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Project	<b>Revenue Recognition</b>
Topic	<b>Segmenting a contract</b>

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## Introduction

1. This paper considers how to segment a contract when applying the proposed model.

### ***Staff recommendations***

2. The staff recommends that:
  - (a) an entity should allocate the transaction price to segments of a contract rather than to individual performance obligations in the contract;
  - (b) 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);
  - (c) the best evidence of a market is observable prices for identical or similar goods and services in the customer's market;
  - (d) when segmenting a contract, an entity should exercise judgment and consider factors such as materiality, when goods and services are transferred, and the margins of the promised goods and services.

### ***Structure of this paper***

3. This paper is organised into the following sections:
  - (a) Why segment a contract?

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This paper has been prepared by the technical staff of the FASB and the IASCF for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of IFRSs or U.S. GAAP do not purport to be acceptable or unacceptable application of IFRSs or U.S. GAAP.

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- (b) What is the principle for segmenting a contract?
- (c) What factors should an entity consider when segmenting a contract?
- (d) What are the implications for segmentation if there is no evidence of a market?

### Why segment a contract?

4. As noted in Paper A, many respondents to the discussion paper expressed a concern that the proposed model would not be operational if it required an entity to allocate the transaction price to individual performance obligations in the contract. The staff acknowledges that concern, and so the aim of this paper is to identify a more practical basis for unbundling the contract for the purposes of applying the proposed model.
5. In the proposed model, revenue is recognised when an entity satisfies performance obligations by transferring goods and services to a customer. The amount of revenue that is recognised should faithfully depict the consideration that the entity expects to receive in exchange for the goods and services transferred to the customer in each period.
6. Determining *when* revenue is recognised is a matter for the recognition principle. The Boards considered that issue in September 2009 in their discussions on control.
7. Determining *how much* revenue an entity recognises when it satisfies performance obligations is based on the allocation of the transaction price. The staff thinks that it is more practical to allocate the transaction price by dividing the contract into distinct segments rather than into individual performance obligations. Depending on the characteristics of the performance obligations, a segment could contain a single performance obligation or a bundle of performance obligations.
8. The following sections discuss the basis for identifying separate segments.

**Comparison with existing standards**

9. Separating a contract into segments is not a new concept. For example, US GAAP currently requires entities to segment contracts into ‘units of accounting’ and ‘profit centers’, both of which can include more than one deliverable for the purposes of allocating the transaction price.

(a) FASB ASC Subtopic 605-25, *Revenue Recognition—Multiple Element Arrangements*<sup>1</sup> requires that:

A vendor shall evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting...<sup>2</sup>

(b) FASB ASC Subtopic 605-35 *Revenue Recognition—Construction-Type and Production-Type Contracts* explains that:

A single contract or a group of contracts that otherwise meet the criteria for combining may include several elements or phases, each of which the contractor negotiated separately with the same customer and agreed to perform without regard to the performance of the others. If those activities are accounted for as a single profit center, the reported income may differ from that contemplated in the negotiations for reasons other than differences in performance. If the project is segmented, revenues can be assigned to the different elements or phases to achieve different rates of profitability based on the relative value of each element or phase to the estimated total contract revenue.<sup>3</sup>

**Staff recommendation and question for the Boards**

**Question 1 Separating a contract into segments**

The staff recommends that an entity should allocate the transaction price to segments of a contract rather than to individual performance obligations in the contract.

Do the Boards agree?

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<sup>1</sup> Formerly EITF 00-21, *Revenue Arrangements with Multiple Deliverables*, amended through EITF 08-1, *Revenue Arrangements with Multiple Deliverables*.

<sup>2</sup> FASB ASC paragraph 605-25-25-4

<sup>3</sup> FASB ASC paragraph 605-35-25-10

## What is the principle for segmenting a contract?

10. In many cases, the segments of a contract are clear. Consider the following example:

**Example: product and maintenance services**

An entity enters into a contract with a customer and promises to deliver a machine and provide maintenance services for one year. The entity often sells machines and maintenance services separately.

11. Although the entity could identify many performance obligations (e.g. machine, delivery services, countless increments of maintenance services), the above contract clearly has two segments—the machine and the maintenance services. Those distinct segments can be readily identified for a variety of reasons, including by looking to:
- (a) the contract—the transfer of the machine and the maintenance services are separately identified in the contract;
  - (b) the form and functions of the items—the machine and the maintenance services are physically different items and they have separate, albeit related, uses;
  - (c) the economic attributes of the items—the risks and rewards associated with transferring the items to the customer are different; and
  - (d) the pattern of transfer—the machine and the maintenance services transfer to the customer at different times.
12. Each of these identifiers can help to identify whether there are distinct segments within a contract, however arguably no single one of these identifiers could be consistently used to determine whether a contract can be segmented. Therefore, one alternative would be to include these identifiers in a non-exhaustive list and ask entities to exercise their judgement in applying them to the specific facts and circumstances of their individual contractual arrangements.
13. However, the staff thinks that underlying each of these identifiers is a common thread—if items are functionally distinct, economically distinct, provided separately and (to some extent) separately identified in a contract, typically they

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would be expected to be capable of being sold by the entity (or other entities) on a standalone basis.

14. Consequently, standalone selling prices of a good or service provide evidence of a market for a good or service. That price could be:
  - (a) the entity's selling price for the identical item in the customer's market;
  - (b) a competitor's selling price for the identical item in the customer's market;
  - (c) the entity's or a competitor's selling price for a similar item in the customer's market; or
  - (d) the price for an identical or similar item that is sold in a market other than the customer's market. The customer's market could be defined by various attributes, such as the structure of the market (i.e. retail or wholesale), focus of the market (i.e. whether the customer is a government, a large corporate, small or medium enterprise or domestic consumer) and geography (i.e. city or rural based, different country or economic market).
15. Any of those prices can provide evidence that an item is capable of being sold on a standalone basis. However, an observable price for an identical item provides the clearest evidence. Observable prices show that a market exists for an item and therefore indicate potential segments of a contract.
16. Observable prices for similar goods and services in the customer's market or for the goods and services sold in a different market also provide evidence of a market—i.e. that the goods and services could be sold separately. This suggests that segmentation of the contract is appropriate.
17. If no evidence of a market exists (ie a good or a service could not ever be sold separately), the staff thinks that segmentation of a contract is inappropriate. This is because, in the staff's opinion, identifying a segment, and allocating transaction price, for a bundle of goods and services that never could be sold separately would provide an artificial distinction within the contract. Creating that distinction is not expected to depict faithfully the pattern of revenue recognition.

***Comparison with existing standards and current tentative decisions for the project***

18. In accounting for multiple element arrangements in US GAAP, ASC subtopic 605-25 requires that a delivered item must have “standalone value to the customer” if it is to be accounted for separately (i.e. segmented). A delivered item has standalone value if the customer can resell the delivered item. Many respondents to the discussion paper suggested this criterion should be included in the model. This criterion is broadly consistent with the staff’s view that there should be evidence of a market. However, the staff are not recommending using the term “standalone value” for the reasons discussed in Appendix A.
19. Similarly, construction contract accounting guidance also requires evidence of a market when segmenting a contract. The segmentation criteria in ASC paragraph 605-35-25-13 includes:
  - ...b. The separable phases or elements of the project are often bid or negotiated separately.
  - c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.
  - d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed. In applying this criterion, values assignable to the segments shall be on the basis of the contractor’s normal historical prices and terms of such services to other customers. A contractor shall not segment on the basis of prices charged by other contractors, because it does not follow that those prices could have been obtained by a contractor who has no history in the market. ...
20. In June 2009, the Boards considered segmentation of a contract in the context of combining or segmenting contracts for the purposes of identifying a net contract position. At that time, the Boards acknowledged that if the combination principle is price interdependency, then the inference is that the segmentation principle should be based on price independence—i.e. evidence of a market for each segment on a standalone basis.
21. This analysis demonstrates that the evidence of a market is a common principle across these standards and the Boards existing tentative decisions on this project.

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Consequently, the staff is recommending that the evidence of a market should be the principle for segmenting a contract.

### ***Staff recommendation and question for the Boards***

#### **Question 2 A principle for segmenting a contract**

The staff recommends that 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.

Do the Boards agree? If not, what should be the principle for segmenting a contract?

### **What factors should an entity consider when segmenting a contract?**

22. In many cases, management of an entity will need to exercise judgement to segment a contract. The principle for segmenting a contract is clear—it is to identify the segments for which evidence of a market exists—but the entity must also consider the following:
- (a) materiality;
  - (b) the timing of transfer of goods and services to the customer; and
  - (c) the margins of those goods and services.

### ***Materiality***

23. Segmenting a contract is not necessary for individually immaterial items. Instead, these items should be included in larger segments for which there is also evidence of a market. Segmenting is also not necessary if identifying separate segments would not materially affect the timing and amount of revenue that is recognised within the contract. This is because in either of these situations an entity could still achieve a faithful depiction of the pattern of revenue recognition

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without segmentation. Existing GAAP or IFRSs should be applied to determine whether something is immaterial.

### ***Timing of transfer***

24. Segmenting a contract is also not necessary for those goods and services that are transferred to the customer at the same time. This is because identifying those goods and services as separate segments would not affect the pattern of revenue recognition.

### ***Evidence of separate margins***

25. Segmenting a contract might not be necessary for goods and services with the same margin because the amount of revenue that is recognised when performance occurs would not be affected. However, segmentation may be necessary if the goods and services within the segment are so distinct that separate drivers would need to be used to assess performance within the segment. This is discussed further in Agenda Paper 3D/Memo 122D, which explains that the entity can determine the amount of revenue to recognise as it satisfies performance obligations in a variety of ways, including in proportion to cost. Segmentation might be required despite evidence of the same margin because Agenda Paper 3D/Memo 122D proposes that a single driver should be used to assess performance within each segment.

### ***Application to continuous delivery contracts***

26. The staff thinks that the segmentation principle outlined in this paper should address many of the concerns raised by the construction industry that the proposed model would require their contracts to be separated into segments that are not consistent with the basis on which they manage those contracts. If the staff's recommendations are adopted, segmentation would be required only where there is:
  - (a) evidence of a market for the goods and services being transferred to the customer;



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- (b) those goods and services are individually material to the construction contract;
  - (c) those goods and services attract margins that are different; and
  - (d) the transfers of those goods and services to the customer occur at different times.
27. If a construction contract exhibited all of these characteristics, the staff thinks that segmenting the contract would be appropriate to ensure that the pattern of revenue recognition would depict the transfer of goods and services to the customer in an amount that reflects the customer consideration in exchange for those goods and services.

### ***Staff recommendation and question for the boards***

#### **Question 3 Factors to consider when segmenting a contract**

The staff recommends that, when segmenting a contract, an entity should exercise judgment and consider factors such as materiality, when goods and services are transferred, and the margins of the promised goods and services.

Do the Boards agree?

### **What are the implications for segmentation if no evidence of a market for some items?**

28. As mentioned earlier, the proposed segmentation principle is that an entity should separate a contract into segments for which the entity has evidence that a market exists for those segments. However, there may be situations where there is no evidence that the goods and services could be sold separately. When this happens, the staff thinks that an entity should assess whether any of those goods and services can be bundled into a segment for which evidence of a market does exist. A consequence of this approach is that sometimes an entity may not be able to segment a contract at all.

29. Consider the following example:

**Example: licence, services, and equipment**

An entity enters into a contract with a customer and promises to deliver:

- a licence;
- services related to the licence; and
- commercial-off-the-shelf equipment.

There is no evidence of a separate market for the acquisition of the same or a similar licence on a standalone basis but there is a market for the provision of similar services. In addition, the entity has previously entered into contracts for the sale of the licence and similar services with other customers.

30. In this example, the equipment and the services could be identified as separate segments because there is a market for the same and similar items. The licence could not be identified as a third segment because it is not sold separately. But, it could be identified in the same segment as the services because the entity has previously sold those items together to other customers. Accordingly, the entity could identify two segments for the contract—an equipment segment and a licence and services segment.
31. Now consider the outcome if the facts of the example were changed so that there is also no evidence of a market for the sale of the licence together with services. In that situation, the contract could not be segmented because there is no evidence of a market for all the goods and services except when they are provided together in a single contract.
32. This outcome may place stress on the measurement of performance as it may be difficult, if not impossible, to find a single driver that faithfully measures the transfer to the customer of what could potentially be an assortment of loosely-related goods and services. However, this could occur only if there is no evidence that the goods and services could be sold separately, which might suggest that the best way to recognise revenue is to use costs incurred, labor hours or the passage of time as the measure of performance. The implication of using one of those methods is that the amount of revenue that the entity

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recognises for the transfer of the equipment to the customer may not correspond to the value of that equipment relative to the transaction price.

## **Appendix A Analysis of the feedback received from respondents on the definition of a performance obligation**

### **Introduction and purpose**

- A1. This appendix analyzes the feedback received from the respondents to the Discussion Paper on the definition and identification of performance obligations. Specifically, on whether an entity should account separately for a performance obligation only if it has “standalone value”.
- A2. This paper is organized as follows:
- (a) Revenue Recognition Model – Discussion Paper
  - (b) Feedback Received from the Respondents to the Discussion Paper
  - (c) Current Guidance on Standalone Value
  - (d) Staff Analysis of the Feedback Received

### **Revenue Recognition Model – Discussion Paper**

- A3. The Discussion Paper defines a performance obligation as a “promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer.”
- A4. The objective of identifying separate performance obligations is to represent faithfully the pattern of the transfer of goods and services to the customer. That is, the Boards concluded that performance obligations should be identified and accounted for separately, only to the extent that the goods or services underlying the performance obligations are transferred to customer at different times.

## Feedback Received from the Respondents to the Discussion Paper

A5. Many respondents to the Discussion Paper think that the identification of separate performance obligations should be based on whether a performance obligation has value to the customer on a standalone basis. That is, many respondents believed that standalone value should be used as a criterion to segment a contract. For example, for something to be separate of another obligation, it must have standalone value. Some respondents clarified that they meant standalone value as described in the ASC 605-25-25-5. Comments from other respondents suggest that by standalone value they mean “utility to the customer”.

## Current Guidance on Standalone Value

- A6. Standalone value in U.S. GAAP does not mean utility to the customer. Subtopic 605-25 specifies that the item or items have value on a standalone basis if:
- (a) the component is sold separately by any vendor, or
  - (b) the customer could resell the delivered item(s) on a standalone basis.
- A7. In the context of a customer’s ability to resell the delivered item(s), the criterion does not require the existence of an observable market for the deliverable(s).
- A8. In order to meet the criterion (b) above, the customer would need to be able to recover a substantial portion of the selling price of that delivered item in a hypothetical sale. If the customer could recover only the scrap value of a delivered item, then the criterion is not met.
- A9. Even with the definition of standalone value in Subtopic 605-25, there is diversity in practice, because Subtopic 605-25 does not clarify the principle of the hypothetical market. That is, would the criterion be met if
- (c) the customer is legally precluded from reselling the delivered item under the terms of the contract or as a matter of law, or

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- (d) the vendor is the only provider of an undelivered item, which is required for the delivered item to function for its intended purpose, and no other vendor sells the delivered item separately?
- A10. Example 6 of Subtopic 605-25 consensus appears to point to a conclusion that the criterion will not be met if the vendor is the only provider of an undelivered item. In that example, a biotechnology company enters into an arrangement that includes a technology license, an R&D agreement and a manufacturing contract. The biotechnology company used personnel with proprietary knowledge about the technology to complete the R&D agreement. The analysis of the example states that even though the customer could theoretically sublicense technology to others, the sublicensee would need to engage the biotechnology company to assist in the R&D and, as a result, the technology could not be resold on a standalone basis.
- A11. An additional example would be where an entity might have concluded under Subtopic 605-25 that highly specialized equipment does not have standalone value in an arrangement involving a sale of the equipment with installation services. Because of the unique nature and specialization of the equipment, only the vendor manufactures or installs the equipment. This effectively prohibits the customer from reselling the equipment on a standalone basis.
- A12. In order to address the above questions, in practice, the following factors are considered indicative that a delivered item has standalone value in situations where a customer is contractually precluded from reselling a deliverable:
- (e) The customer can use the delivered item for its intended purpose without receipt of the undelivered items included in the arrangement.
  - (f) The customer's inability to resell the deliverable is a contractual restriction designed to protect the interests of the vendor. For example, the vendor has provided a significant discount from fair value to the customer, and does not want the customer to resell the delivered item at a profit.
  - (g) The customer has obtained the right to use intellectual property routinely licensed by a vendor on a non-exclusive basis to many

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customers. In such cases, the vendor may prohibit customers from sublicensing the intellectual property to protect its ability to generate revenues from license to future customers.

### **Staff Analysis of the Feedback Received**

- A13. The staff agrees with the points raised by the respondents to the Discussion Paper with respect to the operability of the proposed model. The staff thinks that by clarifying how an entity could bundle performance obligations through contract segmentation, the objective of recognizing revenue when an entity transfers a promised asset to the customer can be achieved more practically than as proposed in the Discussion Paper.
- A14. However, for the following reasons the staff questions whether that clarification would be achieved through the term “standalone value”. One reason is that standalone value would need further definition and description anyway which may add an unnecessary layer of complexity to a revenue recognition standard.
- A15. Other reasons why the staff questions the usefulness of a “standalone value” notion include:
- (h) Standalone value to the customer often is confused with utility to the customer
  - (i) Redundancy with the working definition and indicators of control.

#### ***Confusion with utility to the customer***

- A16. Standalone value to the customer often is confused with utility to the customer—ie a standalone value component must provide functionality in and of itself in the eyes of the customer. The Boards have already rejected that notion. They noted in the Discussion Paper that “customer intent” is not a determinative principle in the proposed model. For example, paragraphs 4.25-4.31 of the Discussion Paper say that the customer’s intended use of the promised goods and services is another factor that might affect an entity’s

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assessment of when assets are transferred. However, the customer's intent in and of itself does not determine when a customer has an asset.

- A17. In its deliberations, the Boards observed that recognizing revenue when an entity transfers a good or service to the customer reflects the economics of most transactions because determining whether a good or service has utility to the customer is subjective and may lead to different patterns of revenue for economically similar transactions.
- A18. The staff thinks that the confusion of standalone value with utility to the customer might have been caused by the requirements of "essential to the functionality" concept in SEC Staff Accounting Bulletin No. 101, *Revenue Recognition* (SAB 101). Entities with arrangements in the scope of SAB 101 have been required to determine whether undelivered items are "essential to the functionality" of delivered items. If they are, no revenue is recognised for the delivered item. In Subtopic 605-25, *Multiple-Element Arrangements* deliberations (before the amendments resulting from Issue 08-1), the EITF concluded that the term "essential to the functionality" could not be defined precisely enough to yield consistent results in practice outside the software industry. As a result, the EITF chose to focus on whether a customer could sell a delivered item on a standalone basis as one of the means to demonstrate that the item has standalone value.

### ***Redundancy with the working definition and indicators of control***

- A19. Finally, the staff thinks that revenue recognition should be based on the control principle and not based on a criterion as to whether services could be provided by other entities. The staff notes that the indicators considered in practice (see paragraph A11) to evaluate whether a delivered item has standalone value are operationally similar to the factors an entity would consider in assessing whether it has transferred control of the underlying asset to the customer. In practice, if a customer is contractually precluded from reselling a deliverable, this in and of itself does not indicate that the deliverable does not have standalone value to the customer.



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A20. Using the control principle in the proposed revenue recognition model, some might think that the specialized equipment example noted in paragraph A10 will not result in a transfer of an asset to the customer before installation because the customer cannot use the transferred asset for its intended purpose. The staff notes that these factors considered in the application of Subtopic 605-25 are similar to the indicators of control transfer in the proposed model.