35 and 36, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict the transfer of control of goods or services to the customer—that is, to depict an entity’s performance. As circumstances change over time, an entity shall update its measure of progress to depict the entity’s performance completed to date. Such changes shall be accounted for as a change in accounting estimate in accordance with IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>.</p>	No material change expected.
<p>39 In accordance with the objective of measuring progress, an entity shall exclude from a measure of progress any goods or services for which the entity does not transfer control to the customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to the customer.</p>	No material change expected.
<p>40 For each separate performance obligation satisfied over time, an entity shall apply a method of measuring progress that is consistent with the objective in paragraph 38 and shall apply that method consistently to similar performance obligations and in similar circumstances. Appropriate methods of measuring progress include output methods and input methods.</p>	No material change expected.
<p><i>Output methods</i></p> <p>41 Output methods recognise revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date (for example, surveys of performance completed to date, appraisals of results achieved, milestones reached or units produced) and can be the most faithful depiction of the entity’s performance.</p>	The staff recommend clarification of ‘units produced’ as an output method and the addition of a practical expedient in paragraphs 33-40.
<p>42 If an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity’s performance completed to date (for example, a services contract in which an entity bills a fixed amount for each hour of service provided), the entity shall recognise revenue in the amount to which the entity has a right to invoice.</p>	No material change expected.
<p>43 A disadvantage of output methods is that they are often not directly observable and the information required to apply them may not be available to the entity without undue cost. Hence, an input method may be necessary.</p>	No material change expected.

<p><i>Input methods</i></p> <p>44 Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time lapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for an entity to recognise revenue on a straight-line basis.</p>	No material change expected.
<p>45 A shortcoming of input methods is that there may not be a direct relationship between the entity's inputs and the transfer of control of goods or services to the customer because of inefficiencies in the entity's performance or other factors. Hence, when using an input method, an entity shall exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer (for example, the costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract).</p>	The staff recommend a clarification regarding inefficiency and wasted materials, see paragraphs 55-56.
<p>46 When applying an input method to a separate performance obligation that includes goods that the customer obtains control of significantly before receiving services related to those goods, the best depiction of the entity's performance may be for the entity to recognise revenue for the transferred goods in an amount equal to the costs of those goods if both of the following conditions are present at contract inception:</p> <ul style="list-style-type: none"> (a) the cost of the transferred goods is significant relative to the total expected costs to completely satisfy the performance obligation; and (b) the entity procures the goods from another entity and is not significantly involved in designing and manufacturing the goods (but the entity is acting as a principal in accordance with paragraphs B16-B19). 	The staff recommend a clarification for uninstalled materials to link this requirement to the objective of measuring progress in paragraph 38 of the 2011 ED, see paragraphs 49-51.
<p><i>Reasonable measures of progress</i></p> <p>47 An entity shall recognise revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. An entity would not be able to reasonably measure its progress towards complete satisfaction of a performance obligation if it lacks reliable information that would be required to apply an appropriate method of measuring progress.</p>	No material change expected.
<p>48 In some circumstances (for example, in the early stages of a contract), an entity may not be able to reasonably measure the outcome of a performance obligation, but the entity expects to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity shall recognise revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation or until the performance obligation becomes onerous.</p>	No material change expected.

Appendix B

Measuring progress towards complete satisfaction of a performance obligation (paragraphs 38–48)

IE7

[IG65] The following example illustrates the requirements in paragraph 46 on applying an input method to measure progress if the entity has a single performance obligation that includes goods (for example, specialised materials) that the customer obtains control of before services related to those goods (for example, installation).

Example 8—Uninstalled materials

An entity enters into a contract with a customer to construct a facility for CU140 million over two years. The contract also requires the entity to procure specialised equipment from a third party and integrate that equipment into the facility. The entity expects to transfer control of the specialised equipment approximately six months from when the project begins. The installation and integration of the equipment continue throughout the contract. The contract is a single performance obligation in accordance with paragraph 29 because all of the promised goods or services in the contract are highly interrelated and the entity also provides a significant service of integrating those goods or services into the single facility for which the customer has contracted. In addition, the entity significantly modifies the bundle of goods and services to fulfil the contract. The entity measures progress towards complete satisfaction of the performance obligation on the basis of costs incurred relative to total costs expected to be incurred.

At contract inception, the entity expects the following:

Transaction price		CU140,000,000
	Cost of the specialised equipment	CU40,000,000
	Other costs	CU80,000,000
Total expected costs		<u>CU120,000,000</u>

In accordance with paragraph 46, the entity concludes that the best depiction of the entity's performance is to recognise revenue for the specialised equipment in an amount equal to the cost of the specialised equipment upon the transfer of control to the customer. Hence, the entity would exclude the cost of the specialised equipment from its measure of progress towards complete satisfaction of the performance obligation on a cost-to-cost basis and account for the contract as follows.

During the first six months, the entity incurs CU20,000,000 of costs relative to the total CU80,000,000 of expected costs (excluding the CU40,000,000 cost of the specialised equipment). Hence, the entity estimates that the performance obligation is 25 per cent complete ($CU20,000,000 \div CU80,000,000$) and recognises revenue of CU25,000,000 [$25\% \times (CU140,000,000 \text{ total transaction price} - CU40,000,000 \text{ revenue for the specialised equipment})$].

Upon transfer of control of the specialised equipment, the entity recognises revenue and costs of CU40,000,000.

Subsequently, the entity continues to recognise revenue on the basis of costs incurred relative to total expected costs (excluding the revenue and cost of the specialised equipment).