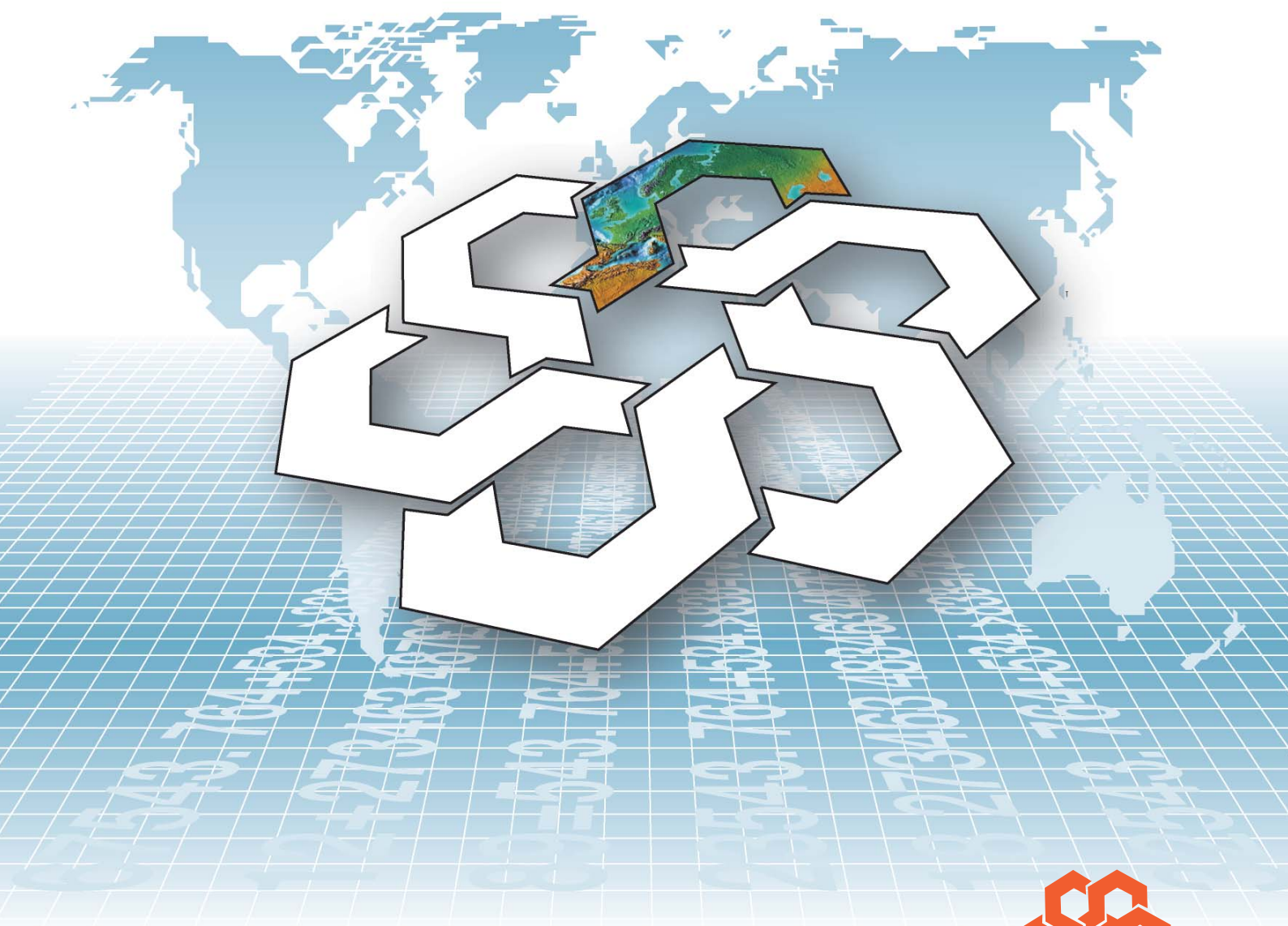


December 2008

DISCUSSION PAPER

Preliminary Views on Revenue Recognition in Contracts with Customers

Comments to be submitted by 19 June 2009



International
Accounting Standards
Board®

Discussion Paper
Preliminary Views on
Revenue Recognition in
Contracts with Customers

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This discussion paper *Preliminary Views on Revenue Recognition in Contracts with Customers* is published by the International Accounting Standards Board (IASB) for comment only.

The discussion paper has been prepared as part of a joint project by the IASB and the US Financial Accounting Standards Board and it sets out the boards' preliminary views. Those views may be modified in the light of comments received before being published as an exposure draft of a proposed standard.

Comments on the contents of the discussion paper should be submitted in writing so as to be received by **19 June 2009**. Respondents are asked to send their comments electronically to the IASB Website (www.iasb.org), using the 'Open to Comment' page. All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Summary and invitation to comment

Introduction

- S1 Revenue is a crucial part of an entity's financial statements. Capital providers use an entity's revenue when analysing the entity's financial position and financial performance as a basis for making economic decisions. Revenue is also important to financial statement preparers, auditors and regulators.
- S2 The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) initiated their joint project on revenue recognition primarily to clarify the principles for recognising revenue. In US generally accepted accounting principles (GAAP), revenue recognition guidance comprises more than a hundred standards—many are industry-specific and some can produce conflicting results for economically similar transactions. In International Financial Reporting Standards (IFRSs), the principles underlying the two main revenue recognition standards (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) are inconsistent and vague, and can be difficult to apply beyond simple transactions. In particular, those standards provide limited guidance for transactions involving multiple components or multiple deliverables.
- S3 This discussion paper invites comments on the boards' preliminary views on a single, contract-based revenue recognition model. The boards are developing that model to improve financial reporting by providing clearer guidance on when an entity should recognise revenue, and by reducing the number of standards to which entities have to refer. As a result, the boards expect that entities will recognise revenue more consistently for similar contracts regardless of the industry in which an entity operates. That consistency should improve the comparability and understandability of revenue for users of financial statements.
- S4 Because the boards are still developing the proposed model, this discussion paper does not include all the guidance that would be included in a proposed standard. Instead, this discussion paper presents the basic model and its implications in order to seek views from respondents before the boards publish a proposed standard.

Next steps

- S5 The boards will review the comments received on this discussion paper and modify or confirm their preliminary views. They will then develop, for public comment, an exposure draft of a revenue recognition standard for IFRSs and US GAAP. In doing so, the boards will consider the need for users of financial statements to receive useful information, which can be provided by preparers at a reasonable cost, as a basis for making economic decisions.
- S6 Next steps also may include public hearings to discuss the proposed model. After reviewing the comments on this discussion paper, the boards will decide whether to hold public hearings.
- S7 During the comment period on this discussion paper, the boards plan to conduct field visits. The boards will focus initially on industries with contracts that the proposed model is most likely to affect. The field visits will continue into the exposure draft stage of the project.
- S8 The boards have not yet discussed all matters relating to the proposed model. They will discuss some of those matters during the comment period. For information on the boards' ongoing project activities, please see www.iasb.org or www.fasb.org.

Summary of preliminary views

- S9 The boards have reached some preliminary views in developing a revenue recognition model. This section summarises those views.

Scope

- S10 The proposed model would apply to contracts with customers. A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract. A customer is a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities.
- S11 The boards have not excluded any particular contracts with customers from the proposed model. However, because of the potentially broad scope of a standard on contracts with customers, they have considered whether the proposed model, and in particular its measurement approach, would provide decision-useful information for the following contracts:

PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

- (a) financial instruments and some non-financial instrument contracts that otherwise would be in the scope of standards such as IAS 39 *Financial Instruments: Recognition and Measurement* and SFAS 133 *Accounting for Derivative Instruments and Hedging Activities*. In the boards' view, because of the potential volatility in the value of those contracts, the proposed revenue recognition model might not always provide decision-useful information about them.
 - (b) insurance contracts that are in the scope of IFRS 4 *Insurance Contracts* and SFAS 60 *Accounting and Reporting by Insurance Enterprises* (and other related US GAAP). The boards have an active project on their agendas for insurance contracts. In the boards' view, the proposed revenue recognition model might provide decision-useful information for some contracts that the insurance project is considering, but not all of them.
 - (c) leasing contracts that are in the scope of IAS 17 *Leases* and SFAS 13 *Accounting for Leases* (and other related US GAAP). The boards have a joint project on their agenda for lease accounting. The boards have tentatively decided to defer consideration of lessor accounting and to concentrate on developing an improved lessee accounting model. The boards have not yet decided how the proposed revenue recognition model would apply to lessor accounting.
- S12 In future deliberations, the boards will consider the implications of the proposed model for entities that recognise revenue or gains in the absence of a contract. For example, some entities recognise revenue or gains from increases in inventory before obtaining a contract with a customer (in accordance with IAS 41 *Agriculture* and AICPA SOP 85-3 *Accounting by Agricultural Producers and Agricultural Cooperatives*). In this project, the boards do not intend to change the way that those entities measure inventory. However, the boards will consider whether those entities should be precluded from presenting increases in inventory as revenue and should, instead, present those increases as another component of comprehensive income.
- S13 The boards plan to consider whether any contracts with customers should be excluded from the proposed model after reviewing comments on this discussion paper.

Recognition

Contract-based revenue recognition principle

- S14 The boards propose that revenue should be recognised on the basis of increases in an entity's net position in a contract with a customer.

- S15 When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract.
- S16 In the proposed model, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.

Identification of performance obligations

- S17 An entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit.
- S18 When an entity promises to provide a good, it is promising to transfer an asset to the customer. When an entity promises to provide a service, it similarly is promising to transfer an asset, even though the customer may consume that asset immediately.
- S19 An entity accounts for performance obligations separately if the promised assets (goods or services) are transferred to the customer at different times. The objective of separating performance obligations is to ensure that an entity's revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.

Satisfaction of performance obligations

- S20 An entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset (such as a good or a service) to the customer. The boards propose that an entity has transferred that promised asset when the customer obtains control of it.
- S21 In the case of a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the *customer's* asset. Typically, that occurs when the customer takes physical possession of the good.
- S22 In the case of a service, an entity similarly satisfies a performance obligation when the service is the customer's asset. That occurs when the customer has received the promised service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognised as an asset.

- S23 Consequently, activities that an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer. For example, in a contract to construct an asset for a customer, an entity satisfies a performance obligation during construction only if assets are transferred to the customer throughout the construction process. That would be the case if the customer controls the partially constructed asset so that it is the customer's asset as it is being constructed.

Measurement

- S24 To recognise a contract, an entity measures its rights and its performance obligations in the contract. The boards have not yet expressed a preliminary view on how an entity would measure the rights. However, measurement of the rights would be based on the amount of the transaction price (ie the promised consideration).
- S25 The boards propose that performance obligations initially should be measured at the transaction price—the customer's promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative stand-alone selling prices of the goods and services underlying those performance obligations.
- S26 Subsequent measurement of the performance obligations should depict the decrease in the entity's obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognised is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognises over the life of the contract is equal to the transaction price.
- S27 The boards propose that after contract inception, the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous. A performance obligation is deemed onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation. In that case, the performance obligation is remeasured to the entity's expected cost of satisfying the performance obligation and the entity would recognise a contract loss.

Potential effects on present practice

- S28 For many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the boards' proposed model would differ from present practice. For example:
- (a) *use of a contract-based revenue recognition principle.* An entity would recognise revenue from increases in its net position in a contract with a customer as a result of satisfying a performance obligation. Increases in other assets such as cash, inventory in the absence of a contract with a customer, and inventory under a contract with a customer (but not yet transferred to the customer) would not trigger revenue recognition. For instance, entities that at present recognise revenue for construction-type contracts would recognise revenue during construction only if the customer controls the item as it is constructed.
 - (b) *identification of performance obligations.* In present practice, entities sometimes account for similar contractual promises differently. For example, some warranties and other post-delivery services are accounted for as cost accruals rather than as 'deliverables' in or 'components' of a contract. In the proposed model, entities would account for those obligations as performance obligations and would recognise revenue as they are satisfied.
 - (c) *use of estimates.* Some existing standards limit the use of estimates more than the boards' proposed model would. For example, entities sometimes do not recognise revenue for a delivered item if there is no objective and reliable evidence of the selling price of the undelivered items (eg EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* and AICPA SOP 97-2 *Software Revenue Recognition*). In contrast, in the proposed model, entities would estimate the stand-alone selling prices of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer.
 - (d) *capitalisation of costs.* At present, entities sometimes capitalise the costs of obtaining contracts. In the proposed model, costs are capitalised only if they qualify for capitalisation in accordance with other standards. For example, commissions paid to a salesperson for obtaining a contract with a customer typically do not create an asset qualifying for recognition in accordance with other standards. As a result, an entity would recognise such costs as expenses as incurred, which may not be the same period in which revenue is recognised.

Invitation to comment

- S29 This discussion paper invites comments on the preliminary views of the IASB and the FASB on the recognition of revenue in contracts with customers.
- S30 In their joint project on revenue recognition, the boards have considered a number of approaches to recognising and measuring revenue in contracts with customers. This discussion paper describes some of those approaches.
- S31 The boards seek comment on whether the revenue recognition model proposed in this discussion paper would provide clearer guidance for determining when revenue should be recognised. The boards also are seeking comment on whether revenue recognition would be more consistent and comparable for contracts across industries.
- S32 The boards invite comment on all matters addressed in this discussion paper. Respondents need not comment on all issues and are encouraged to comment on additional issues they think the boards should consider. Comments are most helpful if they:
- respond to the questions as stated
 - indicate the specific paragraph or paragraphs to which the comments relate
 - contain a clear rationale
 - describe any alternative the boards should consider.
- S33 Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and consider jointly all comment letters that are received by 19 June 2009.

Questions for respondents

- S34 For ease of reference, the discussion questions in this discussion paper are presented here. Each question is repeated at the end of the chapter to which it relates.

Chapter 2

Question 1

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Chapter 3

Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Chapter 4

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Chapter 5

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- (a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?
- (b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?
- (c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.
- (d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- (a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?
- (b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Chapter 1: Revenue recognition based on changes in assets and liabilities

Introduction

- 1.1 Most revenue transactions—those initiated and completed almost at the same time—pose few problems for revenue recognition. However, not all transactions are that simple. For example, customers might pay at a time different from that when they receive goods or services, and an entity might provide the promised goods and services over many reporting periods. To account for those transactions, accountants have developed a model in which an entity recognises revenue when payment is received or receivable from a customer and the entity ‘earns’ that revenue by providing the goods or services promised to the customer. In other words, entities recognise revenue when payment is realised or realisable and the ‘earnings process’ is substantially complete.¹
- 1.2 As straightforward as that earnings process approach may appear, it sometimes provides users of financial statements with information that is not the most useful for making economic decisions. Moreover, it has created problems for financial statement preparers, auditors, regulators and standard-setters. The next section considers some of the problems in US GAAP and IFRSs.

Problems in US GAAP

Numerous standards that define an earnings process inconsistently

- 1.3 The application of the earnings process approach has led to more than 100 standards on revenue and gain recognition in US GAAP—many of which are industry-specific and some of which can produce conflicting results for economically similar transactions. That is largely because the notion of an earnings process is not precisely defined and people often disagree on how it applies to particular situations.

¹ As described in FASB Concepts Statement No. 5 *Recognition and Measurement in Financial Statements of Business Enterprises* and, to a lesser extent, in the IASB’s *Framework for the Preparation and Presentation of Financial Statements*.

- 1.4 For example, consider a cable television provider. Does its earnings process involve only the provision of a cable signal to the customer over the subscription period? Or is the service of connecting the customer to the cable network an additional earnings process? In accordance with SFAS 51 *Financial Reporting by Cable Television Companies*, an entity accounts for connection services as a separate earnings process and recognises revenue for them when rendered (but only in an amount equal to direct costs).
- 1.5 In contrast, consider a telecommunications provider that requires a customer to pay an upfront, non-refundable 'activation fee' plus regular monthly fees for telephone usage. Does the provider's earnings process involve *only* the provision of access to the telecommunication network during the contract period? Or is the service of connecting the customer's telephone to the network a separate earnings process? That service is similar to the connection services provided by a cable television provider. However, in accordance with SEC SAB 104 *Revenue Recognition*, a telecommunication provider does not account for that service as a separate earnings process. As a result, a telecommunication provider does not recognise revenue for non-refundable activation fees when the activation services are rendered (not even in an amount equal to direct costs).
- 1.6 Many more examples like this exist in US GAAP. The fact that entities apply the earnings process approach differently to economically similar transactions calls into question the usefulness of that approach. Moreover, the existence of different requirements for economically similar transactions reduces the comparability of revenue across entities and industries.

Gaps in guidance and conflicts with asset and liability definitions

- 1.7 Despite the numerous standards in US GAAP, gaps in guidance still exist. For example, there is no general standard on recognising revenue for services. Moreover, as evidenced by topics recently on the agenda of the FASB's Emerging Issues Task Force (EITF), revenue recognition questions continue to arise. That continuing need for guidance suggests that more robust revenue recognition guidance is needed in US GAAP.
- 1.8 Guidance also is needed because the earnings process approach sometimes leads to a misrepresentation of an entity's contractual rights and obligations in financial statements. In other words, an earnings process approach accounts for revenue with little consideration of how assets and liabilities arise and change over the life of a contract. Assets

and liabilities are the cornerstone elements in the FASB's and IASB's conceptual frameworks—indeed, the definition of revenue depends on changes in assets and liabilities. Therefore, some think that the earnings process approach could be improved by focusing on changes in specified assets or liabilities.

Problems in IFRSs

- 1.9 IFRSs have fewer standards on revenue recognition than US GAAP. However, those standards also need improvement.

Inconsistency with asset and liability definitions

- 1.10 Similarly to US GAAP, some criticise revenue recognition standards in IFRSs because an entity applying those standards might recognise amounts in the financial statements that do not faithfully represent economic phenomena. That can happen because revenue recognition for the sale of a good depends largely on when the risks and rewards of ownership of the good are transferred to a customer. Therefore, an entity might recognise a good as inventory (because a preponderance of risks and rewards may not have passed yet to the customer) even after the customer has obtained control over the good. That outcome is inconsistent with the IASB's definition of an asset, which depends on control of the good, not the risks and rewards of owning the good.
- 1.11 The risks and rewards notion in IAS 18 can also cause problems when a transaction involves both a good and services related to that good. To determine when the risks and rewards of ownership of the good are transferred, an entity often considers the transaction as a whole. That can result in an entity recognising all of the revenue on delivery of a good, even though it has remaining contractual obligations for the services related to the good (eg a warranty). As a result, revenue does not represent the pattern of the transfer to the customer of *all* of the goods and services in the contract. In addition, depending on how the accruals for the services are measured, an entity might recognise all of the *profit* in the contract before the entity has fulfilled all of its obligations.

Lack of guidance

- 1.12 Another deficiency in IFRSs relates to the lack of guidance for transactions involving the delivery of more than one good or service (ie a multiple-element arrangement). For example, consider the guidance for multiple-element arrangements in IAS 18:

... in certain circumstances, it is necessary to apply the [revenue] recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. [paragraph 13]

Although there are a few more sentences on the topic, IAS 18 does not state clearly when or how an entity should separate a single transaction into components (or units of account). Some interpret paragraphs 17 and 19 of IAS 18 as permitting the recognition of all the revenue for a multiple-element arrangement upon delivery of the first element if all the elements are sold together. Others, however, interpret the same paragraphs to require deferral of revenue for all the elements until delivery of the final element.

- 1.13 IFRSs also lack guidance on how to measure the elements in a multiple-element arrangement. Without a specified measurement objective for the remaining elements in such an arrangement, entities apply different measurement approaches to similar transactions, which reduces the comparability of revenue across entities.
- 1.14 Distinguishing between goods and services is another problem in IFRSs. The International Financial Reporting Interpretations Committee (IFRIC) recently dealt with this question in IFRIC 15 *Agreements for the Construction of Real Estate*. Without a clear distinction between goods and services, some entities were accounting for real estate contracts as construction (service) contracts, recognising revenue throughout the construction process. Other entities were accounting for similar contracts as contracts for goods, recognising revenue when the risks and rewards of owning the real estate were transferred to the customer. The lack of a clear distinction between goods and services reduced the comparability of revenue across entities.

Inconsistency between IAS 11 and IAS 18

- 1.15 Gaps in guidance would not be as problematic if there was a clear principle to apply to ever-changing and increasingly complex transactions. However, the principles of IAS 11 and IAS 18 are inconsistent.
- 1.16 For instance, the principle of IAS 11 (which applies only to construction contracts that meet specified requirements) appears to be that an entity should recognise revenue as the *activities* required to complete a contract take place (even if the customer does not control and have the risks and rewards of ownership of the item being constructed). In contrast, the

principle of IAS 18 for the sale of goods is that revenue should be recognised only when an entity *transfers* control and the risks and rewards of ownership of the goods to the customer.

A focus on assets and liabilities

1.17 To address the problems in US GAAP and IFRSs, the boards propose to develop a single revenue recognition model using a recognition principle that can be applied consistently to various transactions.

1.18 In developing this principle, the boards considered the following existing definitions of revenue in both US GAAP and IFRSs:

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
[FASB Concepts Statement No. 6 *Elements of Financial Statements*, paragraph 78]

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. [IAS 18, paragraph 7]

1.19 In both definitions, revenue is an increase in assets, a decrease in liabilities or some combination of the two.² Using those definitions, the boards propose to focus the recognition principle on changes in assets and liabilities. By focusing on changes in assets and liabilities, the boards do not intend to abandon the earnings process approach. On the contrary, the boards think that focusing on changes in assets and liabilities will bring discipline to the earnings process approach so that entities can recognise revenue more consistently. In other words, the boards think there will be more agreement on whether an asset has increased or a liability has decreased than there is currently on what an earnings process is and whether it is complete. This does not mean that judgements will be easy; however, a focus on assets and liabilities provides a clearer objective for making those judgements.

1.20 A focus on changes in assets and liabilities should not fundamentally change current practice for most transactions. But it should provide a set of principles that could simplify US GAAP and provide the guidance lacking in IFRSs. Moreover, that set of principles should assist in

² The definition of revenue in IAS 18 does not use the terms 'assets' and 'liabilities', but does depend on their net, which is equity.

addressing future revenue recognition questions and therefore should benefit preparers, auditors, regulators and standard-setters. In turn, users of financial statements should benefit because economically similar transactions would be reported similarly.

Summary

- 1.21 The boards propose using their existing definitions of revenue as the basis for developing a revenue recognition model. Those definitions lead to revenue being recognised from changes in an entity's assets or liabilities.
- 1.22 The next chapter considers on which assets or liabilities a revenue recognition model should focus.

Chapter 2: A contract-based revenue recognition principle

Introduction

- 2.1 Because revenue recognition depends on increases in assets and decreases in liabilities, a revenue recognition model needs to specify the relevant assets or liabilities. This chapter considers that issue and its consequences for revenue recognition.

Which asset or liability?

- 2.2 The existing definitions of revenue (paragraph 1.18) suggest that revenue arises from changes in the assets and liabilities that arise in connection with the provision of goods or services that constitute an entity's 'ordinary' or 'ongoing major or central' activities. Many assets and liabilities can arise in connection with those activities.

- 2.3 Consider the following example:

A manufacturing entity enters into a contract with a customer in which the entity promises to deliver a product in three months. The entity manufactures its own products, usually over a three-month period. The customer pays for the product in advance.

- 2.4 In this example, many assets and liabilities arise and change in connection with making and delivering the product. Perhaps the most obvious of those is the cash received from the customer. An increase in that asset (when the customer pays) would lead to revenue recognition in a model that focuses solely on cash. That model would ignore whether the entity transfers the product to the customer because the model's focus would be on one asset—cash.
- 2.5 Another asset in this example is the product that the entity manufactures. An increase in that asset (as the entity acquires materials and applies labour to those materials throughout the manufacturing process) would lead to revenue recognition in a model that focuses on the product being manufactured, ie the inventory. That model would ignore whether any other asset (such as cash) has increased. Revenue would be recognised on the basis of the enhancement in the value of the product being manufactured.

- 2.6 In this example, the entity also has a liability because the contract obliges the entity to deliver the product in three months. A decrease in that liability (when the entity delivers the product to the customer) would lead to revenue recognition in a model that focuses on the settlement of such liabilities. That model would ignore whether assets (such as cash or the product being manufactured) have increased. Revenue would be recognised only when liabilities to the customer are settled.
- 2.7 A revenue recognition model could focus on changes in any of the assets and liabilities identified in this example. In fact, it can be argued that the different revenue recognition models used in existing standards arise from implicitly focusing on different assets or liabilities depending on the circumstances. However, if the boards were to select more than one asset or liability, then they would need to specify which asset or liability should determine revenue recognition in particular cases. That could result in entities accounting for similar transactions differently.
- 2.8 Therefore, the boards propose that a revenue recognition model should focus on a single asset or liability—an entity's contract with a customer. The boards propose that focus for two reasons. First, contracts to provide goods and services are important economic phenomena and are the lifeblood of most entities—any entity providing goods or services to customers enters into contracts, either explicitly or implicitly, with customers.
- 2.9 Secondly, most revenue recognition standards in IFRSs and US GAAP focus on contracts with customers. For instance, SEC SAB 104 *Revenue Recognition* requires persuasive evidence of an arrangement. Similarly, most transactions within the scope of IAS 18 envisage a customer, and any transaction with a customer explicitly or implicitly involves a contract. Because the boards' objective is to develop a model that can replace most of the existing standards, that model needs to be at least as broad in scope as those standards.
- 2.10 By focusing on the contract, the boards do not intend to preclude the possibility of an entity recognising revenue, in accordance with other standards, from increases in the value of a good being produced. Indeed, the boards acknowledge that some entities (eg some in the agricultural industry) might argue that they should recognise revenue before the existence of a contract with a customer because obtaining a contract may

be trivial if buyers are readily available in active markets.³ For the proposed revenue recognition model, however, the boards propose to focus on the changes in a contract with a customer. In other words, the contract with the customer is the economic phenomenon for which an entity should account to determine revenue recognition.

What do the boards mean by a contract?

- 2.11 If the contract with the customer is the asset or liability that determines revenue recognition, it is important to define a contract. For their revenue recognition model, the boards propose the following definition of a contract:

A contract is an agreement between two or more parties that creates enforceable obligations.

- 2.12 This definition is consistent with the IASB's definition of a contract in IAS 32 *Financial Instruments: Presentation*:

... 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 by law. Contracts ... may take a variety of forms and need not be in writing. [paragraph 13]

- 2.13 The boards' proposed definition is also consistent with the following definition commonly used in the US:

An agreement between two or more parties creating obligations that are enforceable or otherwise recognizable at law.
[*Black's Law Dictionary*, 8th edition, page 341]

- 2.14 The proposed definition emphasises that a contract exists when an agreement between two or more parties creates enforceable obligations between those parties. Such an agreement does not need to be in writing to be considered a contract.

3 Although the notion of recognising revenue without a contract may be unfamiliar, it is contemplated by FASB Concepts Statements No. 5 *Recognition and Measurement in Financial Statements of Business Enterprises* and No. 6 *Elements of Financial Statements*. Concepts Statement No. 5 states 'If products or other assets are readily realizable because they are salable at reliably determinable prices without significant effort (for example, certain agricultural products, precious metals, and marketable securities), revenues and some gains or losses may be recognized at completion of production or when prices of the assets change' (paragraph 84(e)).

- 2.15 The simplest example of a contract is a cash sale. Consider a shopkeeper selling a product to a customer. In that situation, the shopkeeper and the customer typically agree to terms with no written expression. The implicit terms of the contract are simply, 'You (the customer) pay me (the shopkeeper) the stated price and I give you the product.' In that setting, a contract is created when the customer presents the product at the checkout and pays the shopkeeper (although such a simple transaction would rarely be thought of as a contract). At that time the shopkeeper is obliged to deliver the product or return the customer's money and those obligations would be enforceable.
- 2.16 Another example of a contract is a retail sale of a good with a right of return. In that situation, a customer pays for and accepts title to the good before leaving the store, but the customer has a right to return the good within a specified time for a full refund. The agreement between the retailer and the customer is a contract because the agreement creates obligations that are enforceable at law. On entering into the contract, the retailer promises to transfer a good to the customer and permit the customer to return the good for a refund. Because of the retailer's promises, the customer can require delivery of the good. The customer also can require the retailer to accept the good (if returned) and refund the consideration. The customer's right to return the good is a term of the contract and does not mean that a contract does not exist.
- 2.17 A contract is an *agreement* between an entity and another party (or parties). In other words, both the entity and the other party have agreed to the terms of the arrangement. When an entity makes a firm offer, that offer—although binding against the entity in many jurisdictions—is not an agreement between the entity and another party because that other party has not accepted the terms of the offer. Once the other party has accepted the offer, a contract exists if it results in enforceable obligations.
- 2.18 In summary, whether the agreed-upon terms are written, oral, or evidenced otherwise, if that agreement creates obligations that are enforceable against the parties, it is a contract.

What do the boards mean by a customer?

- 2.19 Entities enter into various contracts in the course of their business and financing activities. Potential parties to those contracts include the entity's customers, suppliers, owners and other capital providers. As paragraph 2.8 states, the boards propose that a revenue recognition model should focus on an entity's contracts with its customers.
- 2.20 That distinction helps to distinguish an entity's *revenue* contracts from other contracts into which the entity may enter. A revenue contract should give rise to revenue consistently with the boards' existing definitions of revenue (paragraph 1.18). Those definitions state that revenue arises 'in the course of the ordinary activities of an entity' or from 'the entity's ongoing major or central operations'.
- 2.21 Therefore, the boards propose the following definition of a customer:
- A customer is a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities.
- 2.22 The reference to 'ordinary activities' is derived from the IASB's definition of revenue. That notion of an entity's ordinary activities is consistent with the notion of an entity's 'ongoing major or central operations' in the FASB's definition of revenue.

How does a contract give rise to an asset or a liability?

- 2.23 A contract with a customer conveys rights to an entity to receive consideration from the customer and imposes obligations on the entity to transfer assets (in the form of goods and services) to the customer. The combination of the rights and obligations (ie the net rights and obligations) gives rise to a single asset or liability, depending on the relationship between the entity's rights and obligations. A contract is an asset if the measurement of the remaining rights exceeds the measurement of the remaining obligations. Similarly, a contract is a liability if the measurement of the remaining obligations exceeds the measurement of the remaining rights. That contract asset or contract liability reflects the entity's net position in the contract with respect to its remaining rights and obligations.⁴

⁴ A contract also conveys rights to and imposes obligations on a customer, the combination of which can be an asset or a liability to the customer. However, accounting for the customer's net position in a contract is outside the scope of this project and is not discussed in this discussion paper.

- 2.24 The notion of a net position in a contract is not unusual. For example, in a forward contract for the transfer of a financial asset, two parties agree to exchange a fixed amount of consideration for a financial asset at a future date. The parties to the contract then recognise their respective net contract positions in the financial statements, reflecting the relationship between the promised consideration and the current price of the financial asset. If the measurement of the promised consideration exceeds the current price of the financial asset, then (a) the party that promised the consideration has a liability because the settling of the contract would result in a net outflow of assets, and (b) the party that promised the financial asset has an asset because the settling of the contract would result in a net inflow of assets.
- 2.25 In a similar way, a contract between an entity and a customer would be recognised as an asset or a liability depending on the relationship between the remaining rights and obligations in the contract. Consider again the example in paragraph 2.3, in which a manufacturing entity contracts to deliver a product in three months and the customer pays in advance. Immediately after the customer pays, the manufacturing entity has no remaining rights in the contract. Instead, all that is left is an unfulfilled obligation. As a result, the entity's net position in the contract is a liability. At that time, the entity would recognise cash and a contract liability in its statement of financial position. Recognising a liability when the customer pays before the delivery of goods and services is similar to present practice, although present practice might present that liability as 'deferred revenue'.
- 2.26 Now consider the same example immediately before the customer pays. At that time, the manufacturing entity has an obligation to deliver the machine in three months and has a right to the customer's payment for it. If the measurement of the right to payment exceeds the measurement of the obligation to deliver the machine, the entity's net position in the contract would be an asset. In contrast, if the measurement of the obligation to deliver the machine exceeds the measurement of the right to payment, the entity's net position in the contract would be a liability. If the measurement of the rights is equal to the measurement of the obligations, the entity would recognise a net contract position at nil. In other words, the entity would, in effect, not recognise the contract.
- 2.27 An entity's contract with a customer reflects only the rights and obligations that arise from that contract. It does not reflect future cash flows from potential contracts the customer might enter into because the entity and the customer have formed a potentially lasting relationship. The focus is on the rights and obligations in that particular contract, and

the unit of account is the entity's net position from the remaining rights and obligations in that contract only (or a group of contracts, if they are deemed to be related—a matter not discussed in this discussion paper).

- 2.28 In summary, when an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract. (Chapter 5 discusses measurement.)

How does a contract asset or a contract liability give rise to revenue?

- 2.29 An entity's net position in a contract can change for various reasons, for instance because of the entity's performance, the performance of the customer, or changes in other economic circumstances. This section considers the changes arising from the customer's and the entity's performance.
- 2.30 As noted above, when a customer performs by paying, the entity's net position in the contract decreases because the entity no longer has remaining rights to that payment in the contract. An entity's contract asset would decrease or its contract liability would increase. (The decrease in the asset or increase in the liability would correspond to an increase in cash.) However, according to the definitions of revenue in paragraph 1.18, neither a decrease in a contract asset nor an increase in a contract liability would lead to revenue recognition. Thus, performance by the customer does not lead to revenue recognition for the entity.
- 2.31 An entity's net position in a contract also changes when the entity provides a promised good or service. Once the entity provides the good or service, the entity no longer has the obligation to provide that good or service. As a result, its net position in the contract increases. For example, if an entity has a contract liability because it has remaining obligations to deliver goods or services (but has no remaining rights), then that contract liability would decrease when the entity provides a promised good or service. If an entity has a contract asset from the combination of its remaining rights and obligations, then that contract asset would increase when the entity provides a promised good or service. The reason for that increase is that the entity's rights remain unchanged but its obligations have reduced. In contrast to performance

by the customer, those changes from the entity's performance would lead to revenue recognition according to the definitions of revenue in paragraph 1.18, because the entity's contract asset would increase or its contract liability would decrease.

- 2.32 The following table summarises the effects of a customer's and an entity's performance on the entity's net contract position. The table also shows how a customer's and an entity's performance affect the entity's net contract position if that position is a contract asset or a contract liability.

	Net contract position	Contract asset	Contract liability
Customer pays (reduces remaining rights)	Decreases	Decreases	Increases
Entity provides goods and services (reduces remaining obligations)	Increases	Increases (entity recognises revenue)	Decreases (entity recognises revenue)

- 2.33 In a contract-based revenue recognition model, there are essentially two changes in a contract position that could lead to revenue recognition. The first is the point at which an entity enters into a contract with a customer.⁵ For an entity to recognise revenue at contract inception, the measurement of the entity's rights must exceed the measurement of the entity's obligations. That would lead to revenue recognition because of an increase in a contract asset. However, as Chapter 5 discusses, the boards' preliminary view on measurement of performance obligations would preclude the recognition of a contract asset and revenue at contract inception.
- 2.34 The second point at which an entity could recognise revenue is when the entity satisfies an obligation in the contract. As described above, that would lead to revenue recognition because satisfying an obligation in the contract leads to either an increase in a contract asset or a decrease in a contract liability.

⁵ For brevity, this discussion paper refers to the point at which an entity enters into a contract with a customer (before either party to the contract has performed) as 'contract inception'.

Contract-based revenue recognition principle

- 2.35 This chapter explains the boards' proposed focus on an entity's contract with a customer for a revenue recognition model. When combined with the boards' existing definitions of revenue (paragraph 1.18), that focus results in the following revenue recognition principle:

For a contract with a customer, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two).

- 2.36 That principle suggests that an entity would recognise all increases in the net contract position as revenue. However, in the boards' proposed model, not all of those changes would be recognised as revenue. For example, Chapter 5 considers how an entity might recognise an increase in a net contract position from a remeasurement as a contract gain, rather than as revenue.

Summary

- 2.37 The boards propose that revenue should be recognised on the basis of increases in an entity's net position in a contract with a customer.
- 2.38 A contract is an agreement between two or more parties that creates enforceable obligations. Such an agreement does not need to be in writing to be considered a contract. A customer is a party that has contracted with an entity to obtain an asset (such as a good or a service) that represents an output of the entity's ordinary activities.
- 2.39 When an entity becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset, a contract liability or a net nil position depends on the measurement of the remaining rights and obligations in the contract.
- 2.40 In the proposed model, revenue is recognised when a contract asset increases or a contract liability decreases (or some combination of the two). That occurs when an entity performs by satisfying an obligation in the contract.
- 2.41 Because of the importance for revenue recognition of determining when an entity satisfies an obligation in a contract with a customer, the next two chapters consider those obligations in more detail.

Questions for respondents

Question 1

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Chapter 3: Performance obligations

Introduction

- 3.1 As Chapter 2 discusses, an entity's contract with a customer obliges the entity to provide goods or services in exchange for payment from the customer. To distinguish those obligations from other obligations, the boards describe them as 'performance obligations'. Performance obligations are generally similar to the notions of 'deliverables', 'components' or 'elements' of a contract in existing standards. This chapter discusses performance obligations and how an entity would identify them in a contract.

Definition of a performance obligation

- 3.2 Although the notion of a performance obligation is implicit in many existing standards, there is no precise definition of a performance obligation. Hence, the boards propose the following definition:

An entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer.

- 3.3 The previous chapter discusses what the boards mean by a contract with a customer. The following sections discuss the other components of the proposed definition.

Promise in a contract

- 3.4 The promise underpinning a performance obligation usually is stated in the contract. For example, a contract to deliver a good typically details the specifications of the good. Similarly, a contract to provide payroll services typically includes details such as how often the payroll will be processed and the number of transactions to be processed in a specified period. Such explicit promises within a contract are easily identified.
- 3.5 The promise underpinning a performance obligation may also arise from the operation of law. For example, when a manufacturer sells a product, local law may require the manufacturer to warrant the product for a period of time. Even if the warranty is not stated in the contract, the manufacturer is obliged to provide warranty coverage as a result of the contract. In that way, the warranty obligation imposed by statutory requirement is a promise in a contract with a customer.

- 3.6 In addition, sometimes an entity establishes a practice of providing particular goods or services, such as a warranty service. Even if neither the contract nor the law explicitly requires such a service, the entity by its customary business practice may have implicitly or constructively created an obligation that would be enforceable.
- 3.7 Therefore, whether by explicit or implicit terms, any enforceable promise that obliges an entity to transfer an asset to a customer as a result of entering into a contract is a performance obligation of the entity.

Asset (such as a good or a service)

- 3.8 A performance obligation represents an entity's promise to transfer an asset to the customer. The boards define an asset as follows:

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [IASB's *Framework for the Preparation and Presentation of Financial Statements*, paragraph 49(a)]

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [FASB Concepts Statement No. 6 *Elements of Financial Statements*, paragraph 25, footnote reference omitted]

- 3.9 In contracts with customers, assets typically are thought of as goods and services.

Goods

- 3.10 A good is an asset of an entity because it is a resource that can be controlled as a result of past events and from which future economic benefits can be expected to flow. Because a good is an asset, a promise in a contract with a customer to transfer a good to the customer gives rise to a performance obligation.
- 3.11 Assessing whether a good could be sold separately in a contract with a customer is a useful way of identifying a performance obligation. However, assessing whether a good could be sold separately often identifies more goods than those explicitly promised in the contract. For example, a contract in which an entity promises to paint a customer's house may make no mention of the primer and the other materials that will be used in painting the house. In fact, painting contracts are often thought of in terms of the painting services only, and the paint and the other materials are considered merely an input into that service. However, the paint and the other materials are all goods that could be

sold separately and must be transferred to the customer to satisfy the promises in the contract. As a result, the paint, the primer and the other materials are promised goods in the contract and, thus, the implicit promises to provide them are performance obligations. Whether and when performance obligations are accounted for separately is discussed in paragraphs 3.21–3.25.

- 3.12 This example highlights that a good does not have to be promised explicitly in a contract to give rise to a performance obligation. If an entity must transfer a good to the customer to fulfil a contractual promise, then promising that good gives rise to a performance obligation.

Services

- 3.13 A service also can be an asset promised by an entity in a contract with a customer. Although a service typically is not thought of as an asset, the boards have explained that concept in existing literature:

Although services to be received in the future might not meet the definition of an asset, services are assets when received. These assets are usually consumed immediately. [IFRS 2 *Share-based Payment*, paragraph BC47, footnote reference omitted]

Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. [FASB Concepts Statement No. 6, paragraph 31]

- 3.14 Those extracts suggest that when an entity provides a service to a customer, the customer receives an asset. For example, if a customer receives legal services, in concept the customer's accounting entry would be as follows:

Dr Legal services received (asset)
Cr Cash/accounts payable

- 3.15 In this example, the customer immediately consumes the asset. In concept, the accounting entry to reflect that consumption of the asset would be as follows:

Dr Expense
Cr Legal services received (asset)

- 3.16 However, in practice, the customer would combine the two events of the receipt and the consumption of the asset, and would simply recognise the legal services as an expense on receipt. In other cases, as with some construction services, the services received are capitalised as part of a recognised asset because the services enhance an asset that the customer already controls.
- 3.17 In summary, because both goods and services are assets, a promise in a contract with a customer to provide a good or a service is a performance obligation. Chapter 4 further considers the distinction between a promise to provide a good and a promise to provide a service.

Transferring an asset

- 3.18 A performance obligation exists when an entity promises in a contract to *transfer* an asset (a good or a service) to the customer. Therefore, the entity fulfils that promise—satisfies the performance obligation—only when it has transferred the promised asset to the customer. Said differently, an entity satisfies a performance obligation when the customer has the promised asset and the entity no longer has it.
- 3.19 In both the IASB's and the FASB's asset definitions (paragraph 3.8), 'control' determines whether the customer has the promised asset. However, with the FASB's definition of an asset, whether the customer has the promised asset depends on whether the customer controls or obtains the 'future economic benefits'. In contrast, with the IASB's definition of an asset, whether the customer has the promised asset depends on whether the customer controls the 'resource' underlying the asset.
- 3.20 The boards propose that the customer has the promised asset when it controls the resource underlying the promised asset. That view of control is consistent with the boards' recent discussions on a revised asset definition in their joint conceptual framework project. Chapter 4 further examines the issue of how and when an entity satisfies a performance obligation.

Identifying separate performance obligations

- 3.21 The previous discussion suggests that even a simple contract can comprise many performance obligations. For example, a computer manufacturer sells computers that consist of many parts (eg central processing unit, monitor, keyboard and mouse) that could be sold separately. Moreover, the manufacturer provides the services of

procuring the components that make up those parts (eg motherboard, hard drive and plastic housings) and assembling them according to customer specifications. Because those goods and services are assets, the computer manufacturer's promise to deliver a computer could, in concept, be separated into many performance obligations.

- 3.22 In practice, however, identifying many performance obligations in a contract such as the above example and accounting for them separately would be unnecessarily complex. Furthermore, doing that would not provide more decision-useful information to users than if those obligations were accounted for together.
- 3.23 In the computer example, the computer manufacturer transfers the various goods and services identified in paragraph 3.21 to the customer as a single bundle. Even if the manufacturer were to separate the contract into performance obligations for every promised component and service associated with providing the computer, the entity fulfils those promises at the same time (ie when the customer obtains the computer).⁶ Therefore, there would be no benefit in separating the performance obligations.
- 3.24 Hence, if an entity promises to transfer a bundle of goods and services to the customer at the same time, then the entity can account for those promised assets as a single performance obligation. In other words, an entity needs to separate a contract's promises into separate performance obligations only when the customer receives the promised assets at different times.
- 3.25 The objective of identifying separate performance obligations is to represent faithfully the pattern of the transfer of goods and services to the customer. In assessing whether a performance obligation should be accounted for separately, an entity should consider whether separation is needed to reflect faithfully the changes in the performance obligations over the life of the contract.

Examples of identifying performance obligations

- 3.26 The examples in Appendix A demonstrate how the proposed definition of a performance obligation can help an entity to identify performance obligations. This section considers two examples of frequently

⁶ The computer manufacturer also might promise to provide some services with the computer, eg warranty or support service. Those promises would not be satisfied when the customer obtains the computer.

encountered promises to customers. The boards do not have a preliminary view on whether those promises are performance obligations.

Promotional promises (sales incentives)

3.27 Consider the following:

TuneCo is a manufacturer of music players and is an online music retailer. As part of a seasonal promotion, TuneCo gives each customer a CU40⁷ gift card with the purchase of a music player. The customer can redeem the gift card on TuneCo's Website by downloading music. SongCo, a TuneCo competitor, also manufactures music players and retails music online. As part of a seasonal promotion, SongCo gives each customer a 40 per cent discount on its online music (for purchases up to CU100) with the purchase of a music player.

- 3.28 When a customer purchases a music player from either entity, the customer also receives a discount on a future music download. A TuneCo customer receives a music player and a discount of 100 per cent on up to CU40 of online music. A SongCo customer receives a music player and a 40 per cent discount on up to CU100 of online music.
- 3.29 In both cases, the entity's promise to transfer a music player to the customer is a performance obligation. The music players clearly are promised assets that each entity transfers to the customer in the contract. Determining whether the promised music discounts are performance obligations can be more difficult.
- 3.30 TuneCo promises to transfer discounted music to the customer as part of a bundle of goods and services in the contract.⁸ The option to purchase online music at a discount clearly is an asset because it could be sold separately. Thus, TuneCo's promise in the contract to transfer online music at a discount is a performance obligation.
- 3.31 SongCo also promises to transfer online music at a discount—in this case a 40 per cent discount on music up to CU100—when the customer redeems the discount. Here again, the option to purchase online music at a discount is an asset. Thus, SongCo's promise in a contract to transfer

7 In this discussion paper, monetary amounts are denominated in 'currency units' (CU).

8 Entities often offer discounts on products as part of a marketing strategy. If those discounts are not part of a bundle of goods and services promised in a contract with a customer, then they would not give rise to performance obligations.

online music at a discount is also a performance obligation. However, the measurement of that performance obligation might differ from the measurement of TuneCo's performance obligation because of the potentially different likelihoods of being redeemed (Chapter 5 discusses measurement of performance obligations).

- 3.32 Some think that TuneCo's obligation differs from SongCo's and that SongCo's promise to transfer music at a 40 per cent discount is not a performance obligation. Proponents of that view note that the TuneCo customer is not required to pay additional consideration to obtain the online music. In contrast, the SongCo customer must pay additional consideration to obtain the online music. Moreover, that additional consideration may exceed SongCo's cost of providing the online music to the customer. Some think that those differences suggest that SongCo's promised discount relates only to a *future* contract, and therefore is not a performance obligation in the *existing* contract.
- 3.33 Accounting for a promised discount as a performance obligation means that some revenue would be attributed to the option to obtain online music at a discount. Hence, TuneCo and SongCo would not recognise all of the revenue when the music player is provided to the customer (some is recognised if and when the discount card is redeemed). In contrast, if SongCo does not account for the discount as a performance obligation, then it would recognise all of the revenue when the music player is provided to the customer. If the customer redeems the discount, then whatever amount of consideration the entity receives at that time would be recognised as revenue.

Goods sold with a right of return

- 3.34 Consider the following:

RetailCo is an electronics retailer that requires customers to pay for goods at the time of purchase (when the goods are transferred to the customer). The customer can return any good within 90 days for a full refund as long as it is in good condition.

- 3.35 In this example, RetailCo's promise to transfer a good to a customer is a performance obligation. This section considers whether RetailCo's promise to accept a potential return of that good (and refund the customer's consideration) is a service that gives rise to a performance obligation.

- 3.36 Some think that an entity's promise in a contract with a customer to provide a right of return with the sale of a good is a performance obligation. Proponents of that view note that the entity is obliged to accept returns and refund the customers' consideration, suggesting that the promised right of return is an enforceable term of the contract. Moreover, they think that the right of return is a service (an asset) that is transferred to the customer.
- 3.37 A simple way of determining whether the right of return is a service (an asset) to the customer is to ask whether customers would pay additional consideration for that right. For example, customers often pay additional consideration for a return right option when buying flexible airline or rail tickets and hotel reservations. Moreover, some entities might charge a restocking fee to customers who return goods—effectively selling a return service.
- 3.38 If the promise to provide a return right to the customer is a performance obligation, then RetailCo would not recognise all of the revenue when the good is transferred to the customer at the point of sale. Some of the revenue would be attributed to the return service. In addition, RetailCo would no longer recognise the transferred good as inventory but, instead, would account for that inventory as having been transferred to the customer.
- 3.39 However, others think an entity's promise to provide a return right to a customer is not a performance obligation. Instead, proponents of that view argue that a return right represents a failed sale. They argue that when customers obtain a good with a right to return that good for a full refund, the customers have not accepted the entity's proposed terms of the sale because they have the ability to unwind the transaction without consequence (ie put themselves in the position they were in before entering into the contract).
- 3.40 If a customer's right to return a good indicates that the customer has not accepted an entity's proposed terms of the sale, then the entity would not recognise any revenue until the return right expires. Only at that time would the entity conclude that the customer has accepted the terms of the contract. Proponents of that view think that a sale has not occurred until expiry of the right of return because the customer is not obliged to keep the asset.
- 3.41 However, proponents of the failed-sale notion note that an entity may have many homogeneous transactions that give the entity the ability to estimate the proportion of the goods that is likely to be returned (ie the proportion of sales that is likely to fail). In those circumstances, an entity

would recognise revenue for the proportion of transactions that the entity expects not to fail, on the basis that the customer has accepted the terms of the contract and has chosen to accept control of the good even though the return right still exists.

- 3.42 A consequence of that view is that an entity would continue to recognise inventory when that inventory has been transferred to the customer. In the above example, the customer controls the good at the point of sale (ie the good is the customer's asset at that time). If RetailCo accounts for all or even a proportion of sales as if they had not occurred, then RetailCo would recognise inventory for goods that are its customers' assets.

Summary

- 3.43 In the boards' preliminary view, an entity's performance obligation is a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. That contractual promise can be explicit or implicit.
- 3.44 When an entity promises to provide a good, it is promising to transfer an asset to the customer. When an entity promises to provide a service, it similarly is promising to transfer an asset, even though the customer may consume that asset immediately.
- 3.45 An entity accounts for performance obligations separately if the promised assets (goods or services) are transferred to the customer at different times. The objective of separating performance obligations is to ensure that an entity's revenue faithfully represents the pattern of the transfer of assets to the customer over the life of the contract.
- 3.46 The next chapter further discusses when assets are transferred to the customer and, hence, when an entity satisfies performance obligations and recognises revenue.

Questions for respondents

Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Chapter 4: Satisfaction of performance obligations

Introduction

- 4.1 This chapter explains when an entity transfers assets to a customer and, hence, when the entity satisfies performance obligations. The satisfaction of a performance obligation increases an entity's net position in a contract. Accordingly, this chapter discusses *when* revenue is recognised.
- 4.2 An entity's performance obligation is satisfied when the entity no longer has that obligation. In some instances, this may occur because the entity settles with the customer, transfers the obligation to another party or otherwise is relieved of the obligation. However, typically, an entity satisfies its performance obligations to a customer by transferring the promised assets to the customer. Therefore, this chapter focuses on the satisfaction of an entity's performance obligations through the transfer of goods and services.
- 4.3 This chapter is organised as follows:
- (a) When are assets transferred to the customer? (paragraphs 4.4–4.19)
 - (b) How do customer acceptance, customer intent and customer payment affect the satisfaction of performance obligations? (paragraphs 4.20–4.37)
 - (c) How does an entity distinguish between goods and services? (paragraphs 4.38–4.48)
 - (d) When is an asset transferred if that asset is subsequently used in satisfying another performance obligation? (paragraphs 4.49–4.58)

When are assets transferred to the customer?

- 4.4 Chapter 3 explains that a performance obligation is an entity's promise in a contract with a customer to transfer an asset to that customer. Hence, the satisfaction of a performance obligation depends on when the promised asset is transferred to the customer. When the customer receives the asset, the entity's obligation to transfer the asset no longer exists and, thus, is satisfied.
- 4.5 In accordance with the boards' existing definitions of an asset (paragraph 3.8), the customer has the promised asset when it controls the resource underlying that promised asset. Accordingly, to determine

when a good is transferred to a customer, an entity assesses whether the customer controls the good so that the good is the *customer's* asset. Typically, the customer controls the good when it takes physical possession of the good.

- 4.6 In some cases, an entity may retain physical possession of a good although the entity no longer controls the good. For example, in some bill and hold arrangements, a customer controls the good even though the entity has physical possession of the good. The entity in such an arrangement cannot use the good to fulfil other contracts and is, in effect, merely providing custodial services to the customer for the customer's asset.
- 4.7 Similarly, to determine when a service is transferred to a customer, an entity assesses whether the customer has received the promised service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognised as an asset (paragraph 3.13).
- 4.8 In essence, an entity satisfies performance obligations, and recognises revenue, when the customer receives the promised goods and services. Consequently, in the proposed model revenue would reflect the *transfer* of promised goods and services to customers, and not the *activities* of the entity in producing those goods and services. Activities that an entity undertakes in fulfilling a contract result in revenue recognition at the time of those activities only if they simultaneously transfer assets to the customer and, hence, satisfy a performance obligation.
- 4.9 Recognising revenue when assets are transferred to a customer is consistent with many existing standards (although the terminology may differ). However, identifying that transfer on the basis of control of an asset may differ from standards that identify the transfer on the basis of the risks and rewards of ownership.

Comparing control with the risks and rewards of ownership

- 4.10 When determining whether an entity has transferred an asset to a customer (ie when determining whether the customer has received a promised good or service), it is important to distinguish between the transfer of control of an asset and the transfer of the risks and rewards of owning an asset. In some cases those notions coincide, but in other cases they do not.

- 4.11 Consider the following example:

ToolCo sells power tools. To encourage customers to make purchases, ToolCo allows them to return the tools within 30 days of purchase and to receive a full refund of the purchase price.

- 4.12 In this example, a customer controls the tool at the point of delivery. In other words, at that time the tool is the customer's asset and ToolCo no longer has enforceable rights to it.
- 4.13 In contrast, the risks and rewards of owning the tool are not entirely transferred to the customer when the tool is delivered. Although the customer bears some risks of owning the tool, such as the risk of loss or theft, ToolCo bears other risks, such as the risk that the tool will be returned, and the risk that the returned tool will have a reduced value to ToolCo.
- 4.14 Now consider a slightly different example:

ToolCo sells power tools. To encourage customers to make purchases, ToolCo allows them to use the tools on a trial basis for 30 days. ToolCo can take possession of a tool at any time during the trial period and is entitled to full payment if the tool is not returned within 30 days.

- 4.15 In this example, ToolCo's risks and rewards are similar to those in the first scenario. In both scenarios, ToolCo delivers the tool to the customer at contract inception, and bears the risk that the customer will return it within 30 days and not pay any consideration.
- 4.16 However, in the first scenario, ToolCo does not control the tool after the point of delivery (the tool is the customer's asset). In the second, the tool is ToolCo's asset until the expiry of the 30-day trial period—until that time, ToolCo has the enforceable right to the tool. It is not the likelihood of return that determines which entity has the asset (indeed, the likelihood of a return may be the same under either scenario). Rather, the decision is based on which entity controls the tool.
- 4.17 The fact that the risks of owning the tool are shared by more than one party in the contract makes the risks and rewards notion difficult to apply when determining whether an asset has transferred from one party to another. Applying that notion requires an entity to judge whether a preponderance (or some other balance) of the risks and rewards of an asset has transferred to the customer. That judgement could vary from

one transaction to another and could result in an entity recognising different assets and liabilities for similar transactions, even though it has identical rights and obligations from those transactions.

- 4.18 Therefore, the boards think that a focus on control results in more consistent decisions about when assets are transferred. Some may think that this focus is too legalistic and that its use may result in information that is not comparable across different countries and legal jurisdictions. However, the boards note that this concern also applies to the notion of risks and rewards. For example, the appendix to IAS 18 relating to sales of goods states the following:

The law in different countries may mean the recognition criteria in this Standard are met at different times. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership.

- 4.19 In addition, in the boards' view, if in one legal jurisdiction an asset has not been transferred to the customer whereas in another legal jurisdiction an asset in a similar contract has been transferred, then those differences are substantive (they are real economic differences between two contracts). Therefore, in those cases the boards think that the two contracts should be accounted for differently in order to provide relevant, comparable information to users of financial statements.

How do customer acceptance, customer intent and customer payment affect the satisfaction of performance obligations?

- 4.20 In determining when a performance obligation is satisfied, an entity must consider the effect, if any, of the customer's acceptance of the promised goods and services, the customer's intended use of those goods and services, and the customer's payment.

Customer acceptance

- 4.21 Some contracts include customer acceptance clauses that are substantive contractual terms that ensure the customer's satisfaction with the goods and services promised in a contract. Without the customer's acceptance, the entity may not be entitled to customer consideration or may be required to take remedial action.

- 4.22 Customer acceptance clauses can affect the assessment of when an asset is transferred to the customer. For example, consider an equipment manufacturer that promises to deliver a specified quantity of equipment of a particular model. If the manufacturer is not entitled to payment until the equipment is accepted by the customer within five days (as evidenced by a written notification of receipt of the specified quantity and model), then is the equipment transferred to the customer upon delivery or only upon receipt of the customer's acceptance?
- 4.23 If the manufacturer can objectively verify that the equipment is delivered in accordance with the agreed-upon specifications in the contract, then the written customer acceptance is a formality that does not affect the transfer of the asset. In other words, if an entity can objectively determine that an asset has been transferred to a customer, then the entity would recognise revenue for the satisfaction of the related performance obligation.
- 4.24 If, however, an entity cannot objectively determine whether an asset has been transferred, then the entity cannot determine that a performance obligation has been satisfied and, therefore, would not recognise revenue. In the above example, suppose that the customer's acceptance is subject to the customer's judgement of whether the equipment is suitable to the customer's site. In that case, the customer's written acceptance probably indicates the point at which the asset is transferred, a performance obligation is satisfied and revenue is recognised.

Customer intent

- 4.25 The customer's intended use of the promised goods and services is another factor that might affect an entity's assessment of when assets are transferred to a customer. However, the customer's intent in and of itself does not determine when a customer has an asset.
- 4.26 In the boards' view, in assessing whether an asset has been transferred, an entity should focus on whether the customer controls the asset, rather than on whether the customer can use that asset as intended. It is difficult, if not impossible, for an entity to know the customer's intent in any given contract. Hence, if the transfer of an asset is based on the customer's intent, then two otherwise similar contracts could result in different patterns of revenue recognition depending on what an entity presumes to be the intentions of each customer (thus impairing the comparability of revenue).

- 4.27 Consider the following example:

EngineeringCo sells a manufacturing process consisting of three pieces of equipment (X, Y and Z). It does not sell equipment X, Y and Z separately. EngineeringCo delivers equipment X and Y on 27 March, at which point the customer controls the equipment. Equipment Z is not delivered until 3 April. Without equipment Z, the customer cannot use equipment X and Y as intended.

- 4.28 Equipment X, Y and Z are separate performance obligations because they are separate assets (evidenced by the fact that they could be sold separately) that EngineeringCo promises to transfer to the customer.
- 4.29 Each performance obligation is satisfied when each piece of equipment is transferred to the customer. At 27 March, the customer controls equipment X and Y. Hence, the performance obligations to transfer equipment X and Y are satisfied, and EngineeringCo recognises revenue even though the customer cannot use the equipment as intended until equipment Z is delivered on 3 April. The performance obligation to transfer equipment Z is satisfied (and revenue recognised) on 3 April when equipment Z is transferred to the customer.
- 4.30 It does not matter that the customer does not intend to (or cannot) use equipment X and Y without equipment Z. The fact that the customer has the promised assets means that the entity no longer has an obligation to transfer those assets. In other words, because equipment X and Y are the customer's assets, EngineeringCo cannot have a remaining obligation to transfer those assets to the customer. Moreover, EngineeringCo would no longer be able to recognise equipment X and Y as assets.
- 4.31 The customer's intended use of the promised goods and services may affect the negotiated contract terms, which, in turn, may indicate when the assets are transferred to the customer. In the above example, the customer might negotiate terms of the contract that result in the customer not obtaining control of any of the equipment until the final piece is transferred. In that case, the customer would be the custodian of EngineeringCo's equipment until the final piece of equipment is delivered. Until that time, EngineeringCo would control the equipment and could use it in whatever way it chooses—even to satisfy another customer's order.

Customer payment

- 4.32 In the boards' proposed model, customer payment does not determine when an entity would recognise revenue. However, in some cases, considering customer payment terms may help the entity to assess whether the customer has an asset.
- 4.33 For instance, consider an entity's contract to build an asset for a customer. Over the life of the contract, the customer is obliged to pay for the partially completed asset and cannot recover that payment, even if the entity fails to build the rest of the asset. In the absence of other indicators, the fact that the entity has a right to a non-refundable payment from the customer may suggest that the customer controls the partially completed asset. Typically, a customer would not make a non-recoverable payment without receiving an asset in exchange.
- 4.34 Considering customer payment terms may be particularly helpful in contracts for services when, in some cases, it can be difficult for an entity to determine whether the customer receives an asset over the life of the contract.
- 4.35 Consider the following example:

ConsultCo contracts with a customer to analyse the customer's business process and to deliver a report recommending process improvements. The report takes three months to produce. ConsultCo requires the customer to make progress payments throughout the contract on the basis of labour hours incurred to date.

- 4.36 In this example, the question is whether ConsultCo transfers an asset to the customer over the life of the contract or only when it delivers the completed report. In other words, is the performance obligation a promise to provide a report (a good) or a promise to provide consulting services?
- 4.37 Suppose that the customer's payments to ConsultCo cannot be recovered even if ConsultCo fails to provide the report. That payment term may suggest that the customer receives an asset (consulting services) over the life of the contract. Conversely, if the customer can recover its payments if ConsultCo does not provide the report, then that payment term may suggest that the customer does not receive an asset until receipt of the final report.

How does an entity distinguish between goods and services?

4.38 Chapter 3 explains how both goods and services are assets. In most contracts, it is straightforward to determine whether an entity promises to transfer a good or a service (or both). In some contracts, however, it can be more difficult, particularly when an entity promises to build an asset for a customer (a construction-type contract). In those cases, considering when assets are transferred to a customer helps to distinguish between the promise to deliver a finished good and the promise to provide a construction service. Typically, a good is an asset that is transferred to a customer at a point in time, whereas a service typically is a continuous transfer of assets to a customer over a period of time.

4.39 To illustrate, consider the following:

SteelCo is a manufacturer of structural steel used in the construction of commercial buildings. SteelCo contracts with a customer to deliver steel girders, which require three months to manufacture. The contract specifies that the girders are SteelCo's asset until delivery.
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4.40 In this example, is SteelCo promising to deliver finished girders (a good) or is it promising to provide the services and materials necessary to produce the girders? That distinction is important because if SteelCo's performance obligation is to deliver a good, then revenue is not recognised until the good is transferred at the end of three months. If, however, SteelCo's performance obligation is to provide manufacturing services, then revenue is recognised throughout the three months as the services and materials are transferred to the customer.

4.41 The pattern of revenue recognition (satisfaction of performance obligations) depends on the pattern of the transfer of assets in the contract. According to the contract terms in this example, the girders are transferred to the customer at the end of the three months. Until that time, the customer does not control the girders (SteelCo retains control of them). SteelCo's activities to manufacture the girders enhance SteelCo's inventory and do not transfer assets to the customer. Hence, SteelCo satisfies the performance obligation (and recognises revenue) on delivery of the girders.

4.42 Now consider the following:

MetalCo is a manufacturer of structural steel used in the construction of commercial buildings. MetalCo contracts with a customer to deliver steel girders, which require three months to manufacture. The girders are of no value (except as scrap metal) to MetalCo or any other customer once the steel is cast because they are customised to the customer's unique specifications. Hence, the customer is required to pay for the work completed to date throughout the contract and has the unconditional right to take over the work in progress at any time.

4.43 Given these different facts, is MetalCo promising to deliver the finished girders (a good) or is it promising to provide the services and materials to produce the girders? The terms of the contract do not specify clearly when the girders are transferred to the customer. However, the level of customisation of the girders, the payment terms and the customer's right to take over the work in progress at any time suggest that control of the girders is transferred to the customer throughout the contract. Those facts in and of themselves do not determine when assets are transferred to a customer. However, they help an entity to assess whether the customer has received the promised assets.

4.44 Hence, in this example, MetalCo promises to provide the services and materials necessary to produce the girders. MetalCo satisfies that performance obligation when the girders are transferred to the customer during the manufacturing process, and when further services and materials enhance the value of the girders. Therefore, revenue is recognised throughout the manufacturing process.

4.45 Consider the following:

HomebuilderCo contracts with a customer to build a house in accordance with the features and designs chosen by the customer.

4.46 In this example, HomebuilderCo must assess whether it is providing construction services or a completed house (a good). As in the SteelCo example, that assessment depends on when the entity transfers assets to the customer. If, for instance, the customer does not receive any goods or services until it takes possession of the completed house, then HomebuilderCo would not satisfy a performance obligation until that time. That would be the case if HomebuilderCo controls the partially constructed house throughout the construction process

(the materials and the construction services enhance *HomebuilderCo's* asset). One indication that *HomebuilderCo* controls the partially constructed house would be if the house is constructed on *HomebuilderCo's* land.

- 4.47 Conversely, if *HomebuilderCo* transfers the materials and services throughout the construction process, then *HomebuilderCo* would satisfy the performance obligation throughout the construction process. That would be the case if the customer controls the partially constructed house throughout the construction process (the materials and the construction services enhance the *customer's* asset). One indication that the customer controls the partially constructed house would be if the house is constructed on the customer's land.
- 4.48 In many contracts (such as the *MetalCo* scenario in paragraph 4.42), it may appear that an entity's promise to transfer customised goods suggests that the contract is for services instead of a good. Customisation of a good is an indicator that the contract may be for services, but customisation in and of itself does not lead to that conclusion. Instead, an entity must consider factors such as the contract terms and the operation of law to determine when the customer receives an asset. The decision of which party controls the asset (ie the work in progress) as it is being constructed indicates whether a promise is for a good or for a service and, consequently, when revenue is recognised from satisfying a performance obligation.⁹

When is an asset transferred if that asset is subsequently used in satisfying another performance obligation?

- 4.49 In many service contracts, an entity promises (whether explicitly or implicitly) to transfer goods to the customer in conjunction with a service. In those contracts, it can be difficult to determine when the goods are transferred to the customer.
- 4.50 Consider the following example:

<p>PainterCo provides painting services for commercial properties. PainterCo contracts with a customer on 25 June to paint the customer's property. The contract price is inclusive of the paint, which is delivered to the customer on 30 June. PainterCo provides the painting services from 1 July to 15 July.</p>

⁹ The IFRIC recently discussed similar issues with respect to real estate sales when developing IFRIC 15 *Agreements for the Construction of Real Estate*.

- 4.51 Although this contract might often be thought of as a contract to provide a painting service only, it requires PainterCo to transfer both goods and services to the customer. (In that regard the example is, in principle, similar to a more complex construction contract in which materials are delivered before they are used in the construction process.)
- 4.52 In this example, the customer receives the painting service as it is provided from 1 July to 15 July (the painting service enhances the customer's assets). Hence, the painting service obligation is satisfied as the walls are painted.
- 4.53 But when is the paint transferred to the customer? Is it transferred when the paint is delivered to the customer on 30 June, or only when it is used in the painting service (ie applied to the customer's walls)? Put simply, whose asset is the paint on 30 June?
- 4.54 If the paint is the customer's asset on 30 June, then the performance obligation to transfer paint to the customer is satisfied and some revenue is recognised. That would be the case if the contract terms specify that title to the paint passes to the customer on delivery. That may also be the case under the operation of law if the customer is obliged to pay for the paint on delivery and cannot return it. Of course, the performance obligation to provide the painting services would not be satisfied on 30 June.
- 4.55 In contrast, the terms of the contract or the operation of law could indicate that the paint is not transferred to the customer at delivery on 30 June. For example, if the contract specifies that the painter retains title to the paint at delivery (and can thus redirect the paint to fulfil other contracts if necessary), then PainterCo controls the paint. In that case, although the customer has physical access to the paint, that access does not give the customer control of the paint. Rather, the customer has temporary custody of PainterCo's paint.
- 4.56 Given the difficulties that may arise in determining when an asset is transferred if that asset is used in satisfying a subsequent performance obligation (as with the paint in the painting example), the boards propose the following rebuttable presumption:
- An asset that is used in satisfying another performance obligation in the contract is not transferred to a customer until the asset is used in satisfying that performance obligation.
- 4.57 That presumption would be rebutted if the terms of a contract, or operation of law, clearly indicate that the asset has been transferred to the customer before it is used in satisfying the other performance obligation.

- 4.58 In the above painting example, on the basis of the facts given, it is unclear whether the customer controls the paint when delivered on 30 June. In the absence of a clear indication to the contrary, the presumption would be that the paint is not transferred to the customer until the paint is used in satisfying the painting service performance obligation (ie when the paint is on the customer's walls). Similarly, that presumption would apply to a good that is used in providing another good and to an entity's activities that precede the delivery of a good.

Summary

- 4.59 An entity satisfies a performance obligation and, hence, recognises revenue when it transfers a promised asset (such as a good or a service) to the customer. The boards propose that an entity has transferred that promised asset when the customer obtains control of it.
- 4.60 In the case of a good, an entity satisfies a performance obligation when the customer obtains control of the good so that the good is the *customer's* asset. Typically, that occurs when the customer takes physical possession of the good.
- 4.61 In the case of a service, an entity similarly satisfies a performance obligation when the service is the customer's asset. That occurs when the customer has received the promised service. In some cases, that service enhances an existing asset of the customer. In other cases, that service is consumed immediately and would not be recognised as an asset.
- 4.62 Consequently, activities that an entity undertakes in fulfilling a contract result in revenue recognition only if they simultaneously transfer assets to the customer. For example, in a contract to construct an asset for a customer, an entity satisfies a performance obligation during construction only if assets are transferred to the customer throughout the construction process. That would be the case if the customer controls the partially constructed asset so that it is the customer's asset as it is being constructed.
- 4.63 The boards' proposed model presumes that an asset that is used by an entity in satisfying another performance obligation in the contract is not transferred to the customer until the asset is used in satisfying that other performance obligation. That presumption would be rebutted if other indications such as the terms of the contract or the operation of law clearly indicate that the asset is transferred to the customer at a different time.

Questions for respondents

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Chapter 5: Measurement of performance obligations

Introduction

- 5.1 Previous chapters explain the asset or liability arising from the combination of rights and obligations in a contract with a customer, ie the contract asset or contract liability. This chapter considers how that contract asset or liability is measured over the life of the contract.
- 5.2 Measurement of a contract is fundamental to the proposed revenue recognition model because measurement affects how the entity depicts its financial position and financial performance in the contract. Therefore, measuring a contract affects more than the top line of the statement of comprehensive income (revenue). It also affects an entity's contractual position recognised in the statement of financial position and can affect other components of the statement of comprehensive income (eg gain or loss).
- 5.3 As Chapter 2 discusses, a contract creates rights and obligations. The rights result from the customer's promise to provide cash (or other consideration) to the entity. The obligations result from the entity's promise to transfer assets to the customer. Therefore, measuring a net contract position requires the measurement of both rights and obligations.
- 5.4 This chapter discusses the boards' preliminary views on measuring an entity's performance obligations, ie the contractual promises that result in *outflows* of assets to a customer. Measuring an entity's performance obligations is generally more difficult than measuring rights. That is because an entity's obligations typically result in an outflow of non-monetary goods and services, whereas its rights often result in *inflows* of fixed monetary amounts.
- 5.5 The boards have not yet expressed a preliminary view on how an entity would measure the rights. However, any measurement of the rights would be based on the amount of the promised consideration (ie the transaction price). It may also need to reflect the time value of money and any uncertainties in the amount and timing of consideration. Because the boards have not yet expressed a preliminary view on the measurement of rights, this discussion paper ignores the time value of money and assumes that the consideration is fixed and paid in cash. By making those assumptions, this discussion paper can focus on the measurement of performance obligations.

- 5.6 This chapter discusses the following aspects of the measurement of performance obligations:
- (a) objective of measuring performance obligations (paragraphs 5.7–5.13)
 - (b) initial measurement of performance obligations (paragraphs 5.14–5.36)
 - (c) subsequent measurement of performance obligations (paragraphs 5.37–5.54)
 - (d) remeasurement of performance obligations (paragraphs 5.55–5.101).

Objective of measuring performance obligations

- 5.7 The objective of measuring performance obligations is to depict decision-useful information about an entity's:
- (a) obligation at each financial statement date arising from its promise to transfer goods and services to a customer
 - (b) contractual performance during the reporting period.

Depicting the entity's obligation

- 5.8 One purpose of measuring a performance obligation is to depict an entity's present obligation arising from its contractual promise to transfer goods and services to a customer. In other words, the measurement is meant to quantify the amount of assets required to satisfy the performance obligations at the financial statement date.
- 5.9 In the boards' view, that amount includes three main components:
- (a) *expected costs*—those costs include the direct costs (such as the raw materials and labour) that would be expected to be incurred in providing the promised goods and services. They also include the indirect costs (such as administrative costs and the use of plant and equipment) that would be expected to be incurred in providing the promised goods and services.
 - (b) *time value of money*—an obligation that will be fulfilled in a year's time is, all other things being equal, less burdensome than an obligation to be fulfilled tomorrow. Therefore, two otherwise identical obligations should not be presented as being the same if they will be fulfilled at different times. Nevertheless, the effects of the time value of money are ignored in this chapter to simplify the discussion.

- (c) *margin*—the measurement of a performance obligation should include a margin because entities price their contracts not only to recover their expected costs of providing goods and services (and the timing of those costs), but also to obtain a return for providing those goods and services.

Depicting the entity's contractual performance

- 5.10 Another purpose of measuring an entity's performance obligations is to depict in the statement of comprehensive income the entity's performance in the contract.
- 5.11 With existing standards, an entity generally recognises and measures performance using criteria such as 'earned and realised' and the contract's 'percentage of completion'. Any residual debits or credits after applying those criteria are recognised in the statement of financial position.
- 5.12 In contrast, in the proposed revenue recognition model, an entity would first measure its contract asset or contract liability and then assess contractual performance from the changes in the measurement of the contract position from one financial statement date to the next. As paragraph 2.36 notes, not all of those changes need to be presented as revenue; some could be presented as contract gains or contract losses.
- 5.13 A revenue recognition model that is founded on measuring contract assets and contract liabilities to determine an entity's contractual performance is not intended to imply that the statement of financial position is more important than the statement of comprehensive income. The objective of measuring performance obligations gives equal importance to both statements. However, in the boards' view, deriving revenue and profit or loss from measurements of the contract asset and the contract liability provides a more consistent and coherent framework to determine an entity's performance than existing revenue recognition models.

Initial measurement of performance obligations

- 5.14 With the objective of measuring performance obligations in mind, the boards considered the following approaches to measuring performance obligations at contract inception:
 - (a) current exit price approach
 - (b) original transaction price approach.

Current exit price approach

- 5.15 One approach for measuring performance obligations is to measure them at a current exit price. That is the amount that the entity would be required to pay to transfer those obligations to an independent third party at the financial statement date. Measuring performance obligations by determining the price to transfer them to another party is not intended to imply that the entity would in fact transfer them. Indeed, in most cases, the entity either would choose not to transfer them or would not be able to do so. Rather, exit price would be used because it provides a clear objective for measuring performance obligations (on the basis of the market's perception of them).
- 5.16 Some support a current exit price approach because they think it would capture only the components of a decision-useful measure of an entity's obligation to transfer goods and services to a customer and would not capture anything else. Paragraph 5.9 notes that those components reflect the expected costs to satisfy a performance obligation, the timing of those costs and the margin required for providing the promised goods and services.
- 5.17 However, the boards rejected a current exit price approach for the following reasons:
- (a) pattern of revenue recognition
 - (b) complexity
 - (c) risk of error.

Pattern of revenue recognition

- 5.18 Measuring performance obligations independently of the transaction price may result in the recognition of a contract asset or contract liability at contract inception, depending on whether the measurement of the rights exceeds that of the obligations or vice versa. In most cases, it would result in the recognition of a contract asset and revenue. That is because the transaction price (which affects the measurement of the *rights* at contract inception) includes components that may not relate to the remaining *performance obligations* that exist once the contract is formed. For example, entities often include in the transaction price amounts to recover their costs and margin associated with obtaining the contract. Accordingly, the measurement of the rights at contract inception typically would be greater than the measurement of the remaining performance obligations—thus leading to the recognition of a contract asset and revenue.

5.19 Consider the following:

Suppose Retailer enters into a contract with a customer on 30 June for the sale of a good for CU150. The customer prepays and the good will be provided to the customer on 10 July.

All things being equal, Retailer would expect to pay less than CU150 at 30 June to transfer its remaining performance obligations to a third party. That is because Retailer incurs costs in obtaining the contract such as the direct and indirect costs of its selling activities (sales commission, staff wages, rent of retail facilities, etc). Retailer implicitly charges the customer for all of those activities. In other words, the customer pays for more than just the good. Therefore, in determining the price to transfer the performance obligations, Retailer would expect a third party not to demand payment for those activities.

The customer and the contract are in place so that the third party needs only to satisfy the remaining performance obligations.

- 5.20 Recognising a contract asset at contract inception would result in the recognition of revenue, or income, at contract inception. However, an entity would not recognise the entire profit from the contract at inception because the exit price of the performance obligations would include the profit margin that a third party would require for providing the remaining goods and services.¹⁰ Nonetheless, the boards are uncomfortable with an approach that allows an entity to recognise revenue before the entity transfers to the customer any of the goods and services that are promised in the contract.

Complexity

- 5.21 A current exit price would rarely be observable for the remaining performance obligations in a contract with a customer. Consequently, measuring performance obligations at a current exit price would typically require the use of estimates. The boards note that estimating the current exit price for the remaining performance obligations at contract inception would be complex and that the resulting measurement might be difficult to verify. The boards think that any improvements to the decision-usefulness of the financial information from using a current exit price generally would not be sufficient to justify the resulting costs.

¹⁰ In addition, any revenue recognised at contract inception would be offset by any expenses that the entity may have recognised at the same time in obtaining the contract.

- 5.22 Also, the boards acknowledge that many think it is counter-intuitive to have a measurement approach based on transferring obligations to a third party when, in most cases, the entity neither intends nor has the ability to transfer them. Many think the measurement approach should reflect that the entity intends to satisfy its performance obligations by providing the goods and services promised in the contract.

Risk of error

- 5.23 As paragraph 5.18 notes, measuring a performance obligation at a current exit price means that a contract asset and revenue could be recognised at contract inception. If an entity fails to identify a performance obligation at contract inception, then that error would result in an entity recognising too much revenue at contract inception. The entity's net contract position would remain misstated until the omitted performance obligation is satisfied. Furthermore, if an entity either understates or overstates the measurement of a performance obligation, that error would be included in profit or loss at contract inception.
- 5.24 Therefore, the boards were concerned with a current exit price approach because it might be difficult for an entity to establish whether revenue (and profit or loss) recognised at contract inception is the result of an error rather than from an increase in the entity's net contract position.

Original transaction price approach

- 5.25 Another approach for measuring performance obligations is to measure them at the original transaction price, ie the consideration the customer promises in exchange for the promised goods and services.¹¹
- 5.26 Typically, the transaction price reflects the amount an entity requires in exchange for taking on the related performance obligations. That amount implicitly includes the entity's expected costs to transfer the promised goods and services to the customer, the timing of those costs and the margin required for providing those assets. Unlike an exit price, the transaction price also includes any amounts that the entity charges its customer to recover the costs of obtaining the contract and any related margin.

¹¹ As noted, the boards have not yet expressed a preliminary view on whether and how to adjust the transaction price (customer consideration amount) for the time value of money and any uncertainties in the amount and timing of consideration.

5.27 In the boards' preliminary view, an entity initially should measure performance obligations at the transaction price for the following reasons:

- (a) pattern of revenue recognition
- (b) simplicity of measurement.

Pattern of revenue recognition

5.28 If at contract inception an entity measures its performance obligations at the transaction price (ie at the same amount as the measurement of the rights), then neither a contract asset nor revenue is recognised at contract inception. Some think this is a useful depiction of an entity's position and performance in the contract because they think that revenue should depict only the satisfaction of obligations in the contract. Proponents of that view think that measuring performance obligations at the transaction price provides a better depiction of an entity's performance in a contract because revenue is recognised only when an entity transfers an asset to the customer under the contract. In other words, they view the transaction price as relating only to the goods and services to be provided under the contract.

5.29 Others think that an asset is likely to exist at contract inception and, therefore, revenue could arise (in principle) in the boards' proposed revenue recognition model. However, some of them are not comfortable recognising that contract asset and revenue at contract inception because of the complexity and risk of error associated with a current exit price approach.

5.30 Consequently, with the transaction price approach, the statement of comprehensive income does not reflect an entity's performance in the contract until the entity transfers goods and services to the customer. Some think this is an appropriate depiction of the entity's performance in the contract at inception because neither party has performed yet in accordance with that contract.

5.31 Although no revenue is recognised at contract inception, to the extent that an entity incurs any costs in obtaining a contract, those costs are recognised as an expense unless they result in an asset that qualifies for recognition in accordance with other standards. If those costs are recognised as an expense at contract inception, then the entity would recognise a loss at contract inception. However, those costs may have been recognised as an expense in reporting periods before contract inception.

Simplicity of measurement

- 5.32 Typically, at contract inception, the transaction price is observable. The boards' view is that using that price avoids the cost and complexity of an entity searching for another price or estimating one if it is not observable.
- 5.33 Additionally, using the original transaction price reduces the risk of recognising revenue at contract inception as a result of either omitting a performance obligation or understating or overstating the measurement at that time.

Concerns with a transaction price approach at contract inception

- 5.34 The boards acknowledge that using the transaction price can sometimes misrepresent the entity's obligation to transfer goods and services to a customer.
- 5.35 As paragraph 5.18 notes, a transaction price typically includes more than just the amount to satisfy a performance obligation. It might include an amount to recover the costs and margin associated with obtaining the contract. For that reason, some think the transaction price typically overstates an entity's performance obligations at contract inception. However, they think this disadvantage is preferable to the disadvantages of the current exit price approach (as discussed in paragraphs 5.18-5.24).
- 5.36 In addition, using the original transaction price approach to measure performance obligations can understate an entity's performance obligations. For example, that would be the case in a contract in which the entity's expected costs to satisfy the performance obligations exceed the transaction price. In those cases, the boards propose that the measurement of the performance obligation should be increased to an amount greater than the transaction price with the corresponding entry recognised as a contract loss (see discussion of onerous performance obligations starting at paragraph 5.58).

Subsequent measurement of performance obligations

- 5.37 After contract inception, an entity's performance obligations change for various reasons. The most obvious reason is the entity's transfer of goods and services to the customer. Performance obligations also may be affected by changes in the quantities or prices of the goods and services

required to satisfy those performance obligations. Therefore, the initial measurement of the performance obligations in a contract must be updated if it is to continue to provide a useful depiction of the entity's obligations to provide goods and services in accordance with the contract.

- 5.38 To capture all of those changes affecting an entity's performance obligations, the entity would need to measure them at each financial statement date using the same basis as for their initial measurement. The measurement would then provide users with a consistent depiction of those performance obligations over the life of the contract.
- 5.39 However, the boards think that an approach that explicitly measures performance obligations at each financial statement date is unnecessarily complex for most contracts with customers. In most contracts with customers, the most significant change in an entity's performance obligations arises from the transfer of goods and services to the customer to satisfy those obligations. Changes for other reasons (eg changes in the price or quantity of goods and services yet to be transferred to the customer) are not significant in most contracts with customers. That is either because the values of the goods and services promised in those contracts are not inherently volatile or because those contracts are of short duration, which itself minimises the risk of volatility.
- 5.40 Therefore, the boards propose that the subsequent measurement of performance obligations should capture at least those changes that arise when the entity satisfies a performance obligation by transferring goods and services to the customer.
- 5.41 If an entity transfers all the promised goods and services to the customer at one time, then subsequent measurement of the performance obligations is straightforward. The obligations are measured at the transaction price if the entity has not yet satisfied the performance obligations, or they are measured at nil if the entity has satisfied them. As a result, in the period in which the performance obligations are satisfied, revenue is recognised equal to the initial measurement of the performance obligation (the transaction price).
- 5.42 However, if an entity transfers the promised goods and services to a customer at different times, then the entity needs to find a way to measure the remaining performance obligations at the end of any reporting period during the life of the contract. In other words, the entity must find a way to depict its performance in each reporting period over the life of the contract.

- 5.43 The boards propose that an entity's performance should be depicted by allocating part of the original transaction price to each performance obligation at contract inception. As each performance obligation is satisfied, the entity's net contract position increases and revenue is recognised in the amount allocated to the satisfied performance obligation at contract inception. Hence, over the life of the contract, the total amount of revenue that the entity recognises from that contract is equal to the transaction price.
- 5.44 Therefore, the allocation of part of the transaction price to each performance obligation determines the measurement of the remaining performance obligations at each financial statement date and the amount of revenue that an entity recognises as each performance obligation is satisfied. The following section discusses the allocation process.

Allocating the transaction price to separate performance obligations

- 5.45 An entity could allocate the transaction price to identified performance obligations on various bases. For example, the transaction price could be allocated on the basis of the current exit price of the promised goods and services, the entity's expected cost (at contract inception) of the promised goods and services, or the selling price of the promised goods and services.
- 5.46 The boards' preliminary view is that the transaction price should be allocated to each performance obligation in proportion to the stand-alone selling price of the promised good or service underlying that performance obligation. The stand-alone selling price of the promised good or service is the price at which the entity would sell that good or service if it was sold separately at contract inception (ie not as part of a bundle of goods and services). The best evidence of that price is the stand-alone selling price of a good or service when the entity actually sells that good or service separately. However, in some cases, neither the entity nor any other entity sells the good or service separately and stand-alone selling prices are not observable. In those cases, the entity would estimate them.

Estimating stand-alone selling prices

- 5.47 The boards acknowledge that estimating a stand-alone selling price for a promised good or service can be difficult. Nevertheless, if an entity was not required to estimate a price, then the entity would have to account

for that performance obligation together with other performance obligations. That could result in an entity accounting for a satisfied performance obligation as if it was unsatisfied (in other words, accounting for a delivered good or service as if it was undelivered). Failing to account for the satisfaction of a performance obligation would impair the depiction of an entity's financial position and performance in a contract with a customer. Consequently, the boards propose that estimated prices should be used when observable prices are not available.

5.48 An entity can use various methods to estimate a stand-alone selling price of a promised good or service. The boards do not intend to preclude or prescribe any particular method as long as it is consistent with the stand-alone selling price basis described above. Observable inputs should be maximised regardless of the estimation method. Suitable estimation methods include (but are not limited to):

- (a) *expected cost plus a margin approach*—an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity typically requires on other similar goods and services.
- (b) *adjusted market assessment approach*—an entity could examine the market in which it regularly sells goods and services, and could estimate the price that customers in that market would be willing to pay for those goods and services. That approach might also include referring to quoted prices from the entity's competitors and adjusting them as necessary to reflect the entity's own costs and margins.

5.49 The following example illustrates how an entity might allocate a transaction price to identified performance obligations on a relative stand-alone selling price basis:

SellerCo enters into a contract with a customer in which it promises to transfer products A, B and C to the customer (at different times). The customer pays CU100 at contract inception.

SellerCo regularly sells product A on a stand-alone basis for CU60. Products B and C are not sold on a stand-alone basis. However, SellerCo's competitor sells a product similar to product B for CU28.

5.50 In this example, the promise to transfer each product is a separate performance obligation because each product is transferred to the customer at a different time. To allocate the transaction price to each performance obligation, SellerCo first would identify the stand-alone

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selling prices of each product at contract inception and then allocate the total CU100 transaction price relative to those prices. SellerCo regularly sells product A separately for CU60. That amount is the best evidence of a stand-alone selling price.

- 5.51 Product B is not sold separately but the competitor's price of CU28 can be used to estimate SellerCo's stand-alone selling price of product B. SellerCo uses the observed CU28 amount as a starting point and then adjusts it on the basis of the nature of its own product, cost structure and historical pricing relative to the competitor's. On the basis of that assessment, SellerCo estimates that it would sell product B separately for CU30.
- 5.52 Because of its unique nature, no competitor of SellerCo sells product C. Therefore, SellerCo forecasts its costs of providing this product to the customer and, based on a reasonable margin for similar products, estimates a stand-alone selling price of CU20.
- 5.53 On the basis of the above information, SellerCo allocates the CU100 transaction price to products A, B and C as follows:

<i>Performance obligation</i>	<i>Stand-alone selling price</i>	<i>Proportion of stand-alone selling price</i>	<i>Allocation of transaction price</i>
	CU	%	CU
Product A	60.0	54.5	54.5
Product B	30.0	27.3	27.3
Product C	20.0	18.2	18.2
Total	110.0	100.0	100.0

- 5.54 Over the life of the contract, the measurement of the remaining performance obligations is updated to reflect SellerCo's transfer of products to the customer. For example, when product A is transferred to the customer, SellerCo's net position in the contract increases (from the satisfaction of a performance obligation) and revenue of CU54.5 (the amount allocated to the performance obligation at contract inception) is recognised. In other words, the initial CU100 measurement of the performance obligations is reduced to CU45.5 to reflect SellerCo's remaining performance obligations as well as SellerCo's performance in the contract.

Remeasurement of performance obligations

- 5.55 The previous section discusses how the measurement of an entity's performance obligations is updated to reflect the entity's transfer of goods and services to the customer. However, as paragraph 5.37 notes, performance obligations can change for reasons other than an entity's performance, including changes in the price or quantity of goods and services that an entity expects to transfer to the customer to satisfy the remaining performance obligations.
- 5.56 In most contracts, those changes are not significant. That is why the boards think that the allocation approach described above generally would provide decision-useful information about the entity's remaining performance obligations and its performance in the contract.
- 5.57 However, the boards acknowledge that sometimes those changes can be significant to the depiction of an entity's obligation to provide goods and services and the entity's performance in the contract. When those changes are significant, an entity may need to recognise them by updating the initial measurement of the performance obligations. This discussion paper refers to updating the initial measurement of performance obligations for reasons other than an entity's transfer of goods and services to the customer as 'remeasurement'.

Remeasure when deemed onerous

- 5.58 In the boards' preliminary view, an entity should remeasure a performance obligation upwards if significant adverse changes in circumstances suggest that the measurement of that performance obligation is inadequate. In other words, a performance obligation should be remeasured upwards if its carrying amount¹² does not depict faithfully the entity's obligation to provide goods and services to the customer. This discussion paper refers to those performance obligations as 'onerous'.
- 5.59 An onerous test for performance obligations is similar to asset impairment tests in existing standards in which an entity periodically assesses whether an asset is overstated relative to a current price or value for that asset. Similarly, the boards think it is important to ensure that a performance obligation is not understated relative to a current measurement of that obligation.

12 The carrying amount is the measurement of the performance obligation included in the recognised net contract position.

- 5.60 The boards have not yet discussed all of the issues associated with an onerous test and how it would work. Rather, the boards have considered only the main issues that enabled them to express a preliminary view on the subsequent measurement of performance obligations in their proposed revenue recognition model. Those issues are:
- (a) *the onerous trigger*, ie when should a performance obligation be deemed onerous?
 - (b) *the remeasurement basis*, ie how should a performance obligation be remeasured if deemed onerous?

When should a performance obligation be deemed onerous?

- 5.61 The boards considered two main triggers for identifying an onerous performance obligation:
- (a) cost trigger
 - (b) current price trigger.

Cost trigger

- 5.62 One way to identify onerous performance obligations would be to specify that a performance obligation is onerous when the expected costs to satisfy that performance obligation exceed its carrying amount (ie a cost trigger).
- 5.63 A cost trigger is used for construction contracts in IAS 11 and in AICPA SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Those standards, in effect, deem a contract onerous¹³ when the current total expected contract costs exceed the expected inflows in the contract (ie when the total contract is expected to generate a cash loss). When the loss becomes probable, the contract is remeasured and the loss is recognised.
- 5.64 The main consequence of a cost trigger is that any margin in the measurement of the performance obligation would act as a buffer to absorb adverse changes in the performance obligation. In other words, the measurement of the performance obligation would remain unchanged until the entity expects that the satisfaction of a performance obligation would result in a loss. Only then would remeasurement be triggered. As a result, an adverse change in expected costs first reduces *future* profits—because it reduces the remaining margin implicit in the measurement of the performance obligation—rather than *current* profits.

13 The standards do not use the term 'onerous'. IAS 11 refers to 'expected losses', and SOP 81-1 refers to 'anticipated losses'.

- 5.65 To illustrate this point, consider the following example:

On 2 January 20X1 ConstructorCo enters into a two-year construction contract. For simplicity, assume that the customer prepays the contract price of CU100,000 and that the construction services and materials transfer to the customer evenly over the two years. Hence, the amount of the transaction price allocated to the performance obligations satisfied in 20X1 and 20X2 is the same—CU50,000.

At contract inception, the expected costs to fulfil the contract are CU80,000, so the margin implied by the transaction price is CU20,000. Suppose that on 31 December 20X1, because of an increase in labour and material costs, the expected costs to fulfil the remaining part of the contract increase from CU40,000 to CU48,000. Because the costs to fulfil the remaining performance obligation (CU48,000) do not exceed the carrying amount of the remaining performance obligation (CU50,000), the performance obligation is not deemed to be onerous.

- 5.66 Because the margin would act as a buffer, a cost trigger can result in an entity recognising adverse changes in circumstances in periods after the period in which the changes occur. In the above example, a margin of CU10,000 (revenue CU50,000 less costs of CU40,000) is recognised in 20X1 and a margin of CU2,000 (revenue CU50,000 less costs of CU48,000) in 20X2. Thus, the adverse change in circumstances that occurred in 20X1 is not recognised until 20X2.
- 5.67 Another consequence of a cost trigger is that it would require guidance on what costs to include in the onerous test. That is because those costs could vary depending on how the entity intends to satisfy the performance obligation. For instance, they might include the expected costs to perform in the contract, the costs to legally transfer the obligation, or the costs to breach the contract and settle with the customer. In addition, if the costs are those to perform in the contract, should they include only the direct costs of providing goods and services or should they also include administrative costs for managing the contract? Those, of course, are not new questions and the boards could adopt guidance similar to that in IAS 11 and SOP 81-1 for determining whether a contract is onerous.

Current price trigger

- 5.68 The boards also considered an alternative onerous trigger that uses a current price (ie a trigger that includes a margin as well as expected costs) to determine when a performance obligation is onerous. The obvious trigger in IFRSs would be a measurement in accordance with IAS 37

Provisions, Contingent Liabilities and Contingent Assets. That trigger is already used in IFRS 4 *Insurance Contracts* if an insurer's accounting policies do not require an onerous test¹⁴ that meets specified minimum requirements. Using the IAS 37 measurement as a trigger means that a performance obligation would be onerous if its measurement in accordance with IAS 37 exceeds its carrying amount.

- 5.69 The IASB is discussing the existing measurement requirements of IAS 37. One interpretation of that standard is that it would require entities to measure a performance obligation at the lower of (a) the amount to transfer the obligation to a third party at the financial statement date and (b) the amount to settle with the customer at that date. The former measure appears to be similar to a current exit price and the latter consistent with a current transaction price (ie consistent with the transaction price approach of measuring performance obligations at contract inception).¹⁵ In contrast with a cost trigger, both the transfer price and the settlement price include a margin.
- 5.70 Consider again the example in paragraph 5.65:

Suppose that there has been a general increase in labour and material costs. Further suppose that at 31 December 20X1 the measurement of the remaining performance obligation in accordance with IAS 37 is CU56,000. (For simplicity, this example assumes that the amount to transfer and the amount to settle are the same.) Because that amount exceeds the carrying amount of the remaining performance obligation (CU50,000), the performance obligation is deemed onerous.

- 5.71 Unlike an expected cost trigger, a trigger with a margin would not result in the entire margin acting as a buffer to absorb adverse changes in circumstances. Therefore, depending on how an onerous performance obligation is remeasured (a matter discussed in the next section), more adverse changes in circumstances might be recognised in the period in which the changes occur. In the above example, assuming that the performance obligation is remeasured to CU56,000 at 31 December 20X1, a margin of CU4,000 (revenue of CU50,000 less costs of CU40,000 less remeasurement of CU6,000) would be recognised in 20X1. Margin of CU8,000 (revenue of CU50,000 less costs of CU48,000 plus reversal of the 20X1 remeasurement of CU6,000) would be recognised in 20X2. Therefore, a trigger with a margin might provide more timely information to users about adverse changes in circumstances.

¹⁴ In IFRS 4, 'liability adequacy test' is used rather than 'onerous test'.

¹⁵ The transaction price at contract inception might be the amount to settle with the customer at that time.

- 5.72 However, a trigger with a margin is likely to increase the frequency of remeasurement. Therefore, it more closely resembles a measurement approach in which performance obligations are remeasured at each financial statement date. As noted in paragraph 5.39, the boards think that such an approach would be unnecessarily complex for most contracts with customers.

How should a performance obligation be remeasured if deemed onerous?

- 5.73 The boards' view is that once a performance obligation is deemed onerous, it should be remeasured on a basis that is consistent with the trigger. Hence, if the remeasurement is triggered when the expected costs exceed the carrying amount, then the performance obligation would be remeasured upwards to the revised expected costs. If the trigger is a current price such as a measurement in accordance with IAS 37, then the performance obligation would be remeasured upwards to that price.
- 5.74 As with the trigger, the main difference between remeasuring a performance obligation to the expected cost of performance and remeasuring it to the amount in accordance with IAS 37 is whether to include a margin.
- 5.75 Consider again the example in paragraph 5.65:

Suppose that at 31 December 20X1 the expected costs have increased by CU11,000, so that the performance obligation is deemed onerous using both a cost trigger and a current price trigger (in accordance with IAS 37). Further suppose that at 31 December 20X1, the IAS 37 measurement is CU59,000. ConstructorCo would present the following:

	<i>Remeasured to cost</i>		<i>Remeasured to current price</i>	
	20X1	20X2	20X1	20X2
	CU	CU	CU	CU
Revenue	50	50	50	50
Remeasurement gains/(losses)	(1)	1	(9)	9
Expenses	(40)	(51)	(40)	(51)
Margin	<u>9</u>	<u>-</u>	<u>1</u>	<u>8</u>
Carrying amount of performance obligation	51	-	59	-

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

Appropriateness of including a margin in the remeasurement

- 5.77 As paragraph 5.9 notes, the measurement of a performance obligation should include a margin. That is because a profit-oriented entity typically does not promise to transfer goods and services to a customer without a margin. Also, including a margin is consistent with the measurement requirements of an onerous contract in IAS 37.
- 5.78 Although a measurement of a performance obligation should include a margin, often it is not practical to do so. Standards such as IAS 11 and SOP 81-1 do not require a margin in the remeasurement of loss contracts. Some support an approach that measures onerous performance obligations without a margin because those obligations result in an entity transferring goods and services to a customer at a loss. Others note the complexity of determining what margin should be included in the remeasurement, particularly when observable prices do not exist.
- 5.79 In addition, some think that the pattern of profit recognition when measuring onerous performance obligations with a margin is counter-intuitive. That pattern arises because an incremental expense is recognised in one period when the performance obligation is remeasured with a margin, and then additional income is recognised when the obligation is satisfied in a subsequent period. For instance, in the example in paragraph 5.75, a remeasurement gain of CU9 and a margin of CU8 are recognised in 20X2, but there is no additional consideration from the customer. Some also think that recognising in one period the reversals of remeasurements from prior periods reduces the understandability of profit or loss.
- 5.80 Others think that the pattern of profit recognition when remeasuring with a margin is a faithful representation of the entity's performance in the contract. Proponents of that view note that the additional income (recognised in periods following the remeasurement) can be presented as a component of the statement of comprehensive income other than revenue (as in the example in paragraph 5.75). That presentation would depict the change in circumstances, while maintaining the revenue amount at the amount of consideration from the customer. Also,

proponents of that view note that an onerous test of a liability is the mirror image of a traditional asset impairment test. And because the remeasurement of an impaired asset typically includes a margin, they think the remeasurement of an onerous performance obligation also should include a margin.

Summary of options for an onerous test

5.81 Therefore, the boards have two main options for an onerous test:

	Cost test	Current price test
<i>Remeasurement trigger</i>	When the entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation.	When the measurement of the performance obligation at a current price (eg in accordance with IAS 37) exceeds the carrying amount of the performance obligation.
<i>Remeasurement</i>	Remeasure the performance obligation to the entity's expected cost of satisfying the performance obligation.	Remeasure the performance obligation to the current price (eg the amount in accordance with IAS 37).

5.82 The boards' preliminary view is in favour of the cost test. Some prefer that approach because it is similar to that in some existing standards and, therefore, might not change significantly the frequency of remeasurement in present practice. Others support the cost test because, as discussed later in this chapter, they think that most performance obligations for which a current price test would be necessary should be subject to an alternative measurement approach.

Concerns about remeasuring performance obligations only when deemed onerous

5.83 The boards' proposed measurement approach described so far in this chapter can be summarised as follows. Performance obligations are measured initially at the transaction price. That transaction price is allocated to each performance obligation on the basis of the relative stand-alone selling prices of the goods and services underlying the performance obligation. The amount initially allocated to each performance obligation is not updated subsequently (the initial

measurement is 'locked-in') unless a performance obligation is deemed onerous. This discussion paper refers to the boards' proposed approach as an 'allocated transaction price approach'.

- 5.84 For most contracts with customers, the boards think that an allocated transaction price approach results in decision-useful information to users of an entity's financial statements.
- 5.85 However, some are concerned that the proposed approach might not result in decision-useful information for some contracts, particularly for contracts with highly variable outcomes. In those contracts, there is a risk that the initial locked-in measurement may not continue to provide decision-useful information about the entity's performance obligations at each financial statement date. Variability in the outcome of a contract may arise if uncertainty is a significant inherent characteristic of the contract, the prices of the underlying goods and services are volatile, or the duration of the contract is such that significant changes in circumstances are likely.
- 5.86 Specifically, proponents of that view have the following concerns with an approach that remeasures performance obligations only when they are deemed onerous:
- (a) *It is remeasurement by exception.* Such an approach increases the risk that an entity may not identify and recognise changes in circumstances, particularly if the initial locked-in measurement contains a significant implicit margin buffer.
 - (b) *It is a one-way test.* Adverse changes that do not cause a contract to become onerous are ignored along with all favourable changes (except those favourable changes that prevent the contract from becoming onerous). That is inconsistent with the concept of neutrality in the boards' conceptual frameworks. In contracts in which circumstances change significantly, failing to recognise those changes as they arise diminishes the decision-usefulness of the financial information to users.
 - (c) *It is inconsistent with IAS 37.* IAS 37 requires the use of current cash flow estimates at each financial statement date. The boards note that some transactions are likely to be moved from the scope of IAS 37 into the revenue recognition standard (eg warranty and refund obligations).

Addressing concerns about remeasuring performance obligations only when deemed onerous

- 5.87 The boards are considering the following options for addressing concerns about remeasuring performance obligations only when they are deemed onerous:
- (a) scope of the revenue recognition standard
 - (b) disclosure
 - (c) another measurement approach for some performance obligations.

Scope of the revenue recognition standard

- 5.88 Some think that other standards may address many of the performance obligations for which an allocated transaction price approach might not provide decision-useful information, eg financial instruments including derivative contracts for non-financial items. If those contracts are initially and subsequently measured at fair value, then *any* changes in circumstances that affect their fair value are recognised in the period in which they arise. The boards could exclude those obligations from the scope of a revenue recognition standard.
- 5.89 Some insurance contracts are another example of performance obligations for which the allocated transaction price approach may not provide decision-useful information. The outcome of an insurance contract can be highly variable because uncertainty is an inherent characteristic of insurance contracts and those contracts often cover many reporting periods. For those reasons, the IASB tentatively rejected an approach similar to the allocated transaction price approach in its discussion paper *Preliminary Views on Insurance Contracts* (published in 2007). Instead, it tentatively adopted an approach in which insurance contracts are measured at each financial statement date (an explicit measurement approach).¹⁶ Because the IASB and the FASB¹⁷ are undertaking a joint project on insurance contracts, the boards could also exclude insurance contracts from the scope of a revenue recognition standard.

16 The IASB's discussion paper discusses an unearned premium approach, which the IASB acknowledged might be appropriate for many short-duration insurance contracts. That approach is similar to the allocated transaction price approach.

17 In October 2008, the FASB announced that it would join the IASB in its insurance contracts project.

- 5.90 However, others think that an allocated transaction price approach might not provide decision-useful information for some performance obligations beyond financial instruments and insurance contracts. For instance:
- (a) long-term, fixed price contracts for goods and services with volatile prices, eg a take-or-pay contract for power or a commodity.
 - (b) contracts in which the outcome depends on specified uncertain future events, eg many guarantees, warranties, contracts with customer options and other stand-ready obligations, particularly if longer-term. With such contracts, the amount (quantity) of the resources required to satisfy the performance obligations can be highly uncertain.
 - (c) long-term contracts involving 'big ticket' items, such as large construction projects. With such contracts, some argue that although the expected outflows of resources may not be highly uncertain or variable, the size of those contracts means that relatively small changes in circumstances can be significant to an entity's cash flows and should be recognised as they arise and not just when they result in an onerous performance obligation.

Disclosure

- 5.91 As part of a revenue recognition standard, the boards intend to use disclosures to enhance the decision-useful information about an entity's contracts with customers.
- 5.92 Some think that disclosures could address the above concerns about remeasuring a performance obligation only when it is deemed onerous. They think that remeasurement of performance obligations may not be necessary if disclosure requirements provide sufficient information to users of an entity's financial statements about the changes in circumstances affecting those performance obligations.
- 5.93 Those in favour of additional disclosure think that the advantages of specifying a single, straightforward measurement approach would outweigh the disadvantage of that approach possibly providing less decision-useful information about some contracts. For those contracts, they think that the boards could require disclosures to enhance the decision-usefulness of the information provided by the single measurement approach.
- 5.94 Others, however, note that the boards' conceptual frameworks state that disclosure is not a substitute for adequate recognition and measurement.

Another measurement approach for some performance obligations

- 5.95 Some think that neither scope decisions nor disclosures can adequately address the concerns with applying the boards' proposed measurement approach to some contracts. Therefore, they think it may be necessary for a revenue recognition standard to provide a different measurement approach for those contracts. In such an approach, the performance obligations would be measured (in either direction) at each financial statement date, rather than only by exception when deemed onerous.
- 5.96 Those supporting another measurement approach note that the scope of a revenue recognition standard would be very broad, covering the most simple transactions to the most complex. Hence, they think that more than one measurement approach would be required unless a single measurement approach is adopted that can handle the most complex transactions. In their view, an allocated transaction price approach cannot handle the most complex transactions.
- 5.97 If the boards were to specify another measurement approach for some performance obligations, they would need to specify which types of performance obligations should be subject to that other approach. It would be difficult to draw the line between two measurement approaches—any line is bound to be somewhat arbitrary and inconsistent with a principle-based approach.
- 5.98 However, the boards note that if they adopt the allocated transaction price approach for a revenue recognition standard, and if the boards continue in their present direction in their insurance project, then they will have to draw that line. That is because an insurance contract contains elements that might otherwise be accounted for in a revenue recognition standard.
- 5.99 Instead of having an explicit measurement approach only for insurance contracts, the boards could develop a second measurement approach in a revenue recognition standard that would be suitable for contracts with specified characteristics (eg those with highly variable outcomes). That second approach could also apply to some insurance contracts. Insurance contracts without those characteristics could then be accounted for in accordance with the allocated transaction price approach.

- 5.100 If the two approaches were consistent in their initial measurement (ie if they both use a transaction price measurement), then having two approaches for subsequent measurement would not necessarily be inconsistent. Rather, if the line between the two approaches was carefully drawn, the use of the allocated transaction price approach could be viewed as a less burdensome way for entities to arrive at a reasonable approximation of the second explicit measurement approach.
- 5.101 The boards have not expressed a preliminary view on whether or how to apply another measurement approach. However, Appendix B discusses alternative approaches for subsequent measurement.

Summary

- 5.102 The measurement of a performance obligation should depict decision-useful information about an entity's obligations to provide goods and services to a customer, and the entity's contractual performance in the reporting period.
- 5.103 The boards propose that performance obligations initially should be measured at the transaction price—the customer's promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative stand-alone selling prices of the goods and services underlying those performance obligations.
- 5.104 Subsequent measurement of the performance obligations should depict the decrease in the entity's obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognised is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that an entity recognises over the life of the contract is equal to the transaction price.
- 5.105 The boards propose that after contract inception, the measurement of a performance obligation should not be updated unless that performance obligation is deemed onerous. A performance obligation is deemed onerous when an entity's expected cost of satisfying the performance obligation exceeds the carrying amount of that performance obligation. In that case, the performance obligation is remeasured to the entity's expected cost of satisfying the performance obligation and the entity would recognise a contract loss.

- 5.106 Some are concerned about a measurement approach that remeasures a performance obligation only when it is deemed onerous. They think that the boards' proposed measurement approach would not provide decision-useful information to users of financial statements about some contracts (eg those with highly variable outcomes).
- 5.107 The boards have not reached a preliminary view on how to address those concerns with an allocated transaction price approach. However, they are considering scope, disclosures and another measurement approach for some contracts.

Questions for respondents

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- (a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?
- (b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?
- (c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.
- (d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

- (a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?
- (b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Chapter 6: Potential effects on present practice

Introduction

- 6.1 The previous chapters discuss the boards' preliminary views on a contract-based revenue recognition model. This chapter discusses how that model could affect present practice.
- 6.2 To some, it may seem premature to discuss the effects of the proposed model when that model is still subject to change in the light of responses to this discussion paper and the boards' future discussions. Nevertheless, the boards think it is useful at this stage of the project to highlight some areas of present practice that the proposed model could change significantly.
- 6.3 For many contracts with customers the proposed model would not change the way an entity recognises revenue. For example, the proposed model would not change how revenue is recognised for typical retail transactions in which the entity and the customer fulfil their respective promises at the point of sale. Moreover, the proposed model would not significantly change how entities recognise revenue for many long-term contracts in which revenue recognition already reflects the transfer of goods and services to the customer.
- 6.4 For other transactions, however, the boards think that the proposed model might have significant effects on present practice. This chapter discusses the following potential effects:
- (a) use of a contract-based revenue recognition principle (paragraphs 6.7–6.21)
 - (b) identification of performance obligations (paragraphs 6.22–6.35)
 - (c) use of estimates (paragraphs 6.36–6.42)
 - (d) capitalisation of costs (paragraphs 6.43–6.46).
- 6.5 The boards invite comments not only on the areas listed above, but also on any other area of present practice for which respondents think that implementing the boards' proposed model would affect an entity's revenue.
- 6.6 The potential effects discussed in this chapter are based on an allocated transaction price approach. In other words, the potential effects of implementing another measurement approach (Appendix B) are not considered here.

Use of a contract-based revenue recognition principle

- 6.7 In the boards' preliminary view, an entity should recognise revenue when its net position in a contract with a customer increases as a result of satisfying a performance obligation. An entity satisfies a performance obligation when it transfers goods and services to a customer. That principle, which the boards think can be applied consistently to all contracts with customers, is the core of the boards' proposed model for a revenue recognition standard.
- 6.8 Many existing standards are consistent with that principle because they implicitly require satisfaction of a performance obligation (through delivery of promised goods and services) to recognise revenue. For example, many standards are founded on a notion in FASB Concepts Statement No. 5 *Recognition and Measurement in Financial Statements of Business Enterprises*, which states that in recognising revenue:
- The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities ... are commonly recognized at time of sale (usually meaning delivery). [Paragraph 84(a), footnote reference omitted]
- 6.9 Similarly, IAS 18 implies that an entity should recognise revenue from the sale of a good when a performance obligation is satisfied, because an entity recognises that revenue only when it has transferred to the customer the risks and rewards of ownership and control of the good.
- 6.10 Some standards, however, are inconsistent with the boards' proposed revenue recognition principle and might be affected significantly. For example, sometimes revenue is recognised on the basis of increases in assets such as cash, inventory in the absence of a contract and inventory under a contract, rather than an entity's contract with a customer.

Potential effect on cash-based revenue recognition

- 6.11 In some cases revenue is recognised from an increase in cash rather than from an increase in an entity's net position in a contract with a customer.¹⁸ For example, in some instances in which collectibility is not reasonably assured, an entity does not recognise revenue until it receives

¹⁸ This section is not referring to retail transactions in which an entity receives cash at the same time as transferring the promised good. In those transactions, although in practice the entity would simply debit 'cash' and credit 'revenue', in concept the entity would be recognising revenue from satisfying a performance obligation.

cash from the customer. In those instances, an entity may have already transferred the promised goods and services to the customer and, thus, satisfied a performance obligation. However, no revenue would be recognised until payment is received.

- 6.12 Present practice sometimes uses the collectibility of payment as a criterion for revenue recognition. Hence, if collectibility is not reasonably assured, revenue recognition is determined by the increase in cash rather than by an increase in the entity's net contract position.
- 6.13 When collectibility is not reasonably assured, the boards' proposed model, in the absence of any other criterion, could result in the recognition of revenue sooner than at present. That is because the proposed model would recognise revenue on the basis of the transfer of assets to the customer (and the resulting increase in the entity's net position in the contract), rather than on the basis of cash collection.
- 6.14 However, collectibility also relates to the measurement of an entity's rights in a contract (ie how uncertainty of customer payment should be reflected in the measurement of rights). The boards have not yet discussed that issue and its potential effect on the amount of the contract's transaction price that is allocated to performance obligations.

Potential effect on accounting for inventory in the absence of a contract

- 6.15 In present practice, revenue is sometimes recognised from an increase in the value of inventory even though a contract with a customer does not exist. For example, revenue is recognised from increases in some biological, agricultural and extractive products before there is a contract with a customer (eg IAS 41 *Agriculture* and AICPA SOP 85-3 *Accounting by Agricultural Producers and Agricultural Cooperatives*). Recognising revenue in those instances is consistent with the boards' existing definitions of revenue and the recognition principles in their conceptual frameworks.
- 6.16 In this project, the boards do not intend to change the way those entities measure inventory. However, in the boards' proposed model, an entity recognises revenue only if it has a contract with a customer. Therefore, the boards need to consider whether those entities should be precluded from presenting increases in the value of inventory as revenue and should, instead, present those increases as another component of comprehensive income.

Potential effect on accounting for inventory under contract

- 6.17 In some existing standards, revenue is recognised from an increase in the value of inventory under a contract with a customer. For example, consider the revenue recognition for construction and production-type contracts in IAS 11 and in AICPA SOP 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. In those standards, an entity's activities may enhance the value of inventory and that increase might result in the recognition of revenue (provided all other necessary criteria are met).
- 6.18 The proposed model focuses on increases in an entity's net position in a contract with a customer rather than on the increases in the value of assets being produced under that contract. As Chapter 4 discusses, if the entity's construction activities continuously transfer assets to a customer (and thus satisfy a performance obligation continuously), then the boards' proposed model would not change significantly the present practice of recognising revenue for construction-type contracts during the construction phase. In other words, if the customer controls the asset being constructed, there would be no significant change to present practice.
- 6.19 However, if the construction activities do not result in a transfer of assets to a customer (and thus do not satisfy a performance obligation), the entity's net position in the contract does not increase, and revenue would not be recognised during the construction phase. In other words, if the customer does not control the asset being constructed, the pattern of revenue recognition might be significantly different from present practice.
- 6.20 The boards' proposed contract-based revenue recognition principle is consistent with the basis for recognising revenue in SOP 81-1. For example, paragraph 22 states:

Under most contracts for construction of facilities, production of goods, or provision of related services to a buyer's specifications, both the buyer and the seller (contractor) obtain enforceable rights. The legal right of the buyer to require specific performance of the contract means that the contractor has, in effect, agreed to sell his rights to work-in-progress as the work progresses. This view is consistent with the contractor's legal rights; he typically has no ownership claim to the work-in-progress but has lien rights ... The buyer's right to take over the work-in-progress at his option (usually with a penalty) provides additional evidence to support that view. Accordingly, the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses.

- 6.21 The boards understand that, at present, some entities recognise revenue throughout construction-type contracts even though 'ownership rights' are not continuously transferred to the customer—ie even though the customer does not control the asset being constructed. In those cases, the boards' proposed model would preclude the recognition of revenue until the inventory transfers to the customer. That might differ significantly from present practice.

Identification of performance obligations

- 6.22 In the boards' proposed model, any promise in a contract (whether implicit or explicit) that meets the definition of a performance obligation could be accounted for separately. When that performance obligation is satisfied, an entity would recognise revenue in the amount that was allocated to it at contract inception.
- 6.23 The boards think that their proposed definition of a performance obligation is generally consistent with the notion in present practice of a 'deliverable' in or a 'component' of a contract with a customer. Consequently, implementing the boards' proposed model would result in the same units of account for many transactions.
- 6.24 However, existing standards do not define a deliverable or component. As a result, similar contractual promises can be accounted for differently. The boards think that applying their proposed definition of a performance obligation would result in entities accounting for contractual promises more consistently than in present practice.
- 6.25 Three categories in which identifying performance obligations in the boards' proposed model may differ from present practice are:
- (a) post-delivery services
 - (b) sales incentives
 - (c) segmentation of a construction contract.

Post-delivery services

- 6.26 Many products are sold with post-delivery services such as warranties, maintenance or other services that often are not sold separately and are considered incidental to the contract. Therefore, total revenue for both the product and the post-delivery service is often recognised upon delivery of the product. The expected costs of providing the post-delivery service are accrued upon delivery of the product and recognised as an expense when the revenue is recognised. Subsequently, when actual

costs are incurred for the post-delivery service, the original amount accrued is reversed to offset the actual costs recognised as an expense.

- 6.27 A common example of this scenario is a standard warranty included with a product sale. A standard warranty obligation (ie one that is not sold separately) meets the definition of a performance obligation in the boards' proposed model. At present, however, those warranties are often accounted for in accordance with standards such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and SFAS 5 *Accounting for Contingencies*. Therefore, the revenue (and sometimes the profit) for a standard warranty is recognised at the time the related product is sold, which is before the warranty services are provided.
- 6.28 In the boards' proposed model, the standard warranty (and other similar post-delivery services) would be accounted for as a performance obligation and would result in the recognition of revenue only when the promised warranty or other services are provided to the customer, regardless of whether they were sold separately. Therefore, revenue would be recognised at the time when the product transfers to the customer and over time as the warranty services are transferred to the customer. The boards think this pattern of revenue recognition better represents the transfer of assets to the customer and therefore results in more relevant information to users of financial statements.
- 6.29 The measurement of such obligations in the proposed model may also differ from present practice. In the proposed model, a portion of the customer's consideration is allocated to such obligations regardless of whether the underlying services are sold separately. That allocation typically includes a margin component, whereas in present practice a performance obligation might be measured at an entity's expected cost of satisfying the performance obligation.

Sales incentives

- 6.30 Sales incentives are another example of contractual promises that might be accounted for differently from present practice. Entities frequently induce a customer to enter into a contract through 'free' products, services, customer loyalty programmes or some other benefit. Entities sometimes account for those contractual promises as additional marketing expense at contract inception, rather than as performance obligations that result in revenue recognition when satisfied.
- 6.31 As Chapter 3 discusses, identifying performance obligations can be difficult and requires judgement based on the facts and circumstances of the contract. However, the boards think that their proposed definition of

a performance obligation provides a useful framework for entities to identify performance obligations more consistently than they do at present. Although promised goods or services might be intended as sales incentives, if those promises meet the definition of a performance obligation, then a portion of the transaction price would be allocated to that performance obligation and would result in revenue recognition when that obligation is satisfied.

- 6.32 For example, an entity's promise to provide a particular number of loyalty points as part of a contract for other goods and services would meet the definition of a performance obligation. Those promised loyalty points represent an entity's promise to transfer assets to the customer. As the customer redeems those loyalty points or as the points expire, the entity would recognise revenue. That pattern of revenue recognition would be consistent with the pattern in accordance with IFRIC 13 *Customer Loyalty Programmes*.
- 6.33 However, the boards think that the proposed model would change present practice for sales incentives and other promotional promises that are not accounted for as a deliverable in or component of a contract with a customer.

Segmentation of a construction contract

- 6.34 In accordance with IAS 11 and SOP 81-1, a construction-type contract would be segmented if components of that contract were negotiated separately with the customer. In the boards' proposed model, separate negotiation of a component of a contract does not determine whether that component is accounted for as a separate performance obligation. Instead, in the proposed model each promised asset in the contract is a potentially separate performance obligation. Hence, a contract that continuously transfers assets to a customer comprises, in effect, a continuous series of performance obligations.
- 6.35 As Chapters 3 and 4 discuss, an entity would account for those performance obligations separately on the basis of when the promised assets are transferred to the customer (and not on the basis of whether each performance obligation was negotiated separately with the customer). Consequently, the boards note that construction-type contracts that continuously transfer assets to the customer might be segmented into more units of account than at present.

Use of estimates

- 6.36 In the boards' proposed model, the transfer of assets to a customer determines when revenue would be recognised, but the *amount* of revenue recognised under the boards' proposed model would often depend on an entity's use of estimated selling prices. As Chapter 5 discusses, the boards' proposed model measures performance obligations at contract inception by allocating the transaction price (ie customer consideration) to performance obligations on the basis of the stand-alone selling prices of the underlying goods and services.
- 6.37 If stand-alone selling prices cannot be observed, then they would be estimated. Estimating a selling price for allocation purposes may not be a significant change to IFRSs. Revenue recognition standards in IFRSs do not prohibit the use of estimates when allocating the transaction price to identified components of the contract.
- 6.38 In US GAAP, however, estimating selling prices would be a significant change to some existing standards, especially for software transactions. AICPA SOP 97-2 *Software Revenue Recognition* requires deferral of revenue for any delivered items if there is no vendor-specific objective evidence (VSOE) of the selling prices of the undelivered items. The use of estimates in the proposed model would result in entities recognising revenue for delivered goods and services, even without VSOE of the selling prices of the undelivered goods and services.
- 6.39 EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* similarly requires objective and reliable evidence of selling prices for undelivered items in order to account for a delivered item as a separate deliverable. However, that evidence does not need to be vendor-specific. Rather, an entity may look to other vendors who sell the same, or similar, products.¹⁹ In the proposed model, the use of estimates would result in entities recognising revenue for delivered goods and services, regardless of whether an entity has VSOE or objective and reliable evidence of selling prices for undelivered goods and services.
- 6.40 Another difference between Issue 00-21 and the boards' proposed model relates to the potential use of the residual method. In the residual method, remaining performance obligations (or items) in an arrangement are measured using objective and reliable evidence of

¹⁹ In November 2008, the EITF agreed to publish, for public comment, a draft of EITF Issue No. 08-1 *Revenue Recognition for a Single Unit of Accounting*. That Issue would amend Issue 00-21 and would allow an entity to use its best estimates of stand-alone selling prices to measure remaining deliverables if those prices cannot be observed.

selling prices of those items. Any difference between that measurement and the total transaction price is recognised as revenue for the delivered items. The boards' proposed model would not allow the residual method, whereas Issue 00-21 requires it in specified cases.

- 6.41 As Chapter 5 discusses, the boards' proposed model allocates the total transaction price to performance obligations in proportion to the stand-alone selling prices of the underlying goods and services. If selling prices cannot be observed, then they would be estimated.
- 6.42 Estimates are more subjective and complex than observed amounts. Therefore, some existing standards limit their use to prevent possible abuse by preparers and to improve enforceability and auditability. However, standards that implement measurement reliability thresholds (such as VSOE in SOP 97-2) and limit the use of estimates often create units of account and patterns of revenue recognition that the boards think do not faithfully represent the economic position and performance of the entity in the contract.

Capitalisation of costs

- 6.43 The boards do not intend a new revenue recognition standard to include guidance on accounting for the costs associated with contracts with customers. Consequently, costs would be recognised as expenses when incurred unless they were eligible for capitalisation in accordance with other standards. Examples of costs eligible for capitalisation in other standards include inventory costs and software development costs.
- 6.44 Contracts with significant contract origination costs might be affected by that preliminary view. In some instances, those costs are often capitalised if they are deemed recoverable in subsequent periods. In other instances,²⁰ an entity recognises the costs of obtaining a contract as expenses when incurred, but revenue is also recognised to offset them. As noted earlier, the boards' preliminary view is that revenue is recognised only when a performance obligation is satisfied. Hence, revenue would neither be recognised at contract inception nor offset any costs of obtaining a contract.
- 6.45 A common example of that potential effect is sales commissions and other marketing expenses associated with obtaining a contract. If those costs are not eligible for capitalisation in accordance with other standards, they would be recognised as expenses as incurred. Because no

²⁰ See, for example, SFAS 51 *Financial Reporting by Cable Television Companies*.

revenue would be recognised at contract inception (unless a performance obligation is satisfied), that may lead to the recognition of a loss when a contract is obtained.

- 6.46 Some note that an allocated transaction price approach could be modified so that rather than allocating the total transaction price to performance obligations, an entity could allocate that price less specified costs of obtaining the contract. Consequently, although some revenue would be recognised at contract inception, no profit would be recognised at that time. That approach would be similar to Implementation A of the IASB's proposed measurement approach in its discussion paper *Preliminary Views on Insurance Contracts*.

Summary

- 6.47 For many contracts (particularly for commonplace retail transactions), the proposed revenue recognition model would cause little, if any, change. However, in some circumstances, applying the boards' proposed model would differ from present practice. For example:
- (a) *use of a contract-based revenue recognition principle.* An entity would recognise revenue from increases in its net position in a contract with a customer as a result of satisfying a performance obligation. Increases in other assets such as cash, inventory in the absence of a contract with a customer, and inventory under a contract with a customer (but not yet transferred to the customer) would not trigger revenue recognition. For instance, entities that at present recognise revenue for construction-type contracts would recognise revenue during construction only if the customer controls the item as it is constructed.
 - (b) *identification of performance obligations.* In present practice, entities sometimes account for similar contractual promises differently. For example, some warranties and other post-delivery services are accounted for as cost accruals rather than as 'deliverables' in or 'components' of a contract. In the proposed model, entities would account for those obligations as performance obligations and would recognise revenue as they are satisfied.
 - (c) *use of estimates.* Some existing standards limit the use of estimates more than the boards' proposed model would. For example, entities sometimes do not recognise revenue for a delivered item if there is no objective and reliable evidence of the selling price of the undelivered items (eg Issue 00-21 and SOP 97-2). In contrast, in the

proposed model, entities would estimate the stand-alone selling prices of the undelivered goods and services and recognise revenue when goods and services are delivered to the customer.

- (d) *capitalisation of costs*. At present, entities sometimes capitalise the costs of obtaining contracts. In the proposed model, costs are capitalised only if they qualify for capitalisation in accordance with other standards. For example, commissions paid to a salesperson for obtaining a contract with a customer typically do not create an asset qualifying for recognition in accordance with other standards. As a result, an entity would recognise such costs as expenses as incurred, which may not be the same period in which revenue is recognised.

Appendix A Examples

- A1 The following examples illustrate the proposed revenue recognition model:
- Example 1: Multiple-element arrangement (paragraphs A4–A9)
 - Example 2: Multiple-element arrangement with estimated selling prices (paragraphs A10–A18)
 - Example 3: Sale of a good with a warranty (paragraphs A19–A23)
 - Example 4: Allocation of revenue over many reporting periods (paragraphs A24–A31)
 - Example 5: Construction—continuous transfer of assets (paragraphs A32–A42)
 - Example 6: Construction—non-continuous transfer of assets (paragraphs A43–A45)
 - Example 7: Non-refundable upfront payment—no initial revenue recognition (paragraphs A46–A48)
 - Example 8: Contract origination costs (paragraphs A49–A51).
- A2 The objective of each of these examples is to illustrate some aspect of the proposed model. As a result, the examples may not be representative of the typical transactions in any particular industry. The aspect of the model being illustrated is highlighted in the introductory paragraph of each example.
- A3 For simplicity, all examples ignore the time value of money.

Example 1: Multiple-element arrangement

- A4 This example illustrates how an entity identifies and measures separate performance obligations. Consider the following:

On 29 February, Vendor enters into a contract with a customer to provide, deliver and install manufacturing equipment for CU15,000, due on delivery. Vendor delivers the equipment on 31 March and installs it during April. Title to the equipment passes to the customer at delivery.

Vendor separately sells the equipment (inclusive of the delivery service) and installation service for CU14,000 and CU2,000, respectively.

Vendor does not sell delivery services separately from equipment.

For simplicity, warranties or any other performance guarantees are ignored.

- A5 The equipment, the delivery service and the installation service could be sold separately. Hence those goods and services clearly are assets. Although Vendor does not sell the delivery service separately, it is an asset (evidenced by the fact that other entities sell such services separately). Accordingly, each of Vendor's promises to provide the equipment, the delivery service and the installation service is a performance obligation.
- A6 Whether Vendor separately accounts for those performance obligations depends on when the underlying assets are transferred to the customer. The equipment is transferred on 31 March when the customer obtains control of it (ie when the equipment becomes the customer's asset). The customer also receives the delivery service when it obtains the equipment. While the good is in transit, no asset is being transferred to the customer (during that time the delivery service benefits Vendor because it is changing the location of *Vendor's* inventory). The customer receives the installation service as the equipment is installed. In other words, the installation service enhances the customer's asset.
- A7 Accordingly, to reflect the pattern of the transfer of assets to the customer, Vendor combines the equipment and delivery service obligations and accounts for them separately from the installation services obligation. Vendor allocates the transaction price of CU15,000 to

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those separate performance obligations as follows:

	<i>Stand-alone selling price</i>	<i>Allocation of discount</i>	<i>Measurement of performance obligations</i>
	A	B	A – B
	CU	CU	CU
Machine and delivery	14,000	875 ^(a)	13,125
Installation	2,000	125 ^(b)	1,875
Total	16,000	1,000	15,000

(a) $CU1,000 \times (CU14,000 \div CU16,000)$
(b) $CU1,000 \times (CU2,000 \div CU16,000)$

- A8 Vendor satisfies the equipment and delivery services obligation on 31 March when the equipment is transferred to the customer. Vendor satisfies the installation service obligation in April as installation progresses. Therefore, Vendor's net contract position and revenue recognition are as follows:

	<i>Net contract position at end of month</i>	<i>Revenue recognition during month</i>
	CU	CU
February	–	–
March	(1,875) ^(a)	13,125
April	–	1,875

(a) Because the customer paid on delivery of the equipment, there are no remaining rights at 31 March. Therefore, Vendor's net contract position at 31 March is a contract liability of CU1,875 (the amount allocated to the remaining performance obligation).

- A9 If control of the equipment does not transfer to the customer until installation is complete, then the installation service obligation would be satisfied only at that point, not as the installation progresses. In that case, the assets (machine, delivery and installation) would be transferred to the customer simultaneously, and none of the performance obligations would need to be separated. Therefore, Vendor would recognise revenue of CU15,000 on completion of the installation services in April.

Example 2: Multiple-element arrangement with estimated selling prices

- A10 This example illustrates how an entity might estimate the stand-alone selling price of a good or service underlying a performance obligation when it does not sell the good or service separately. It also illustrates how in the proposed model an entity might account for more performance obligations separately than in present practice. Consider the following:

On 2 January 20X0, SoftwareCo enters into a contract to create a software program for a customer and to provide two years of software support. The software is transferred to the customer on 30 June 20X0 and the support services are transferred over the following two years. The customer is obliged to pay the entire transaction price of CU400,000 on delivery of the software.

- A11 SoftwareCo's promise to transfer the software and the support services are performance obligations. SoftwareCo accounts for those performance obligations separately because those assets are transferred to the customer at different times.
- A12 Because SoftwareCo does not sell this particular software or customer support separately, it estimates a stand-alone selling price for each. SoftwareCo decides that a reasonable approach to determine the stand-alone selling prices of the software and the customer support is to estimate (a) the cost-weighted labour hours needed to create the software and provide support and (b) the margin required for each.
- A13 SoftwareCo estimates a total cost of CU200,000 to create the software on the basis of 2,000 programmer hours at an hourly labour cost of CU100 (including overhead recovery). It also estimates 600 hours of support in year 1 and 400 hours in year 2 at an hourly labour cost of CU70 (including overhead recovery). Hence, the yearly estimated support costs are CU42,000 in year 1 and CU28,000 in year 2.
- A14 SoftwareCo requires a higher margin on customer-specified software development than on customer support. That is consistent with industry reports about programming and customer support when they are sold separately. SoftwareCo estimates that it would require a 40 per cent margin on its programming and a 20 per cent margin on its customer support.

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A15 Accordingly, SoftwareCo estimates stand-alone selling prices as follows:

	<i>Estimated labour cost</i>	<i>Estimated margin</i>	<i>Estimated selling price</i>
	A	B	A + B
	CU	CU	CU
Software	200,000	133,333	333,333
Support—year 1	42,000	10,500	52,500
Support—year 2	28,000	7,000	35,000
	<u>270,000</u>	<u>150,833</u>	<u>420,833</u>

A16 Those estimated selling prices result in the following allocation of the transaction price to the three performance obligations:

	<i>Estimated stand-alone selling price</i>	<i>Allocation of discount</i>	<i>Measurement of performance obligations</i>
	A	B	A – B
	CU	CU	CU
Software	333,333	16,501 ^(a)	316,832
Support—year 1	52,500	2,599 ^(b)	49,901
Support—year 2	35,000	1,733 ^(c)	33,267
	<u>420,833</u>	<u>20,833</u>	<u>400,000</u>

(a) $CU20,833 \times (CU333,333 \div CU420,833)$
(b) $CU20,833 \times (CU52,500 \div CU420,833)$
(c) $CU20,833 \times (CU35,000 \div CU420,833)$

A17 At 30 June 20X0, the measurement of the remaining customer support performance obligations is CU83,168 (CU49,901 + CU33,267). Revenue of CU316,832 (CU400,000 – CU83,168) is recognised on the transfer of the software. The obligation to provide the first year of support is satisfied continuously over that year (and revenue of CU49,901 is recognised) so that the remaining customer support obligation at 30 June 20X1 is measured at CU33,267. SoftwareCo satisfies continuously its obligation to provide the second year of customer support and recognises revenue of CU33,267 over that year.

- A18 This example illustrates one way in which an entity could determine stand-alone selling prices for the goods and services underlying performance obligations. Other methods might also produce a reasonable estimate.

Example 3: Sale of a good with a warranty

- A19 This example illustrates how in the proposed model an entity would account for a standard warranty as a separate performance obligation. Hence, an entity would allocate some of the transaction price to the warranty performance obligation and would recognise revenue over the warranty period. That pattern of revenue recognition differs from present practice in cases in which an entity recognises all of the revenue on delivery of the good and, at the same time, recognises an expense and corresponding warranty liability. Consider the following:

<p>On 31 December 20X0 Manufacturer sells production equipment to a customer for CU5,000. Manufacturer includes a one-year warranty service with the sale of all its equipment. The customer receives and pays for the equipment on 31 December 20X0.</p>

- A20 Manufacturer's promises to transfer equipment and to transfer warranty coverage are performance obligations because the promised equipment and warranty coverage are assets. Although Manufacturer does not sell the warranty separately from the good, the warranty provides the customer with an asset (warranty coverage) that could be sold separately.
- A21 Manufacturer satisfies the obligation to transfer the equipment on 31 December 20X0 when the customer receives and pays for the equipment. At that time, the customer controls the equipment (the equipment is the customer's asset). Manufacturer satisfies the warranty services obligation continuously over the warranty period as it provides the warranty coverage. Because the equipment and the warranty service are transferred to the customer at different times, the two performance obligations are accounted for separately.
- A22 Manufacturer allocates the transaction price to the two performance obligations in proportion to the stand-alone selling prices of the good and the warranty. Manufacturer estimates those prices to be CU4,950 for the equipment and CU50 for the warranty. Because the sum of the estimated stand-alone selling prices equals the total transaction price, Manufacturer's estimated stand-alone selling prices for the equipment and the warranty service are also the amounts allocated to each performance obligation.

- A23 Manufacturer recognises revenue of CU4,950 when it transfers the equipment to the customer on 31 December 20X0. Manufacturer then has a contract liability of CU50 from its remaining warranty service obligation (Manufacturer has no remaining rights). That obligation is satisfied, and revenue recognised continuously, during 20X1. Example 4 illustrates how an entity would determine the amount of revenue to recognise in each reporting period.

Example 4: Allocation of revenue over many reporting periods

- A24 This example illustrates how an entity would recognise revenue when a performance obligation is satisfied over many reporting periods. Consider the following:

On 31 December 20X0 Retailer sells a television to a customer. The customer also buys a three-year warranty from Retailer. Retailer normally sells the television and warranty separately for CU2,000 and CU400, respectively. However, as part of a year-end promotion it sells the television and warranty together at the reduced price of CU2,300. The customer pays in full at the point of sale and takes immediate delivery of the television.

When a warranty claim arises, Retailer processes the claims and repairs or replaces the television. Its experience with that type of television suggests a 5 per cent likelihood that a claim will be filed during the first year of warranty coverage and a 5 and 10 per cent likelihood of a claim in the second and third years, respectively.

- A25 As in Example 3, Retailer's promises to transfer the television and the warranty service are performance obligations. They are accounted for separately because the underlying assets are transferred to the customer at different times.

- A26 Retailer allocates the transaction price to the two performance obligations on the basis of the stand-alone selling prices of CU2,000 and CU400 for the television and warranty, respectively. That allocation is as follows (rounded to the nearest whole currency unit):

	<i>Stand-alone selling price</i>	<i>Allocation of discount</i>	<i>Measurement of performance obligations</i>
	A	B	A – B
	CU	CU	CU
Television	2,000	83	1,917
Warranty	400	17	383
	<u>2,400</u>	<u>100</u>	<u>2,300</u>

- A27 Retailer recognises revenue as it satisfies each performance obligation. Hence, revenue of CU1,917 is recognised when the television is transferred to the customer on 31 December 20X0. Retailer then has a contract liability of CU383 from the warranty service obligation (Retailer has no remaining rights).
- A28 The warranty service obligation is satisfied, and revenue recognised, continuously as the customer receives warranty coverage during 20X1, 20X2 and 20X3. Although Retailer satisfies the performance obligation continuously, the measurement of the performance obligation does not necessarily reduce on a straight-line basis (so revenue is not necessarily recognised on a straight-line basis). Rather, Retailer measures the remaining performance obligations at December 20X1 and 20X2 at the amount of the transaction price that would have been allocated to the remaining obligations at contract inception.
- A29 The transaction price would be allocated to each of those obligations on the basis of what Retailer would have charged for the warranty coverage for each increment of time on a stand-alone basis. Because those stand-alone prices would have been based on the expected claims profile (1:1:2), Retailer could reasonably allocate the transaction price over the three years on the basis of that profile. Hence, the contract liability would be measured at CU287 at 31 December 20X1 ($CU383 \times (3 \div 4)$) and CU192 ($CU383 \times (2 \div 4)$) at 31 December 20X2.

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A30 Therefore, Retailer's net contract position and revenue recognition are as follows:

	<i>Net contract position at end of year</i>	<i>Revenue recognised during year</i>
	CU	CU
20X1	287	96 ^(a)
20X2	192	95 ^(b)
20X3	–	192 ^(c)
(a) Decrease in contract liability from CU383 to CU287		
(b) Decrease in contract liability from CU287 to CU192		
(c) Decrease in contract liability from CU192 to nil		

A31 In this example, Retailer determines that it would have charged the customer more for warranty coverage in the third year of the warranty than in the first year. Accordingly, more of the transaction price is allocated to the third year of the warranty service obligation than to the first year (and Retailer recognises more revenue in the third year than in the first year). Conversely, if claims were expected to be higher in the first year compared with the third year, then Retailer would recognise more revenue in the first year than in the third year.

Example 5: Construction—continuous transfer of assets

- A32 This example illustrates how the pattern of revenue recognition would be determined in a construction contract in which assets are transferred continuously to the customer during construction. Consider the following:

On 31 March Contractor enters into a contract with a customer to renovate the customer's office building over nine months. The building will be renovated in two phases (floor 1 and floor 2) so that the customer will be able to use one of the floors while the other is being renovated. The stand-alone selling prices for renovating floor 1 and floor 2 are CU600,000 and CU400,000, respectively.

On 30 June Contractor has partially completed the renovation of floor 1. On 30 September Contractor completes the renovation of floor 1. Contractor starts the renovation of floor 2 on 1 October and completes it by 31 December.

For simplicity, assume that Contractor has no warranty obligations after 31 December, the customer prepays the CU1,000,000 and Contractor's costs for materials and labour are incurred and paid in the same period.

The expected costs (at inception) and actual costs are as follows:

	<i>Expected</i>	<i>Actual</i>
	CU	CU
Floor 1	500,000	550,000
Floor 2	300,000	300,000

During the period ended 30 June, Contractor incurs costs of CU300,000 (CU50,000 more than initially expected). Contractor does not incur any further increases in costs.

- A33 In this example, assets are transferred continuously to the customer. In other words, Contractor's renovation services and materials enhance the customer's asset throughout the renovation. Therefore, Contractor's performance obligation is to transfer construction services and materials continuously. That obligation is satisfied, and revenue recognised, as the services and materials are transferred continuously to the customer.
- A34 Conceptually, Contractor has a continuous series of individual performance obligations. Each service hour, brick and nail is a promised asset that is transferred to the customer. Hence, the measurement of the

remaining performance obligations at any date would be the amount of the transaction price that would have been allocated to those obligations at contract inception.

- A35 Practically, however, Contractor might separate the contract into two performance obligations—one for renovating each floor. Separating the contract by phase facilitates Contractor’s assessment of the pattern of assets transferred to the customer and the measurement of the obligations to transfer those assets.
- A36 At 30 June Contractor has obligations for the remaining renovation of floor 1 and all of floor 2. The latter would be measured at CU400,000, the stand-alone price for renovating floor 2. The former would be measured at the amount of the transaction price that Contractor would have allocated at contract inception to the obligation for the remaining renovation of floor 1.
- A37 At 30 June Contractor would assess how much of the renovation of floor 1 it has provided to the customer. In other words, Contractor would estimate the amount of the goods and services that have been transferred to the customer during the period ended 30 June as a proportion of the total goods and services to be transferred in renovating floor 1. On the basis of an examination of the work done and the work necessary to complete the floor 1 renovation, Contractor assesses that the floor 1 renovation was 50 per cent complete at 30 June.
- A38 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. However, in this example, using the incurred and expected costs to assess the transfer of goods and services to the customer would not be a reasonable proxy. Contractor assesses the floor 1 renovation as 50 per cent complete at 30 June. However, the costs incurred (CU300,000) as a proportion of the total expected costs (CU550,000) would suggest that the floor 1 renovation is 55 per cent complete. In other words, the cost overruns in the quarter ended 30 June did not result in an additional transfer of goods and services to the customer.
- A39 Hence, at 30 June Contractor measures its contract liability at CU700,000 (CU300,000 for the remaining obligation to renovate floor 1 and CU400,000 for floor 2). Contractor recognises revenue of CU300,000 (the decrease in the contract liability from CU1,000,000 to CU700,000) in the quarter ended 30 June.
- A40 At 30 September Contractor measures the contract liability at CU400,000 for the obligation to renovate floor 2 (Contractor has no remaining

rights). Contractor recognises revenue of CU300,000 (the decrease in the contract liability from CU700,000 to CU400,000) in the quarter ended 30 September.

A41 In the quarter ended 31 December, Contractor begins and completes the floor 2 renovation. Therefore, Contractor satisfies its remaining performance obligation and recognises CU400,000 of revenue.

A42 Summarised results are as follows:

	<i>31 Mar</i>	<i>30 June</i>	<i>30 Sept</i>	<i>31 Dec</i>	<i>Total</i>
	CU000	CU000	CU000	CU000	CU000
Revenue	–	300	300	400	1,000
Cost of sales	–	(300)	(250)	(300)	(850)
Margin	–	–	50	100	150
Contract liability	(1,000)	(700)	(400)	–	

Example 6: Construction—non-continuous transfer of assets

A43 This example illustrates the pattern of revenue recognition when an entity does not continuously transfer assets to a customer during a construction-type contract. Consider the following:

On 30 September 20X0 Boatbuilder contracts with a customer for a boat to be delivered on 1 April 20X1, for CU50,000. The customer is not obliged to pay Boatbuilder until delivery of the boat, at which point title to the boat passes to the customer. During construction, the customer has no control of the partially completed boat. For instance, the customer cannot take over the partially completed boat and engage another boat builder to complete it. If the customer cancels the contract before delivery, it must pay Boatbuilder for any work completed up to that time.

A44 In this example, Boatbuilder's performance obligation is the promise to deliver a boat to the customer in six months rather than the promise to provide construction services and materials. That is because the customer does not receive any assets until the boat is transferred to the customer on 1 April 20X1. In other words, the customer does not control

the boat until 1 April 20X1. Until that time, the boat is Boatbuilder's inventory. Hence, Boatbuilder satisfies its performance obligation and recognises revenue on 1 April 20X1 when it transfers the boat to the customer.

- A45 If Boatbuilder measures the boat at the lower of cost and net realisable value while it is being built, no profit is recognised from this contract until the performance obligation is satisfied on 1 April 20X1.

Example 7: Non-refundable upfront payment—no initial revenue recognition

- A46 This example illustrates how an entity's activities in fulfilling a contract do not necessarily result in the transfer of assets to a customer. Consider the following:

HealthCo operates a chain of health clubs. HealthCo enters into a contract with a new customer that entitles the customer to use any of its health clubs for one year. The customer pays a non-refundable upfront fee and promises to pay an ongoing monthly fee for one year. At contract inception, HealthCo registers the customer in its membership database and gives the customer a membership card that enables the customer to use any of its health clubs for one year.

- A47 To provide the customer with access to its health clubs, HealthCo registers the customer in its membership database. However, that activity does not transfer a promised asset to the customer. The customer's enforceable right to access the health clubs for one year is a right that the customer already had as a result of entering into the contract. The asset promised under the contract (one year of access to a chain of health clubs) can be provided to the customer only over one year.
- A48 Therefore, HealthCo's only performance obligation is to provide access to its health clubs for one year. That performance obligation is satisfied continuously over one year as access is provided. Hence, the upfront fee is allocated to that performance obligation so that no revenue is recognised from registering the customer.

Example 8: Contract origination costs

- A49 This example illustrates the effect on profit or loss when an entity's costs of obtaining a contract are recognised as an expense as incurred. Consider the following:

On 31 December 20X0 Outsourcer enters into a contract with a customer to provide IT services for five years. The services will be provided continuously from 1 February 20X1. As a result of obtaining the contract, Outsourcer's sales team is due a (non-refundable) commission of CU100,000.

- A50 In this example, Outsourcer has performance obligations to provide IT services. None of those obligations is satisfied until February 20X1, so no revenue is recognised until that time.
- A51 On 31 December 20X0, Outsourcer incurs a commission cost of CU100,000. Although that cost relates to a contract that will be fulfilled at a later date, the commission cost does not give rise to an asset qualifying for recognition. Hence, Outsourcer recognises the cost as an expense on 31 December 20X0.

Appendix B

Subsequent measurement alternatives

- B1 As Chapter 5 mentions, some prefer an approach of measuring an entity's performance obligations at each financial statement date, rather than only when the entity deems a performance obligation onerous. In other words, they favour an explicit measurement approach rather than an allocated transaction price approach that remeasures only when a performance obligation is deemed onerous by exception.
- B2 Proponents of that view prefer explicit measurement at each financial statement date for several reasons. One reason is that explicit measurement would capture both unfavourable and favourable changes in prices and circumstances that occur after contract inception. Another reason is that an explicit measurement would result in a more timely recognition of changes in an entity's net position in a contract.
- B3 This appendix discusses three approaches that could be used for subsequent measurement of performance obligations:
- (a) current exit price approach
 - (b) transaction price approach
 - (c) building block approach.

Current exit price approach

- B4 Chapter 5 discusses a current exit price approach for measuring performance obligations at contract inception. Although the boards rejected that approach as the general approach for measuring performance obligations, they could require its use for measuring some performance obligations, both initially and subsequently. Using that approach, an entity would measure its bundle of remaining performance obligations at any financial statement date at the amount that the entity would be required to pay to transfer those performance obligations to a third party on that date. That measurement approach would capture any change in circumstances affecting the current exit price, and an entity would recognise those changes in the period in which they arise.
- B5 Some think that if a current exit price for a performance obligation is observable, then an entity should use it to measure a performance obligation at each financial statement date. However, as Chapter 5 notes, current exit prices of performance obligations often are not observable. Even if an exit price is observable at contract inception, it may not be

observable after contract inception for a performance obligation that has been partially satisfied. For instance, in some markets entities can legally transfer warranty obligations to third parties at contract inception (ie there is an observable price for a new warranty obligation). However, entities may be less able to legally transfer the warranty obligation after the warranty period begins (ie there is no observable price for a partially satisfied warranty obligation). Hence, an approach in which an entity measures performance obligations at current exit price only if the price is observable would not include all of the performance obligations that some think should be measured at each financial statement date.

- B6 An entity could, of course, estimate a current exit price of a performance obligation. But as Chapter 5 discusses, some have concerns about the complexity of estimating current exit prices of performance obligations. Those concerns primarily relate to estimating the margin required for the remaining performance obligations at that date. It can be difficult for an entity to estimate the margin a third party would demand at each financial statement date for a partially satisfied performance obligation, especially in the absence of observable inputs.
- B7 Moreover, if an entity measures some performance obligations at a current exit price, the measurement might not be consistent with the boards' preliminary view on initial measurement. As discussed in Chapter 5, the boards have expressed a preliminary view that an entity should initially measure performance obligations at the original transaction price in the contract.

Transaction price approach

- B8 Another approach for measuring performance obligations after contract inception would be to use a current transaction price. That approach would be consistent with the boards' preliminary view on measuring performance obligations at contract inception.
- B9 In the proposed model, the original transaction price is allocated to performance obligations on the basis of the relative stand-alone selling prices of the underlying promised goods or services. At subsequent financial statement dates, the measurement of remaining performance obligations is the sum of the amounts allocated to those performance obligations at contract inception. Instead of measuring the remaining performance obligations based on those allocated amounts, performance obligations could be measured at subsequent dates at the current price that the entity would charge a customer for the remaining bundle of goods and services.

- B10 To determine that price, an entity would use its own selling price for that bundle of goods and services if those goods and services are sold as a bundle. If the entity does not sell that bundle of goods and services, the entity would estimate the price for which it would sell that bundle of remaining goods and services at the financial statement date.
- B11 Using a current transaction price to measure performance obligations after contract inception could create challenges for an entity similar to those a current exit price approach creates. In particular, the entity would often need to estimate a margin, including a margin for performance obligations that have been partially satisfied.

Building block approach

- B12 A third approach to measure performance obligations after contract inception is based on the components or building blocks of the original transaction price. By viewing the transaction price as consisting of components or building blocks, the boards could specify that some of those components should be updated after contract inception rather than all of them. Therefore, such an approach could avoid the challenge of the previous two approaches in estimating a current margin that the entity (or the market) would charge on the remaining bundle of goods and services.
- B13 Consider the three components or building blocks of a transaction price described in paragraph 5.9. Those components are the entity's expected costs, the time value of money and margin. For simplicity, this appendix ignores the time value of money.
- B14 To measure a performance obligation after contract inception, an entity could initially estimate the costs, ie the probability-weighted expected amount of direct and indirect costs required to satisfy the performance obligation. The entity could then determine the margin at contract inception by calculating the difference between the transaction price and the expected costs to satisfy the performance obligations.
- B15 At any subsequent financial statement date, an entity could update the cost component to reflect *current* estimates of future costs. However, instead of updating the margin component, the entity could use the margin implied at contract inception.
- B16 This building block approach differs from the allocated transaction price approach (Chapter 5) that locks in the measurement of a performance obligation and does not update *any* of its components unless it is deemed

onerous. In contrast, the building block approach would update at least the cost component, thereby capturing more current information in the measurement. In other words, only the margin component would be locked in.

- B17 If an entity locks in the margin at contract inception, the boards would need to specify how much of that margin should be included in the measurement of the remaining performance obligations at each financial statement date. One method is for the entity to measure the remaining performance obligations at an amount equal to the entity's expected costs of satisfying them, marked up by the margin percentage implied at contract inception. Another method is to recognise the margin in proportion to the pattern of an entity's performance in the contract.
- B18 To illustrate those two methods, consider the following example:

WarrantyCo sells 20 identical three-year warranties on 31 December 20X0 for CU500 each. At that date it expects a 5 per cent probability of a claim arising on any warranty in each of the first two years and 10 per cent in the third year. The cost of a claim is CU1,000. Other costs associated with the warranties are CU25 per warranty per year.

Suppose that at 31 December 20X1 WarrantyCo expects no change in the probability of claims in 20X2 and 20X3. However, the expected costs of satisfying a claim increase to CU1,050.

Further suppose that at 31 December 20X2, WarrantyCo has current information that suggests a 15 per cent chance of a claim arising in 20X3. The expected cost of a claim remains the same (CU1,050) at that date.

Therefore, the expected costs at each financial statement date are as follows:

31 December 20X0	CU5,500 ^(a)
31 December 20X1	CU4,150 ^(b)
31 December 20X2	CU3,650 ^(c)

Assume that actual costs in each year equal the amount expected at the end of the previous year.

(a) $(20\% \times 20 \text{ warranties} \times \text{CU}1,000) + (20 \text{ warranties} \times \text{CU}25 \times 3 \text{ years})$

(b) $(15\% \times 20 \text{ warranties} \times \text{CU}1,050) + (20 \text{ warranties} \times \text{CU}25 \times 2 \text{ years})$

(c) $(15\% \times 20 \text{ warranties} \times \text{CU}1,050) + (20 \text{ warranties} \times \text{CU}25 \times 1 \text{ year})$

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B19 In the first method of recognising the margin throughout the contract, WarrantyCo would measure its remaining performance obligations by marking up its current expected costs by the margin implied at contract inception, as follows:

	<i>Expected costs</i>	<i>Margin</i>	<i>Measurement of performance obligations</i>
	CU	CU	CU
31 December 20X0	5,500	4,500 ^(a)	10,000
31 December 20X1	4,150	3,395 ^(b)	7,545
31 December 20X2	3,650	2,986 ^(c)	6,636

(a) Margin implied by the transaction price (CU10,000 transaction price - CU5,500 expected costs at contract inception)

(b) $CU4,150 \text{ expected costs at 31 December 20X1} \times CU(4,500 \div 5,500)$

(c) $CU3,650 \text{ expected costs at 31 December 20X2} \times CU(4,500 \div 5,500)$

B20 To recognise revenue at an amount equal to the transaction price, WarrantyCo could present the effects of the changes in circumstances (ie the 20X1 CU50 increase in the expected cost of a claim and the 20X2 increase in the expected number of claims) as a contract gain or a contract loss. Therefore, under the first method WarrantyCo could present the following:

	20X0	20X1	20X2	20X3	Total
	CU	CU	CU	CU	CU
Revenue ^(a)	–	2,727	2,727	4,546	10,000
Expenses	–	(1,500)	(1,550)	(3,650)	(6,700)
Net contract (loss)/gain	–	(273) ^(b)	(1,818) ^(c)	2,091 ^(d)	–
Margin	–	954	(641)	2,987	3,300
Contract liability	10,000	7,545	6,636	–	

(a) Revenue is the amount that WarrantyCo would have recognised had there been no change in circumstances. On the basis of the expected costs at contract inception, WarrantyCo would have allocated the transaction price to each year of warranty coverage as follows:

20X1 $CU2,727 = CU10,000 \text{ transaction price} \times (CU1,500 \text{ expected costs in } 20X1 \div CU5,500 \text{ total expected costs})$

20X2 $CU2,727 = CU10,000 \text{ transaction price} \times (CU1,500 \text{ expected costs in } 20X2 \div CU5,500 \text{ total expected costs})$

20X3 $CU4,546 = CU10,000 \text{ transaction price} \times (CU2,500 \text{ expected costs in } 20X3 \div CU5,500 \text{ total expected costs})$

(b) The contract loss of CU273 is the remeasurement of the performance obligation in 20X1 arising from the increase in the expected costs during 20X1 [$CU50 \text{ increase in cost per claim} \times 3 \text{ claims} \times CU(10,000 \div 5,500)$].

(c) The contract loss of CU1,818 is the remeasurement of the performance obligation in 20X2 arising from (i) the increase in the expected number of claims during 20X2 [$1 \text{ additional claim} \times CU1,050 \times CU(10,000 \div 5,500)$] and (ii) the reversal of part of the remeasurement recognised in 20X1 that relates to the performance obligation satisfied in 20X2 [$\text{increase in claim cost of } CU50 \times CU(10,000 \div 5,500)$].

(d) The contract gain of CU2,091 is the reversal of part of the remeasurements recognised in 20X1 and 20X2 that relate to the performance obligations satisfied in 20X3 [$\text{increase in claims of } CU1,050 + \text{increase in claim costs of } CU100 \times CU(10,000 \div 5,500)$].

PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

B21 A second method to determine how much margin to include in the measurement of the remaining performance obligations at each financial statement date is to recognise the margin in proportion to the pattern of performance. In this example, that could be assessed by considering actual costs incurred as a proportion of total expected costs, as follows:

	<i>Costs incurred to date</i>	<i>Remaining expected costs</i>	<i>Total expected costs</i>	<i>Proportion of remaining performance</i>	<i>Proportion of remaining margin</i>	<i>Measurement of performance obligations</i>
	A	B	C = A + B	D = B ÷ C	E = D × CU4,500 ^(a)	B + E
31 Dec	CU	CU	CU	%	CU	CU
20X0	–	5,500	5,500	100.00	4,500	10,000
20X1	1,500 ^(b)	4,150	5,650	73.45	3,305	7,455
20X2	3,050 ^(c)	3,650	6,700	54.48	2,452	6,102

(a) CU4,500 is the margin implied by the transaction price (CU10,000 transaction price – CU5,500 expected costs at contract inception)

(b) CU1,000 claim costs + (20 warranties × CU25 × 1 year)

(c) CU2,050 claim costs + (20 warranties × CU25 × 2 years)

- B22 Assuming that the effects of the changes in circumstances are presented as a contract gain or loss, WarrantyCo would present the following under this second method:

	20X0	20X1	20X2	20X3	Total
	CU	CU	CU	CU	CU
Revenue	–	2,727	2,727	4,546	10,000
Expenses	–	(1,500)	(1,550)	(3,650)	(6,700)
Net contract (loss)/gain ^(a)	–	(182)	(1,374)	1,556	–
Margin	–	1,045	(197)	2,452	3,300
Contract liability	10,000	7,455	6,102	–	

(a) The net contract (loss)/gain is the amount of the change in the performance obligations that is attributed to the change in circumstances each year, as follows:

20X1 Total change in the performance obligation is CU2,545 (CU10,000 – CU7,455). Of this change, CU2,727 is attributed to the entity's performance (revenue) and – CU182 (CU2,545 – CU2,727) to the change in circumstances.

20X2 Total change in the performance obligation is CU1,353 (CU7,455 – CU6,102). Of this change, CU2,727 is attributed to the entity's performance (revenue) and – CU1,374 (CU1,353 – CU2,727) to the change in circumstances.

20X3 Total change in the performance obligation is CU6,102. Of this change, CU4,546 is attributed to the entity's performance (revenue) and CU1,556 (CU6,102 – CU4,546) to the change in circumstances.

- B23 This building block approach does not result in measurements that can be expressed as an attribute of the performance obligation. In other words, the resulting measurements do not represent an economic attribute of the performance obligation at the financial statement date, such as a price or a value at that date. Nonetheless, some think that updating at least some components in the measurement results in more decision-useful information than locking in all the components.

Summary

- B24 This appendix briefly considers how a subsequent measurement approach could work and how it might remeasure those obligations that some think are not handled well by an allocated transaction price approach. This appendix illustrates that a current exit price measurement approach is not the only alternative to an allocated transaction price approach.
- B25 The IASB has discussed various measurement approaches in the insurance contracts project. Those approaches use building blocks similar to those described in this appendix. However, the IASB considered how building blocks could be used to arrive at a measurement attribute that would provide a clear objective to resolve issues in measuring insurance contracts.

Appendix C

Topics not covered in this discussion paper

C1 This discussion paper does not address the topics listed in the following table. The boards expect to discuss these topics at future meetings as they develop a draft standard.

Topic	Description
Scope of a general revenue recognition standard	The boards will decide whether any particular types of transactions should be excluded from the scope of the standard.
Contracts with customers	Among the issues the boards will consider are: <ul style="list-style-type: none"> • contract renewal and cancellation options (including return rights) • combining contracts • changes in the contract's terms and conditions after contract inception.
Measurement of rights	Among the issues the boards will consider are: <ul style="list-style-type: none"> • time value of money • uncertainty (including credit risk and contingent consideration) • non-cash consideration.
Identification of performance obligations	The boards will consider the application guidance required to help entities identify performance obligations consistently.
Satisfaction of performance obligations	The boards will consider the application guidance required to help entities assess when performance obligations are satisfied.
Measurement of performance obligations	The boards will consider developing application guidance on how an entity should determine stand-alone selling prices for the purpose of allocating the transaction price to separate performance obligations.

PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS

Alternative measurement approach	If the boards conclude that a different measurement approach is required for some contracts, they will consider the criteria for determining when that approach is required and the measurement basis for that approach.
Onerous contracts	The boards will consider: <ul style="list-style-type: none"> • which costs should be included in the onerous test and in the remeasurement of an onerous performance obligation • at what unit of account the test should operate (eg a single performance obligation, the remaining performance obligations in a contract or a portfolio of homogeneous performance obligations).
Presentation	The boards will consider: <ul style="list-style-type: none"> • gross or net presentation of the rights and obligations in the contract • gross or net presentation of contract liabilities and contract assets • display of remeasurements in the statement of comprehensive income • gross versus net presentation of revenue.
Disclosure	The boards will consider the disclosures required to improve the decision-usefulness of information provided to users of financial statements.
Transition and effective date	The boards will consider the effective date of the general revenue recognition standard and the transition guidance required.

Consequential amendments to other standards	The boards will consider the required consequential amendments to IFRSs and US GAAP, including: <ul style="list-style-type: none"><li data-bbox="657 566 1171 680">• the effect of a new revenue recognition standard superseding existing revenue recognition standards that also include cost recognition guidance<li data-bbox="657 701 1171 815">• the effect of a new contract-based revenue recognition standard on existing standards that permit the recognition of revenue in the absence of a contract with a customer.
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