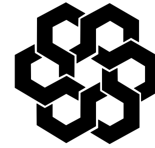

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INFORMATION FOR OBSERVERS

Board Meeting: **17 April 2008, London**

Project: **Revenue Recognition**

Subject: **Performance obligations (Agenda paper 11C)**

CHAPTER 3 (DRAFT)

DEFINITION OF A PERFORMANCE OBLIGATION

1. In a contract between an entity and a customer, the entity promises to provide goods or services in exchange for consideration from the customer. These promises represent performance obligations of the entity and are sometimes referred to as "deliverables" or "elements" in existing literature. This chapter considers how to define performance obligations and identify them within a contract.

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

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

3. What the Boards mean by a contract between an entity and a customer was discussed in the previous chapter. However, the words "promise" and "economic resource" need further explanation, as does the notion of "transferring" an economic resource.

Promises in a Contract

4. The promise underpinning a performance obligation is typically explicitly stated in the contract itself. For example, a contract to deliver a good in six months' time typically details the specifications of the desired good. Similarly, a contract to provide cleaning services typically includes details such as how often the cleaning will be done and the extent of cleaning required. Such explicit promises within a contract are easily identified.

5. However, a promise may also arise when entering into a contract even though the contract itself makes no mention of the promise. For example, when a manufacturer sells a product, local law may require the manufacturer to warrant the product for a certain period of time. Even if the contract makes no mention of this warranty, the promise to provide such warranty coverage exists. In this way, the warranty obligation imposed by statutory requirement is an implicit promise that is added to a contract between the manufacturer and the customer. And this implicit promise gives rise to a performance obligation just as an explicit promise would. Whether by the explicit terms of the contract or by requirements imposed by law, any promise to transfer an economic resource to the customer that arises as a result of entering into the contract is a performance obligation of the entity.

Economic Resource

6. In the definition of a performance obligation, the focus of the promise is an economic resource. In recent work on the conceptual framework project, the Boards have proposed the following tentative definition of an economic resource:

> **An economic resource is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources.**

Goods

7. Goods such as computers, oil, and machinery represent economic resources because they are scarce and they can produce cash inflows or reduce cash outflows for the person or entity that owns them. These goods can produce direct cash inflows for the entity by their sale to another party (including a customer). These goods can also produce indirect cash inflows for an entity as they are used alone or together with other economic resources to produce other goods and services that can be exchanged for cash inflows. Because goods represent economic resources, any promise (in a contract between an entity and a customer) to transfer a good gives rise to a performance obligation.

8. A patented process that reduces the amount of inputs needed to build a product is another example of an economic resource (in this case, an intangible good) because the process is scarce and it can produce cash inflows or reduce cash outflows for its owner. For instance, the entity that owns the process (via the patent) could license the use of the process to a third party, and thus receive direct cash inflows from the licensee. The process also is considered an economic resource because the entity's own use of the process can reduce cash outflows expended on inputs. Because the process represents an economic resource, any promise (in a contract between an entity and a customer) to allow the use of the process represents a performance obligation.

9. The fact that a good (tangible or intangible) can be bought or sold separately on the market is a clear indication that the good is an economic resource. In fact, this simple test can often be used as a shortcut for determining whether a good is scarce and has the capacity, alone or together with other economic resources, to increase cash inflows or reduce cash outflows. An entity could sell a good, and a customer would buy a good, only if that good was indeed scarce and had the capacity to increase cash inflows or reduce cash outflows.

10. Applying this simple test (that is, asking whether a good can be bought or sold separately) will often identify more goods than those explicitly promised in the contract. This is because many contracts are not written in great detail—indeed, many contracts are not written at all. For example, a contract in which

a painting company promises to paint a customer's house may make no mention at all about the paint that will be used to paint the house. In fact, painting contracts are often thought of in terms of the painting services only, and paint is merely considered an input into that service. However, examination of the contract clearly identifies paint as an economic resource to be transferred to the customer because paint can be bought and sold separately. As a result, the promise to transfer paint is its own performance obligation.

11. This example underscores the fact that a good does not have to be explicitly promised in a contract to give rise to a performance obligation. If a good must be transferred to the customer to fulfill a contract, whether explicitly mentioned or not, that promised good gives rise to a performance obligation.

Services

12. Services also represent an economic resource in that the service is scarce (that is, not freely available) and it has the capacity, alone or in combination with other economic resources of the recipient, to increase cash inflows or reduce cash outflows. Both Boards explain elsewhere that services represent economic resources or assets:

> The *Framework* defines an asset and explains that the term 'asset' is not limited to resources that can be recognised as assets in the balance sheet (*Framework*, paragraphs 49 and 50). 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 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 Statement of Financial Accounting Concepts No.6, *Elements of Financial Statements*, paragraph 31).

13. Because a service is an economic resource, the promise within a contract to provide a service is considered a performance obligation. As with goods, a simple test to identify performance obligations for services in a contract is whether the promised service can be bought or sold separately. If the service

14. A difficulty arises when trying to determine whether an activity required to provide a promised service also should be treated as a separate performance obligation. For example, in promising to deliver cleaning services, an entity must assemble a workforce and obtain cleaning supplies in order to ultimately deliver cleaning services to the customer. Do the activities of assembling a workforce and obtaining cleaning supplies constitute separate services that give rise to performance obligations, even though not separately promised?

15. Before answering too quickly, consider that either of these actions—assembling a workforce or obtaining cleaning supplies—can be bought or sold separately in a market. For example, rather than hiring cleaning employees itself, an entity could contract with an employment agency to provide a cleaning crew for the entity's building. The entity could also contract separately with a local cleaning supplies store to provide cleaning supplies. Having assembled the cleaning crew and obtained the supplies, the entity would then only need to pay for the cleaning service itself by paying the newly contracted cleaning crew. So, in a contract in which all of these services are combined, and in which no mention of assembling a workforce or obtaining cleaning supplies is made, do either of these activities represent a separate performance obligation?

16. As discussed in paragraph 2, the definition of a performance obligation is an entity's promise in a contract between an entity and a customer to *transfer an economic resource* to that customer. For activities such as assembling a workforce and obtaining cleaning supplies to be a performance obligation, the activity must actually transfer an economic resource to the customer. In the cleaning services example, the effort to assemble a workforce does not transfer an economic resource to the customer. Although assembling a workforce puts the cleaning service entity that much closer to providing cleaning services, the assembled workforce is not transferred to the customer. Similarly, obtaining cleaning supplies does not necessarily transfer an economic resource to the customer. The obtaining of cleaning supplies (that is, changing the location

property of the cleaning supplies) is an economic resource to the entity if the cleaning supplies are still an asset of the entity. Because the activities of assembling a workforce and obtaining cleaning supplies do not transfer an economic resource to the customer, they do not give rise to performance obligations.

17. In summary, a good is an economic resource, and the promise to transfer a good constitutes a performance obligation. A service also is an economic resource, and the promise to provide a service to a customer constitutes a performance obligation.

Transferring an Economic Resource

18. The definition of a performance obligation emphasizes the word "transfer." In fact, the previous sections have used that word a number of times already without describing what it means. The Boards provide a hint at what transfer might mean in their tentative working definition of an asset in the conceptual framework project:

> **An asset of an entity is a present economic resource to which, through an enforceable right or by other means, the entity has access or can limit access by others.**

19. For an economic resource to be an asset of an entity, the entity must be linked to that economic resource by either an enforceable right or some other means that gives the entity access to the resource or the ability to limit access by others. In a contract in which an entity has promised to transfer an economic resource, the entity must therefore transfer to the customer the enforceable right or other access to that economic resource. Until the customer obtains this enforceable right or access to the promised resource, the entity has not satisfied its performance obligation. In this regard, performance in the proposed model is about output (of economic resources) to customers and not activity of the entity under the contract.

20. Based on this reasoning, a promise to transfer an economic resource exists in any situation in which an entity promises to transfer to the customer an enforceable right or other access to an economic resource. When an entity

promises to transfer a good, it means that the entity is promising to transfer to the customer the enforceable right or access to that good. When an entity promises to provide a service, it means that the entity is promising to transfer access to a resource, even though the resource itself may be simultaneously consumed.

IDENTIFYING PERFORMANCE OBLIGATIONS

21. With the definition of a performance obligation in mind, a few concrete examples can now be considered to see how readily performance obligations can be identified. The following examples will be considered:

- painting (paragraphs 22-28)
- goods sold with a right of return (paragraphs 29-35)
- promotional promises (paragraphs 36-48)

Note that this section only focuses on identifying performance obligations. The next chapter will focus more carefully on how to determine when a performance obligation is satisfied.

Painting

22. Consider the following example:

> PainterCo is a contractor that provides painting services for private residences. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3000. The price is inclusive of all paint, which PainterCo buys from its paint wholesaler. The customer is given the option to buy its own paint, for a corresponding reduction in the contract price, although the customer does not opt to do so.
>
> All paint and materials necessary to complete the contract are delivered to the customer's house on June 30, the end of PainterCo's reporting period. PainterCo renders the painting services continuously from July 1 through July 10. In accordance with the contract terms, the customer pays in full upon completion of the house painting.

23. Based on the discussion in the previous section, performance obligations can be identified by searching a contract for promises to transfer goods and services to a customer. If a contract requires the provision of a number of goods, each good represents a separate performance obligation if that good can be bought or sold separately. Similarly, when multiple services are promised,

each promised service represents a separate performance obligation if it can be bought or sold separately.

24. In this painting services contract, there are a number of goods that PainterCo must transfer to the customer in the process of painting or preparing to paint the customer's house. These include the following:

- putty
- primer
- paint

Because each one of these goods can be bought or sold separately and because PainterCo must transfer each of them to the customer to complete the promised painting services, each good gives rise to a performance obligation.

25. It is important to note that PainterCo does not necessarily have to account for each of these performance obligations separately. After identifying the promised goods in this contract, if PainterCo determines that all of these goods transfer to the customer at the same point in time (a question dealt with in Chapter 4), then the separate performance obligations can be treated as a single unit of account. The important point here is that each good represents its own performance obligation. When those goods actually transfer to the customer does not determine whether the good gives rise to a performance obligation.

26. In this painting services contract, there are also a number of services that PainterCo promises to provide to the customer, including:

- prepping the house
- painting
- project management
- performance guarantee

27. In a typical painting services contract, PainterCo will have to prepare the house to be painted (by power-washing it, scraping off any loose paint, puttying any holes, and priming the surface), paint the house, manage any employees or subcontractors hired to do these tasks, and stand ready to fix or repair any substandard work done during any of these tasks. Because each one of these services can be bought or sold separately, each one represents a performance obligation. Again, this does not necessarily mean that PainterCo

28. Of course, in such a simple painting services contract, it is somewhat artificial to think of project management being a separately promised service. Nonetheless, this example is in principle the same as a more complex construction contract, and the project management obligation is therefore similar to the obligation that a general contractor would have in such a contract. Indeed, each of these resources is currently sold separately in a number of different industries.

Goods Sold with a Right of Return

29. As a second example, consider the following situation:

> RetailCo is an electronics retailer that requires customers to pay for its goods before leaving the store. The printed receipt given to customers clearly states that (in accordance with local law) the title to purchased goods transfers to the customer at the point of payment. The receipt also indicates that the customer can return any good within 90 days for a full refund as long as the good is in its original packaging and in good condition.

30. In this example, the goods that RetailCo promises to transfer to the customer clearly give rise to performance obligations. The more difficult question is whether RetailCo's promise to accept returns gives rise to a performance obligation. As a reminder, a performance obligation is defined as a promise in a contract between an entity and a customer to transfer an economic resource to that customer. RetailCo clearly promises to accept returns, and this promise arises from entering into a contract with a customer. So, the question is whether RetailCo's return right represents an economic resource promised to the customer. If the return right is an economic resource that transfers to the customer, then the promise of a return right meets the definition of a performance obligation.

31. There are two strongly held views regarding this question. The first view argues that a return right is an economic resource. A return right provides

customers a window of time in which they can change their minds about the purchase. This additional time is an economic resource to the customer for one key reason—it can sometimes be bought and sold separately. Customers sometimes purchase this option separately when buying flexible airline tickets and hotel reservations. Some entities even charge a separate "restocking fee" to customers who choose to return goods. Thus, the customer is clearly in a better position having the return right than if it did not. In this way, a return right represents an economic resource promised to the customer. As a result, proponents of this view conclude that return rights represent a separate performance obligation in the contract.

32. The second view argues that return rights convey to customers an ability to cancel or unwind the sale. Because the customer has the ability to cancel or unwind the sale, return rights simply represent the potential for an incomplete or failed sale. Proponents of this view argue that when a customer obtains a good with a right to return that good for a full refund, it is uncertain whether a performance obligation to transfer a good has actually been satisfied. In essence, it is uncertain whether the enforceable rights or other access to the good have actually been taken by the customer. In cases where a return right exists and a customer has paid in advance, the entity treats that advance as a deposit or refund obligation until the customer has accepted the enforceable rights or other access to the good.

33. This second view meets with difficulties on two different fronts. First, treating all sales of goods with a right of return as deposit or refund obligations precludes revenue recognition for the vast majority of retail sales at the point of sale because most retail sales are made with a right of return. Some argue that reliable historical evidence about the likelihood of returns can be used to estimate the percentage of customers who have accepted a good as of a particular point in time. However, this estimate can only indicate the number of customers who are likely to let the return right expire. Until the return period actually expires, all customers still have the right to return the good.

34. The other difficulty with this second view is that it ignores the fact that RetailCo has actually transferred the electronic good to the customer at the

point of sale. That is, according to contract terms plainly stated on the customer's receipt and consistent with the operation of local law, the customer has title—and thus the enforceable rights or access—to the electronic good when he leaves the store. If RetailCo is required to treat all or even a small portion of sales as refund obligations, RetailCo may also want to delay recognizing an expense for the cost of the good. As a result, it may continue to recognize the electronic good as its asset (perhaps described as inventory subject to return). This would not be a faithful depiction of the actual circumstances because RetailCo has *no* present rights to that good. If RetailCo has transferred to the customer the enforceable rights or other access to the good at the point of sale, then RetailCo no longer has an obligation to transfer that good to the customer.

35. The Boards have not reached an agreement on this issue. Because the treatment of return rights can have a significant effect on the timing and amount of revenue recognition, the issue will be revisited again in more detail later in the discussion paper.

Promotional Promises

36. As a final example in this chapter, consider an entity's promise to sell products or services in the future at a discount. When does such a promise result in a performance obligation? Consider the following situation:

> TuneCo is a manufacturer of music players and an online retailer of music. As part of its spring sale, TuneCo is offering with each of its music players a gift card for CU20 worth of free online music.
>
> SongCo is a competitor of TuneCo that also manufacturers music players and retails music online. As part of its spring sale, SongCo is offering with each of its music players a discount card for 20% off its online music, for purchases up to CU100 in value (CU20 maximum discount savings).
>
> TuneCo's gift card and SongCo's discount card expire after one year.

37. When a customer purchases music players from either of these entities, it receives a promised discount on a future product or service. In the case of TuneCo, the customer receives a music player and a gift card that offers a discount of 100% on CU20 worth of online music. In the case of SongCo, the

customer receives a music player and a discount card that offers a discount of 20% on up to CU100 worth of online music. What are the performance obligations in these two situations?

38. In both of these contracts, the promise to transfer a music player to the customer represents a performance obligation. The music players can be bought and sold separately without the gift and discount cards, indicating that they are economic resources on their own. The promise within a contract with a customer to transfer a music player is a performance obligation of the entity.

39. Determining whether the gift card and discount card represent performance obligations is more difficult. TuneCo's inclusion of a gift card in its contract represents a promise to transfer up to CU20 worth of online music in the future, whenever the customer exercises the gift card. Online music is clearly an economic resource in that it can be bought and sold separately. Thus, a promise to transfer online music within a contract with a customer gives rise to a performance obligation.

40. It is important to note here that the gift card itself is not the promised economic resource. It is the online music that is the promised economic resource. The promise to provide the gift card is not itself a performance obligation because the gift card represents the claim that the customer has against TuneCo. In other words, the gift card represents the customer's claim to a promised economic resource, much like a contract can represent a customer's claim to a promised economic resource. TuneCo is not in the business of providing gift cards, but is instead in the business of providing goods (music players and music).

41. Now consider SongCo's contract with its customer. SongCo's 20% discount card also represents a promise to transfer online music—in this case up to CU100 worth of online music for 20% off—whenever the customer exercises the discount card. Here again, online music is clearly an economic resource in that it can be bought and sold separately. Thus, SongCo's promise to transfer online music within a contract with a customer gives rise to a performance obligation.

42. Some Board members disagree with this conclusion for the discount card. They think that a gift card (which implies a 100% discount) is different from a discount card (which implies something less than a 100% discount) in ways that warrant different treatment under the proposed revenue recognition model. For example, with the gift card, the customer is not required to pay any additional consideration to receive the promised music. In contrast, with the discount card, the customer is required to pay additional consideration to receive the promised music. Even though both TuneCo and SongCo are likely to receive additional consideration from customers when they exercise their cards, only SongCo's customers are required to pay additional consideration to exercise their cards. Moreover, the additional consideration paid by SongCo customers to exercise their discount card is likely to exceed SongCo's cost of providing the online music to the customer.

43. Another potentially significant difference between the gift card and the discount card is the likelihood that the customer will exercise the card. Given that the customer does not have to provide any additional consideration to receive TuneCo's music, the customer is much more likely to exercise the gift card than the discount card, which requires additional consideration. In other words, the likelihood of exercising a discount card is so insignificant in some cases that it should not give rise to a performance obligation. Given the difference in expected consideration and the likelihood of exercise, some Board members think the promise to transfer music at a 20% discount (even though included in a contract with a customer) should not be treated as a performance obligation.

44. Other Board members agree with the conclusion that both the gift card and the discount card give rise to performance obligations. These Board members note that both promises (gifts and discounts) arise within a contract with a customer, and the entity is promising to transfer the same economic resource (online music at a discount) to the customer at the customer's option. In neither case has the customer agreed to exercise its option by taking possession of online music. The fact that the customer is more or less likely to exercise one type of card than the other does not change the fact that the entity

has promised within a contract to transfer online music to the customer. Although the likelihoods and the additional consideration should affect the measurement of the performance obligations (indeed, the measurement may be immaterial for some discounts), the likelihoods and additional consideration have no bearing on whether a promise to transfer an economic resource has been made in the current contract.

Promotional promises arising outside of a contract

45. In the previous example, the promotional promises clearly arose as part of a contract with a customer. Sometimes an entity makes promotional promises that are clearly outside of a current contract with a customer. For example, entities frequently make promotional promises in advertisements. Although the entity will often be obliged to honor these promotional promises to its customers, the promise is not made as part of an agreement with a customer. As a result, such promotional promises do not give rise to performance obligations.

46. However, it sometimes is unclear whether an entity's promotional promise is part of or outside of a contract with the customer. For example, consider the situation in which a retailer drops a coupon or voucher into a customer's bag as he is paying for merchandise. This section has already argued that the promise to transfer an economic resource, whether at a 100% discount or a 20% discount, still gives rise to a performance obligation as long as the promise is part of a contract with a customer. Thus, the primary question seems to be whether the promise arises as part of a contract with a customer.

47. One way to determine whether a promotional promise is part of a contract may be to determine whether the entity priced the promised goods and services in the contract differently because of the promotional promise. For example, if the decision to distribute a coupon or voucher in each customer's bag at the point of sale had no bearing on the pricing currently charged to customers for goods and services, that would suggest that the voucher or coupon was not part of the current contract with the customer. However, if the decision to distribute a coupon or voucher to a customer clearly affected the price

currently charged for the goods and services delivered, that would suggest that the coupon or voucher was part of the current contract with the customer.

48. The Boards have not examined this issue in great depth, although the Boards generally agree that the definition of a performance obligation would capture such promotional promises as long as they are clearly part of a current contract with a customer. So, the issue seems to be more practical than conceptual in that the Boards have not yet decided how best to determine whether a promotional promise is part of a contract in some circumstances. The Boards invite comments on how this concept can be applied consistently in practice and whether the concept needs additional refinement that would make the practical determination more straightforward.

CONCLUSIONS

49. This chapter has defined performance obligations and provided a number of examples illustrating how to identify performance obligations in contracts with customers. Appendix X of the discussion paper provides a number of additional examples that illustrate the proposed revenue recognition model from start to finish, including how to identify performance obligations. Having discussed how to identify performance obligations, the discussion paper next explores more carefully when a performance obligation is satisfied.