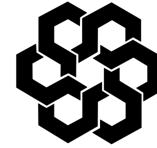

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**January 2008, London**
Project:	**Revenue Recognition**
Subject:	**Customer consideration model – performance obligations (Agenda paper 2 C)**

INTRODUCTION

1. Memo 96 / Agenda Paper 4B, presented to the Boards in November, explained how the rights and obligations in a contract give rise to a contract asset or contract liability under both models being developed within this project. Memo 103 / Agenda Paper 2B described how the contractual rights and obligations are measured in the Customer Consideration model, both at contract inception and subsequently. This paper considers the definition of a performance obligation and the criteria that would indicate such an obligation has been satisfied.

2. This paper begins by considering how the definition of revenue in the Customer Consideration model is dependent on the satisfaction of performance obligations. It considers the definition of performance obligations and how performance obligations are identified. It then presents three examples in which the identification of performance obligations has been problematic in the past. Finally, this paper explains and illustrates how performance obligations are satisfied.

WHAT IS REVENUE?

3. Memo 96 / Agenda Paper 4B in November proposed a tentative definition of revenue that focused on changes in the contract asset or liability with a customer (that is, the asset or liability arising from the remaining rights and

obligations in the contract). This definition stated that revenue is an increase in a contract asset or decrease in a contract liability (or a combination of the two) that results from providing goods or services to a customer.

4. Based on this tentative definition, revenue can potentially arise from two events. First, the obtaining of a contract in which the measure of the rights exceeds the measure of the obligations would give rise to revenue because this would result in an increase in contract assets (as described in the Measurement model). Second, the satisfaction of a performance obligation would give rise to revenue because this would result in either a decrease in a contract liability or an increase in a contract asset.

5. Because of the measurement approach taken in the Customer Consideration model, in which the rights and the obligations are measured equal to the customer consideration amount at contract inception, there is no situation in which the obtaining of a contract would lead to the recognition of revenue. So, for purposes of the Customer Consideration model, a simpler and more direct definition of revenue can be stated as follows:

> **Revenue is an *increase* in a contract asset or a *decrease* in a contract liability (or some combination of the two) that results from the satisfaction of performance obligations to provide goods or services to a customer.**

6. As this suggests, the definition of performance obligations is fundamental to the recognition of revenue. Indeed, the definition of performance obligations is fundamental to revenue for both proposed revenue recognition models. It is the change in the contract asset or liability that results from the satisfaction of performance obligations that ultimately gives rise to revenue. For this reason, this paper now turns to defining what a performance obligation is.

7. Note that the Boards decided in the October joint Board meeting that the definition of a performance obligation and the criteria that determine when such an obligation is satisfied should be the same in both proposed models.

DEFINITION OF A PERFORMANCE OBLIGATION

8. Although the notion of a performance obligation is implicit in much of the existing literature on revenue recognition, there is no definition of a performance obligation. Hence, the staff proposes the following definition that will apply to both proposed revenue recognition models:

> **A performance obligation is an enforceable promise by an entity within a contract with a customer to transfer an economic resource to that customer.**

Enforceable promises

9. The first important phrase in the definition of a performance obligation refers to an *enforceable promise*. An entity's promise is enforceable if the customer can require that the entity fulfil that promise. The ultimate mechanism by

which the customer can require fulfilment is usually the court or legal system, but this mechanism is not necessary. If another mechanism operates in an equivalent fashion to enforce a promise to transfer an economic resource, the fact that this mechanism could be called on would suggest that promise is enforceable. For example, if a particular industry or association (such as a diamond wholesalers association) enforces its members' exchange promises by the threat of expulsion from the association, that mechanism might be seen as equivalent to what a court or legal system would impose.

Contracts with customers

10. The next important phrase in this definition is *contract*, which is meant to capture much more than a written agreement. The word contract represents an enforceable arrangement between two parties, or better stated, the enforceable promises to which two parties have agreed. Although the definition of a contract, the mechanisms of enforcement, and the operation of law will vary across jurisdictions, the word contract in this paper is simply meant to capture the enforceable promises to which the two parties have agreed (implicitly or explicitly).

11. The enforceable promises arising from a contract are often more numerous than first thought. For example, consider the situation in which a customer has ordered a good from an entity but has not paid for the good. If the customer can cancel the order without any penalties, some think that an enforceable contract or a contract with enforceable promises does not actually exist.

12. However, another way of thinking about this situation is that the customer has an enforceable right to cancel, which in turn means that the entity has made an enforceable promise to allow the customer to cancel the order. If the entity tried to require that the customer complete the original purchase agreement, the customer could enforce the right to cancel. The fact that the customer could cancel the contract does not mean that a contract does not exist. In fact, it underscores that an agreement about the terms of the exchange actually do exist, and one of these terms (whether arising within the contract explicitly or because of the operation of commercial law) is that the customer can cancel the order.

13. Consider, as another example, the difference between a non-refundable airline ticket and a flexible (refundable) airline ticket. The fact that the passenger holding a flexible ticket could return the ticket for a full refund does not mean that an enforceable contract does not exist. Instead, it means that one of the promises to which the customer can hold the airline company is the ability to return the ticket for a full refund. After all, it would seem strange to conclude that the non-refundable ticket represented an enforceable contract while the flexible ticket did not.

Transfer an economic resource

14. The next phrase in the definition that needs clarification is *transfer an economic resource*. To understand this phrase, consider the Boards' working definition of an asset (October 2007 Joint Meeting):

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.

15. Based on the logic in this definition, an entity can transfer an economic resource to a customer if it relinquishes its enforceable right (or other means of access) to the resource *and* the customer obtains the enforceable right (or other means of access) to that resource. Thus, a promise to transfer an economic resource exists in any situation in which the selling entity promises to relinquish its enforceable right (or other means of access) to a resource and the customer will obtain the enforceable right (or other means of access) to that resource. Importantly, this suggests that any resource for which the enforceable right (or other means of access) can be relinquished by the entity and obtained by the customer could be the economic resource underlying a performance obligation.

16. This understanding is very helpful when the contractual promise is to transfer a good, such as a computer, oil, or machinery. It is easy to see how enforceable rights (or other means of access) can attach to such goods and that such rights can be transferred. In contrast, it is not as clear how the promise to provide a service to a customer would meet this definition of a performance obligation.

17. To understand how the promise to transfer a service would meet the definition of a performance obligation, consider how the Boards have defined an economic resource (October 2007 Joint Meeting):

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.

18. Goods such as computers, oil, and machinery clearly represent economic resources in that they are scarce and they can produce cash inflows or reduce cash outflows for the person or entity that has access to them. Services such as office cleaning are also economic resources in that the service itself is scarce (that is, not available freely to everyone) and can reduce cash outflows because the customer does not have to pay its own employees to clean the office this week.

19. The key difference between a good and a service is that the economic resource transferred by a good persists as a good beyond the initial exchange, while the economic resource transferred by a service either expires immediately (in the case of tax preparation services) or enhances an asset already owned by the customer (in the case of cleaning services). Because a good can persist, an enforceable right (or other means of access) can attach to it. In contrast, an enforceable right cannot be attached to services already performed, but only to an asset the services might have enhanced.

20. As an example, the effort undertaken by an entity to construct a house ultimately results in the construction of a scarce good, capable of producing cash inflows or reducing cash outflows, and to which an enforceable right (or

other means of access) can attach. These rights can obviously be relinquished by the entity and obtained by the customer—at any point during construction or upon completion of the house.

21. As another example, the effort undertaken by a landscaper to manicure and otherwise maintain a customer's lawn enhances the customer's lawn. Enforceable rights (or other means of access) can attach to the lawn, but not to the landscaping services themselves. Landscaping services are scarce and can produce future cash inflows (because the customer relies on a well manicured lawn to provide wedding reception venues) or reduce future cash outflows (because the customer does not have to pay its own employees to maintain the grounds). No enforceable right (or other means of access) can attach to the services already performed, but they can attach (in this case) to the lawn that was enhanced.

22. The distinction between goods and services is important. If the outcome of an entity's activities is a good for which the enforceable rights can be transferred, then the focus of the performance obligation should be on the good itself. In contrast, if the outcome of an entity's activities is an immediate benefit to the customer, then the focus of the performance obligation should be on the immediate benefit being provided. The staff thinks attention to this distinction will be helpful in determining when a performance obligation is actually satisfied (see paragraphs 61-74).

23. In summary, a performance obligation is an enforceable promise by an entity within a contract with a customer to transfer an economic resource to that customer. To test the usefulness of this definition, we now turn to the task of identifying performance obligations.

IDENTIFYING PERFORMANCE OBLIGATIONS

24. In the Customer Consideration model, the contract with the customer must be disaggregated into its separate performance obligations so that the customer consideration amount can be allocated to those performance obligations. Based on the definition of a performance obligation in the previous section, this means that the contract must be searched for any enforceable promises to transfer economic resources. More precisely, the contract must be searched for:

    - Any promise to transfer to the customer an enforceable right (or other means of access) to a good, and
    - Any promise to undertake activities that will immediately benefit the customer.

    Said simply, this means that the contract must be searched for any promised goods or services.

25. In the summary of the Customer Consideration model presented in October, it was explained that a promised good or service represents a separate performance obligation if it could be sold separately. Hence, if a contract requires the provision of a number of goods, each good potentially represents a

separate performance obligation if that good could be sold separately. Similarly, when a range of services is provided, each service potentially represents a separate performance obligation if it could be sold separately.

26. This characteristic (that a good or service is capable of being sold separately) can now be explained more precisely in light of the proposed definition of a performance obligation. The fact that a good or service is capable of being sold separately suggests that the good or service can actually provide a separate economic resource to a customer (however short-lived that resource may be, such as with cleaning services). Said differently, the only way that a good or service could be sold separately is if a customer would buy it separately. And a customer would not buy a good or service separately unless he thought that the good or service would be an economic resource to him. This means that the previously stated approach to identifying potential performance obligation—looking for any good or service that could be sold separately—is equivalent to looking for any enforceable promise to transfer an economic resource to the customer.

Rejection of customer utility

27. It is important to note that the focus on promises to transfer economic resources to the customer does *not* mean that this model is focusing on customer utility. At one point in the development of this model, some thought that transactions should be viewed from the customer's perspective of utility. Consider the following example:

> Entity sells high-speed aerosol can manufacturing equipment. Entity sells a complete manufacturing process, which consists of Equipment X, Y, and Z. Entity does not sell Equipment X, Y, and Z separately; however, other companies do sell the same equipment separately and there is a market for used equipment. Installation is performed by the customer. Entity delivers Equipment X and Z on March 27, but does not deliver Equipment Y until April 6. Without Equipment Y, the customer does not have use of Equipment X and Z.

28. In this example, the customer would not receive the intended utility from Equipment X and Z until Equipment Y was delivered. As a result, some argued that Equipment X and Z could not on their own represent performance obligations capable of separate satisfaction. Only the combination of Equipment X, Y, and Z could represent a performance obligation under this view.

29. This customer-utility view was rejected for a number of reasons. First, the financial statements are prepared by the entity to reflect its financial position, cash flows, and comprehensive income. To reflect revenue transactions from the customer's perspective would contradict that aim.

30. Furthermore, from a practical point of view it also would be difficult for the entity to establish what the customer's perception of utility was in any given contract. There would be no guarantee that the entity's interpretation of

customer utility within a contract accurately reflected the customer's own view.

31. Most significantly perhaps, a view based on customer utility does not faithfully depict the transfer of economic resources to the customer. In the example above, Entity would still have to recognise Equipment X as its asset after delivery to the customer if transferring Equipment X to the customer did not confer utility to the customer. However, Entity would be recording Equipment X as an asset even though it has no enforceable right (or other means of access) to that equipment. This would not faithfully reflect the assets or liabilities of the entities involved in this transaction, and so the customer-utility view was rejected.

EXAMPLES OF PERFORMANCE OBLIGATIONS

32. To illustrate how the definition of performance obligations is applied to common contract situations, consider three examples that have been problematic in the past:
    - paint (paragraphs 34-37)
    - rights of return (paragraphs 38-53), and
    - promotional promises (paragraphs 54-59)

33. Note that each of these examples has been problematic for different reasons and, with this more precise articulation of what a performance obligation is, we may discover that the problem was not actually deciding whether a performance obligation existed. Instead, the problem may have been in deciding when a performance obligation is actually satisfied.

Paint

34. 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 obtains at a cost of CU800. PainterCo's cost for labour and other painting materials is CU1600. The customer is given the right to obtain its own paint, although the customer does not opt to do so.
>
> All paint necessary to complete the contract is delivered to the customer's house on June 30. PainterCo renders the painting services continuously from July 1 through July 3. In accordance with the contract terms, the customer pays in full upon completion of the house painting.
>
> PainterCo's quarter ends on June 30.

35. To identify performance obligations in this contract, we must identify any promise to transfer to the customer an enforceable right (or other means of access) to a good and any promise to undertake activities that will immediately benefit the customer. This typically means that we are looking for any promised goods or services that could be sold separately. Clearly, the paint itself represents a good that could be sold separately. Similarly, the efforts to

paint the house represent a service that could be sold separately. Thus, according to the proposed definition of a performance obligation, both the paint and the painting services are separate performance obligations.

36. Notice that in this discussion, we have not considered the time at which the promised economic resources (the paint and the painting services) would transfer to the customer. All we are looking for at this point is a promise to transfer an economic resource to the customer, which can be achieved by looking for any promised good or service that could be sold separately.

37. As it turns out, deciding what would represent a performance obligation in this example is not all that difficult. Instead, the difficulty probably lies in deciding when the performance obligations are actually satisfied, in particular when the enforceable right (or other means of access) to the paint is relinquished by the painter and obtained by the customer. This is discussed in paragraphs 61-74.

Return rights

38. As a second example, consider the situation in which an entity promises to allow customers to return goods for whatever reason and receive a refund. This promise can be made explicitly or implied by a history of allowing customer returns. Economically speaking, the promise to allow a customer to return goods for a refund requires that the selling entity provide a means by which the customer can return goods and receive the refund. For most retailers, this involves maintaining a cashier system with appropriate personnel available during store operating hours. For Internet or catalogue retailers, this promise involves maintaining a phone or web system for approving returns and the personnel to receive returned goods and process refunds.

39. In this example, the question to ask is whether the economic activities required by a promise to accept returns meet the definition of a performance obligation. That is, does the requirement to maintain (or have a third party maintain) a cashier system, website, phone system, or storefront with necessary personnel constitute a performance obligation? If so, the Customer Consideration model would require that some amount of consideration be attributed to that performance obligation when measuring the contract at inception. Furthermore, revenue would be recognised when that performance obligation is satisfied. On the other hand, if the activities required by a promise to accept returns do not constitute a performance obligation, then no consideration is attributed to those activities, no obligation for those promised activities is recognised, and no revenue is recognised when those activities are performed.

40. In characterising return rights, it is vital to distinguish between the actual refund that would be due to a customer and the activities necessary to transact the return. That some cash will be returned to some customers is a matter of probabilities that can be estimated based on the entity’s history in selling a particular product. This expected cash refund is already calculated by most entities under existing accounting guidance and reduces the amount of revenue recognised by the entity. An obligation for this expected refund would be measured and recognised under both proposed revenue recognition models and is *not* the focus of this example.

41. Instead, the focus of this example is on the activities that are necessary to transact the return, that is, the activities of accepting returned goods and providing refunds to customers. Do these activities constitute a performance obligation that should be measured at contract inception and result in revenue recognition when the obligation to transact the return (or stand ready to transact the return) is satisfied? The measurement of these activities would be in addition to the expected refund already calculated under current guidance and would further reduce the amount of consideration allocated to other performance obligations identified in the contract.

42. To decide whether these activities represent a performance obligation, we need to ask the same question asked in the paint example. That is, do the required activities to transact the return represent a promise by the entity to undertake activities that will immediately benefit the customer?

Return rights as performance obligations

43. Some think that the promise to transact a return is a promise to undertake activities that will immediately benefit the customer. By making cashiers available, maintaining a website wherein the customer can arrange for a return, and receiving the returns and processing refunds, the entity is providing an immediate benefit to the customer. Even if a relatively small number of customers actually take advantage of the opportunity to return an item for a refund, the entity promised the possibility to all customers. Those who hold this view think that some of the customer consideration should be allocated to this performance obligation at contract inception and revenue should be recognised when that obligation is satisfied.

44. Consider the following case:

> Entity sells 100 sweaters in December 2007. Each sweater sells for CU25 and each costs CU15. On average one sweater in a hundred is returned by a customer. The entity estimates that it could sell sweaters without return rights for CU24, suggesting that customers on average are willing to pay CU1 for the right to return the sweater.

45. Under the view that return rights represent performance obligations, some of the total expected customer consideration to be received from these transactions should be allocated to the activities necessary to transact the return because these activities provide an immediate benefit to the customer. Of the total consideration received up front (CU2500) less the anticipated refund amount (one sweater for CU25), some portion should be allocated to the return service obligation. Following the allocation method outlined in the Memo 103 / Agenda Paper 2B, the anticipated total consideration on these sales (CU2475) should be allocated pro rata in the following way:

	Base	Allocation	Revised
Sweaters without return right			
[(2400/2500)x25]	2400	-24	2376
Return service right			
[(100/2500)x25]	100	-1	99
Total	2500	-25	2475

46. Based on this allocation, the following entries would be made when the sweaters are initially sold:

DR cash	2500	
CR revenue		2376
CR refund obligation		25
CR return service obligation		99
DR cost of sales	1485	
DR goods to be returned (netted against refund obligation)	15	
CR inventory		1500

47. Assuming one sweater is returned, over the return period, the following entries would be made:

DR Refund obligation	25	
DR Inventory	15	
CR goods to be returned (netted against refund obligation)		15
CR cash		25
DR Return service obligation	99	
CR Revenue		99

48. As seen here, CU99 of the anticipated customer consideration is allocated to the return service obligation in addition to the anticipated refund amount of CU25. When the return service obligation is satisfied, the resulting decrease in contract liabilities results in the recognition of CU99 in revenue. Total revenue recognised equals the amount of customer consideration actually received (CU 2475), although CU2376 is recognised in one period and CU99 is recognised in the next.

Return rights as failed sales or cancelled contracts

49. Others think that the promise to transact a return simply represents the possibility that the customer can cancel the contract. A return right merely creates the possibility of a failed sale. Those who hold this view accept that the right to return a good is an enforceable promise made by the entity. However, they do not think that the activities necessary to process the return transfer an economic resource or benefit to the customer. Cashiers, websites, and storefronts are provided as a normal part of doing business, and promising to continue doing that so that a customer can return a good for a refund does not transfer a benefit to the customer. As a result, those who hold this view would not allocate any consideration to these promised activities. Only an estimate of

the expected refund amount would be recognised as an obligation, but no obligation for the transaction services would be recognised.

50. Based on the example above, this means that the total expected consideration from these transactions (CU2475) would be allocated to the sweaters and recognised as revenue upon delivery of the sweaters. This would result in the following entries:

DR cash	2500	
CR revenue		2475
CR refund obligation		25

DR cost of sales	1485	
DR refund obligation (for anticipated return of inventory)	15	
CR inventory		1500

51. On return or expiration of the return period, the following entry would be made:

DR Refund obligation	10	
DR Inventory	15	
CR cash		25

52. As seen here, no consideration is attributed to the return transaction service, so more revenue is recognised in conjunction with the delivery of the sweaters. Although total revenue recognised equals the amount of customer consideration actually received (CU 2475), this full amount is recognised in the period when sweaters are delivered and no revenue is recognised in the later period in which the return transaction is processed.

53. The staff recognises that there are strongly held views on return rights, but hopes that a more careful description of a performance obligation in the discussion paper will provide constituents a meaningful way to think about return rights and provide useful comments.

Promotional promises

54. As a final example, consider an entity that offers all customers during their back-to-school sales event a discount voucher against future purchases. The voucher is placed in the customer's bag at the cash register and promises 10 percent savings off of normal sales prices on a future sale. Does the discount voucher represent a separate performance obligation that would require that some portion of the customer consideration be allocated to that obligation?

55. To answer this question, we must first determine whether the promise of a future discount represents an economic resource. Recall that 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. The possessor of a 10 percent discount on normal store prices holds something that is capable of producing cash inflows or reducing cash outflows, so in that sense the discount voucher would seem to represent an economic resource. The only way the 10 percent discount voucher would not be capable of producing cash inflows or reducing cash outflows is if all

prices in the store were reduced 10 percent during the voucher's exercise period.

56. Although the voucher appears to be a resource, the scarcity of the resource is called into question because all customers receive the voucher. In other words, the fact that the entity distributes the vouchers to all customers that week suggests that it may not actually be a scarce resource. Instead, the voucher may represent a general repricing of store merchandise following the back-to-school sales week. Because the voucher appears not to be a scarce resource (in that it is given to almost all customers), the voucher would not be considered a performance obligation.

57. In addition to these arguments, proponents of the Customer Consideration model have also argued that these vouchers are outside *the contract with the customer*. At the time of purchase, the customer only expects to receive the goods it requested; the voucher with the receipt was outside the customer's knowledge at customer initiation. Contrast this voucher with an identical one printed in the local paper. Publishing these vouchers would not generally be viewed as giving rise to performance obligations because this generally available voucher is not part of an identifiable contract with a customer. No customer is identifiable at publication and no contract has been made.

58. In essence, proponents argue that the giving of a voucher after the fact should not be considered part of the customer's original contract. The difficulty with this line of thought is that it is hard to tell when the customer is aware of the discount voucher. Perhaps one customer has no idea the voucher is even placed in their bag as they leave the store. A different customer may have actually come into the store to make a purchase because they heard that a voucher was being distributed to all customers that week. In principle, the staff does not think that a voucher should be considered a performance obligation of the current transaction unless the customer is aware of the voucher *and* the voucher actually represents an economic resource, as explained previously. But given the difficulty of determining what a customer knows, this principle seems very difficult to apply.

59. In situations in which the entity and the customer have agreed that certain discounts and promotional perks will be given for certain levels of transactions, these discounts do represent performance obligations that would attract some measure of the consideration from each transaction. For example, when a customer applies to join an entity's loyalty reward scheme, the customer is specifically arranging with the entity for that loyalty reward service. The entity is obliged to perform this service for the customer, under the terms of the separate loyalty agreement, thereafter. The entity has an enforceable obligation to its customer. The performance obligation under this loyalty contract will attract an amount of the consideration attributable to all subsequent purchases made by the customer under the terms of that separate loyalty scheme. This amount will be based on the probability of the second transaction itself taking place.

60. To conclude this section on identifying performance obligations, note that a number of examples that have posed difficulties in the past for identifying performance obligations appear to be a little more understandable with the

proposed definition of a performance obligation. For some examples (e.g., paint), the difficulty does not seem to be in identifying performance obligations, but is instead in deciding when the performance obligation is satisfied. It is this topic to which we now turn our attention.

WHEN ARE PERFORMANCE OBLIGATIONS SATISFIED?

61. Having discussed the definition of performance obligations and applied that definition to various examples, this paper now examines when performance obligations are satisfied. Given how strongly revenue recognition depends on the satisfaction of performance obligations (under both proposed models), it is vital to come to some agreement on the criteria that indicate when performance obligations are satisfied.

62. The staff is still developing an understanding of this issue, so the thinking in this section is preliminary. The staff expects to examine this issue in more depth in the discussion paper. However, this current paper would not be complete without some discussion of when performance obligations are satisfied.

63. The definition of performance obligation suggests a framework in which to develop criteria for the satisfaction of performance obligations. Recall that the proposed definition states:

> **A performance obligation is an enforceable promise by an entity within a contract with a customer to transfer an economic resource to that customer.**

64. The key phrase in this definition is the *transfer* of an economic resource. As explained in paragraph 15, a good is transferred when the entity relinquishes its enforceable right (or other access) to the good and the customer obtains this enforceable right (or other access). In the case of services, an economic resource is transferred when the activities undertaken by the entity result in a benefit to the customer. By focusing on the points at which enforceable rights (or other access) to a good are transferred from the entity to the customer or on the point when a service actually benefits the customer, we should be able to articulate a set of criteria that indicate when a performance obligation is satisfied.

Transfers of goods

65. In the case of goods, the satisfaction criteria need to focus on indicators that suggest when an enforceable right (or other access) to the good is relinquished by the entity and obtained by the customer. The paint example in paragraph 34 provides a useful setting in which to discuss this issue. Recall that paint is delivered before the painting service is actually undertaken. Because paint can be sold separately (suggesting that paint is an economic resource in its own right), the promise to provide paint is a separate performance obligation.

66. What indicators would suggest that the enforceable rights (or other access) to the paint have been relinquished by PainterCo when the paint is delivered?

And what indicators would suggest that the customer obtains the enforceable rights (or other access) to the paint upon delivery? Consider the following:

- PainterCo has no access to the paint after delivery.
- The customer has access to the paint and can protect that access by preventing others (including PainterCo) from coming onto its property.
- PainterCo no longer has an enforceable right to the paint, but instead has an enforceable right to payment or the return of the paint.
- If the customer chooses to pay for the paint, PainterCo has no enforceable right to demand the paint instead of payment.

67. Given that PainterCo has no access and no enforceable right to the paint after delivery, it would appear that PainterCo has relinquished its enforceable right and access to the paint. It also appears that the customer obtains the enforceable right and access to the paint. But before accepting that conclusion, are there any indicators that would suggest that PainterCo has *not* relinquished the enforceable rights (or other access) to the paint. Consider the following arguments:

    - The contract requires that PainterCo use the delivered paint in painting the house. Thus, PainterCo has the right to use the paint and has not relinquished this right by delivering the paint.
    - The customer is acting as PainterCo's agent in holding the paint. The risks and rewards of owning paint still reside with PainterCo.

68. Although it is possible that the contract could require that PainterCo use only the paint it has delivered, this seems an unrealistic requirement for most painting contracts. PainterCo would be completely unharmed if the customer decided to use the delivered paint to paint its fence over the weekend and then purchased additional paint in time for PainterCo to paint the house on July 1. Thus, this first indicator seems an unlikely factual circumstance and does not persuasively make the case that PainterCo still retains an enforceable right (or other access) to the exact paint that was delivered.

69. The second indicator suggests that PainterCo could demand that the paint be returned at will. If this was the case, then it would be hard to argue that PainterCo has relinquished the enforceable right to the paint. With such an enforceable right, PainterCo's could also demand access (through the use of local law enforcement officials) to the paint even though it is on the customer's property. This seems to be more a question of fact than it is a question of how the concept would apply. To the extent that PainterCo could demand the return of the delivered paint, and the customer would have no power to decide whether to give back that paint, it would seem that the enforceable right to that paint has not been relinquished by PainterCo.

70. Some of the staff think it is very unlikely that such an arrangement would allow PainterCo to demand that the delivered paint be returned, and in most cases, there would be no way for PainterCo to demand that the exact paint be

returned. As a result, this indicator seems economically unrealistic. Others think that because the customer would have to replace the paint in order for PainterCo to provide painting services, the customer never has enforceable rights to the paint. Clearly, additional thought needs to be expended on this issue. The staff intends to examine this issue in more depth in the discussion paper.

Transfers (or provision) of services

71. The paint example in paragraph 34 provides a useful setting in which to discuss the transfer or provision of services. Painting is performed over a period of three days (July 1-3), which for PainterCo is part of a single reporting period. But suppose that the painting service actually spanned a reporting date, and PainterCo had finished painting three sides of the house by the period's end. Understanding when this performance obligation is satisfied would then be very important.

72. Paragraph 35 concludes that painting service is a separate performance obligation because it can be sold separately. What criteria would suggest when this performance obligation is satisfied? The guidance on services in paragraph 22 suggests that to answer this question, we need to focus on the time at which the painting activities undertaken by PainterCo actually transfer an economic resource to the customer. What indicators would suggest that an activity has transferred an economic resource to the customer?

    - The activities undertaken by an entity enhance an economic resource to which the customer has an enforceable right (or other access).

    - The activities undertaken by an entity can produce cash inflows or reduce cash outflows.

73. Both of these criteria seem to suggest that a resource is passed to the customer with every brush stroke PainterCo makes. That is, as PainterCo applies paint to the customer's house, it is enhancing an asset to which the customer has an enforceable right (or other access). Also, as PainterCo paints the house, the painted house could produce cash inflows (as would-be buyers are willing to pay more for a freshly painted house) or reduce cash outflows (because the customer will not have to pay another painter for five years). The fact that such a benefit passes to the customer with every brush stroke suggests that a service such as painting is satisfied over a period of time—not necessarily evenly through time, but over a period of time.

74. In general, this analysis of the painting services can be applied to all services wherein activities undertaken by an entity enhance an economic resource to which a customer has an enforceable right (or other access).

COMBINING PERFORMANCE OBLIGATIONS

75. This is an appropriate place to note that identified performance obligations do not always need to be accounted for separately. That is, in the Customer Consideration model, just because two goods are promised in a contract, there is no need to determine their separate selling prices and to allocate

consideration to them simply because both goods represent separate performance obligations. If both obligations are satisfied in the same reporting period, there is no need to go through the hassle of determining separate selling prices and then allocating consideration to them. This is an important practical point, especially if the two goods are never sold separately.

76. Consider the following example:

Entity sells Machines F and G for CU100. Entity never sells these machines separately, although its competitors do for CU35 and CU75, respectively. Entity always delivers Machines F and G together.

77. Because Machines F and G could be sold separately (evidenced by the fact that Entity's competitors actually do sell them separately), Entity's promises to transfer each good represent separate performance obligations. This would typically mean that the promised customer consideration of CU100 would need to be allocated to these different performance obligations based on their separate selling prices (in this case, the competitors' separate selling prices). However, in this example, Machines F and G are delivered (that is, the enforceable rights to the machines are relinquished by the entity and obtained by the customer) at the same time. As a result, there is no need to allocate the customer consideration to the separate performance obligations, and they can instead be accounted for as one single unit of account.

78. The key point here is that the time at which a performance obligation is satisfied determines whether to account separately for what are otherwise separate performance obligations. Again, the key is to determine when a performance obligation is satisfied, and that is an issue that this paper has only begun to address.

CONCLUSIONS

79. Based on the measurement approach described in Memo 103 / Agenda Paper 2B, this paper proposes that revenue can only be recognised as performance obligations are satisfied. This paper then proposes a definition of performance obligations that is built on the Boards' working definition of an asset. Finally, this paper discusses preliminary ideas on when performance obligations are satisfied. The staff acknowledges there is still considerable work to be done to develop the criteria for satisfaction of performance obligations and that these criteria should be consistent across both revenue recognition models.