Project: **Revenue Recognition**

Topic: **Background information: Putting the October staff papers in context**

Introduction

1. This paper clarifies how the recommendations the staff has made in October affect the proposed revenue recognition model. The paper is organized as follows:

   (a) An overview of the proposed model (paragraphs 2–12)

   (b) The critical issue for resolution at the meeting in October (paragraphs 13–16)

   (c) The staff's recommendations for applying the model (paragraphs 17–20).

Overview of the proposed model

Objective

2. The proposed revenue recognition model is based on an entity's transfer of goods and services to customers in exchange for consideration from the customer. Hence, the objective when applying the model is for an entity to recognize revenue to depict the transfer of goods and services to customers in an amount that reflects the customer consideration in exchange for those goods and services.

A contract-based model

3. The Boards' proposed revenue recognition model accounts for contracts with customers. A contract consists of an entity's rights to consideration from the customer and obligations to provide goods and services to the customer (that is, *performance* obligations). The combination of the remaining rights and performance obligations in a contract gives rise to a net contract position.

4. A net contract position can be a contract asset or a contract liability depending on the relationship between the entity's and the customer's performance. A contract asset is the result of an entity performing (transferring goods and services) in advance of the customer paying for that performance. A contract liability is the result of a customer performing (paying consideration) in advance of the entity performing (transferring goods and services).

5. In most cases, a single contract gives rise to a single net contract position when applying the proposed model. However, in some cases, an entity must combine two or more contracts into a single net contract position when applying the proposed model. Two or more contracts with the same customer should be accounted for together if the prices of those contracts are interdependent.

6. When an entity modifies an existing contract, the modification should be accounted for as a separate contract if it is priced independently of the original contract. If the prices are interdependent, an entity should account for the original contract and modification together, recognizing the effect of the modification on a cumulative catch-up basis.

Recognition

7. An entity recognizes revenue only when it has satisfied a performance obligation. A performance obligation is a promise in a contract with a customer to transfer a good or a service to that customer. An entity should account for performance obligations separately if the promised assets are transferred to the customer at different times.

8. An entity satisfies a performance obligation by transferring a promised good or service to the customer. A good or a service is transferred when the customer obtains control of that good or service.

9. Control of a good or a service is an entity's present ability to direct the use of and receive the benefit from that good or service. Management of an entity must exercise judgment and consider various facts and circumstances when determining whether a customer has obtained control of an asset (whether a good or a service). Indicators that the customer has obtained control include:

   (a) The customer has an unconditional obligation to pay for the asset (and the payment is non-refundable).

   (b) The customer has legal title to the asset.

   (c) The customer can sell the asset to (or exchange the asset with) another party.

   (d) The customer has physical possession of the asset.

   (e) The customer has the practical ability to take possession of the asset.

   (f) The customer specifies the design or function of the asset.

   (g) The customer has continuing managerial involvement with the asset.

   (h) The customer can secure or settle debt with the asset.

Measurement

10. Total revenue in a contract is the amount of consideration received from the customer—i.e. the transaction price. The transaction price reflects:

   (a) The *time value of money* (if the customer's payment is significantly before or after receipt of goods and services)—An entity would use the discount rate that would be reflected in a financing transaction between the entity and its customer that did not involve the provision of other goods and services.

   (b) *Uncertain consideration* (if the entity can estimate uncertain amounts reliably)—When the customer consideration is uncertain (variable) in amount, the transaction price is the entity's expected (probability-weighted) consideration. An entity would update that estimate to reflect changes in the transaction price and allocate those changes to all the performance obligations. The effects of those changes on satisfied performance obligations would be recognized as revenue in the period of change.

(c) *Noncash consideration* (if the nonmonetary exchange has commercial substance)—An entity measures noncash consideration at fair value. If an entity cannot reliably estimate the fair value of noncash consideration, it should measure the consideration indirectly by reference to the selling price of the promised goods and services.

11. The amount of revenue an entity recognizes when it satisfies a performance obligation is the portion of the transaction price (or consideration) that the entity allocates to each performance obligation. The basis for allocating the transaction price is the relative standalone selling prices of the goods and services underlying the performance obligations. That price must be estimated if it is not observable.

Contract costs

12. An entity should expense contract costs as incurred unless they are eligible for capitalization in accordance with other standards (e.g. inventory, capitalized software, property, plant or equipment). If the entity's expected costs of satisfying a performance obligation exceed its carrying amount, the entity should recognize a contract loss (and increase the measurement of the performance obligation).

Critical issue for resolution

13. Responses to the proposed model indicate support for a contract-based revenue recognition model in which an entity recognizes revenue to depict the transfer of goods and services to a customer. Respondents also seem to support a model

that recognizes revenue in an amount based on an allocation of the transaction price.

14. However, many respondents question whether the proposed model is operational. The primary concern relates to the segmentation of a contract—i.e. the extent to which an entity would be required to identify separate performance obligations and allocate consideration (and different margins) to each performance obligation. Appendix A to this paper summarizes those responses.

15. The Boards have proposed that an entity separate performance obligations based on when the promised goods and services are transferred to the customer. That approach works well for simple contracts. For example, if an entity promises to deliver a computer system to a customer including a central processing unit, a monitor, and a keyboard, the entity would not have to allocate consideration to each component of the system if the customer takes ownership of the entire system all at once.

16. However, the model as articulated to date is not operational for many contracts. For example, it does not seem practical for a construction contractor to allocate consideration on a standalone selling price basis to every brick, board, nail, and labor hour as the customer receives those goods and services. Similar challenges arise in any contract in which the customer obtains control of goods or services continuously. The staff's recommendations in October aim to address those challenges.

Staff's recommendations for applying the proposed model

17. The staff thinks the proposed model can become operational across various industries (including construction) if it has a clearer principle for segmenting a contract—i.e. if entities are not required to allocate the transaction price at the performance obligation level.

18. Hence, segmenting a contract can also be thought of as combining performance obligations for purposes of allocating the transaction price. Instead of allocating the transaction price to each performance obligation, an entity would allocate to

each segment (which may comprise one or more performance obligations). After allocating a portion of the transaction priceto a segment, an entity then would determine the appropriate pattern of revenue recognition for that segment.

19. The staff thinks that segmenting a contract does not change any of the Boards' preliminary views to date. Rather, it clarifies how an entity would practically separate a contract rather than at the level of individual performance obligations.

20. The following diagram illustrates the staff's recommendations:

Steps to Apply the Proposed Revenue Recognition Model

Step 1:
Identify the contract

- A contract is an agreement between two parties that creates enforceable obligations.
- A customer is a party that has contracted for a good or a service that is an output of the entity's ordinary activities.
- Two or more contracts with the same customer should be combined if the prices of the contracts are interdependent.

Step 2:
Segment the contract
(Agenda Paper 3B / Memo 122B)

- An entity should separate a contract into segments for which the entity has evidence of a market—i.e. evidence that those segments could be sold separately.
- The best evidence of a market is observable prices for identical or similar goods and services in the customer's market.
- When segmenting a contract, an entity should consider factors such as materiality, when goods and services are transferred, and the margins of the goods and services.

Step 3:
Allocate consideration to each segment
(Agenda Paper 3C / Memo 122C)

- An entity should allocate the transaction price to each segment on a relative standalone selling price basis.
- If the stand-alone selling price is not directly observable, an entity should estimate it.
- When estimating selling prices, an entity should maximize the use of observable inputs.
- An entity should not use the residual method as a basis to allocate the transaction price.
- An entity should allocate a discount in a contract to all segments of the contract.

Step 4:
Recognize revenue within each segment
(Agenda Paper 3D / Memo 122D)

- A segment can comprise one or more performance obligations.
- An entity should recognize revenue for a segment as goods and services are transferred to the customer in satisfaction of performance obligations.
- An entity can use various methods of determining performance within a segment (e.g. units of output to the customer, labor hours, costs incurred, time).

Appendix A: Responses to the Discussion Paper

A1. This appendix summarizes the feedback received from comment letters with respect to the topics under consideration in October.

Overview

A2. Most respondents support the proposal that an entity should separate performance obligations in a contract based on the timing of transfer of goods and services to the customer.

A3. However, some respondents think the proposal is not sufficiently clear and robust to improve existing standards. For instance, some note the potential uncertainty of (a) when goods and services are to be transferred to the customer and (b) how to unbundle goods and services. Respondents note that in addition to the control principle, criteria for separating performance obligations may ultimately determine the distinction between a good and a service. Therefore, many respondents recommend the Boards provide additional criteria for the identification and separation of performance obligations.

> … the proposed definition of a performance obligation and the proposals on the separation of performance obligations will need to be supported by further guidance if entities are to be able to identify the deliverables in (or components of) a contract and apply the definition of the principle in a consistent way. (CL #192)

A4. A few respondents were concerned with the proposed approach for separating performance obligations in a contract because they think it would provide opportunities to structure contracts to achieve a desired revenue recognition treatment. Respondents were concerned the proposed model would allow for opportunities to accelerate revenue in some multi element contracts, as well as, allowing an entity the ability to unbundled/bundle contracts to receive specific treatment. Furthermore, some respondents worried about the ability to manipulate margin as discussed in Paper C in October.

Further clarification on the identification and separation of performance obligations

A5. Some respondents think that to improve the practicability of the proposed principle for separation of performance obligations, the Boards should retain the notion of standalone value as explained in EITF 00-21, *Revenue Arrangements with Multiple Deliverables* and/or the notion of perfunctory/inconsequential obligations as explained in SAB 104, *Revenue Recognition*. Respondents think these notions would avoid having to unbundle contracts beyond a level that provides decision-useful information.

Standalone value

A6. Respondents mentioned two ways in which the notion of standalone value can assist entities in practically applying the model.

(a) *Identification*—Respondents think if a performance obligation does not have standalone value to the customer, it should not be identified as a separate performance obligation of the contract. In making this assessment, many recommend that the Boards retain the criteria for identifying a deliverable based on standalone value to a customer in EITF 00-21,.

(b) *Separation*—Although some respondents think that standalone value should be used in the identification of performance obligations, others think that standalone value should instead be used as a criterion to evaluate which performance obligations should be separated within the contract. For example, in addition to separating performance obligations based on the timing of transfer, a good or service must also have standalone value to the customer. Some respondents highlighted the example in paragraph 4.27 of the discussion paper concerning a contract that requires delivery of three pieces of interdependent equipment. Respondents think that if an entity delivers equipment X & Y, but the customer cannot use that equipment as intended until equipment Z is delivered, the company should not be allowed to recognize revenue for the delivery of X & Y.

A7. Similar to the notion of standalone value in the delivery of goods, respondents from service-type industries prefer guidance which includes the notion of profit centers in SOP 81-1.

> We thus recommend the guidance related to separation of performance obligations in the discussion paper be modified such that it is based on identifying the lowest unit of account at which the specific product or service would represent a stand-alone profit center to the company. (CL #30)

Perfunctory/inconsequential obligations

A8. Respondents suggested that the notion of perfunctory/inconsequential obligations, as expressed in SAB 104, be included in the exposure draft.

(a) *Identification*—Respondents think if a performance obligation is perfunctory/inconsequential it should not be identified as a separate performance obligation in a contract.

(b) *Separation*—Other respondents think that in separating performance obligations in a contract, a good or a service that is perfunctory/inconsequential to the primary good or service should not be separated.

Long-term services contracts

A9. Many respondents were concerned that the proposed principle is not appropriate when there is continuous transfer of goods and services in a contract, as in long-term service contracts. Respondents think it would be difficult to determine how obligations in such contracts would be identified and separated, which may lead to inconsistent identification, allocation, and timing of revenue recognition between companies.

A10. Furthermore, many respondents question the decision usefulness of identifying many, if not nearly infinite, performance obligations in long-term construction contracts. Many respondents suggest that long-term construction contracts should be treated as a single performance obligation satisfied over the life of the contract, or suggest that units of account should be identified based on the segmentation criteria in IAS 11, *Construction Contracts* and SOP 81-1, *Accounting for Performance of Construction-type and Certain Production-Type Contracts*. Respondents noted that this treatment would be consistent with how construction contracts are bid, negotiated, and internally managed.

> …construction contracts typically do not separately specify all the activities that are required to be performed by the contractor in order to fulfill its obligations. The sheer size and complexity of long-term construction contracts are such that the concept of separate 'performance obligations' may be of little relevance to users and also subject to interpretation. (CL #10)

A11. Respondents note that in some long-term service contracts, for example post contract customer support contracts, an entity may promise to provide various services (including software assistance, hardware assistance, website support, phone support, etc). However, those services are intrinsically linked to one another and, consequently, it is difficult to assign appropriate values to each of those services on a standalone basis.

A12. A few respondents from the insurance industry note that insurance contracts should be considered single performance obligations given the interdependence between obligations.