Project **Revenue Recognition**

Topic **Allocation of the transaction price**

Introduction

1. Once an entity has segmented a contract (Agenda Paper 3B/Memo 122B), it allocates consideration to each segment on a relative stand-alone selling price basis. This paper considers how an entity should do that, and whether any other basis of allocation is appropriate in the proposed model.

Summary of the staff's recommendations

2. This paper recommends that:

   (a) If the stand-alone selling price of a segment is not directly observable, an entity should estimate it for purposes of allocating the transaction price.

   (b) When estimating selling prices, an entity should maximize the use of observable inputs. The Exposure Draft should provide a clear objective for estimation and describe acceptable estimation methods. However, the Exposure Draft should not prescribe or preclude any particular method of estimating a stand-alone selling price.

   (c) An entity should not use the residual method as a basis to allocate the transaction price to segments of a contract. However, an entity might consider a residual method as an input when estimating a stand-alone selling price.

(d) An entity should allocate a discount in a contract to all segments of the contract in proportion to the relative stand-alone selling prices of the segments.

Background

3. In the proposed model, an entity recognizes revenue in the amount of consideration received from the customer in exchange for transferring goods and services. If the contract covers more than one reporting period, the entity should recognize revenue in a way that depicts the transfer of goods and services to the customer. To achieve that objective, the Boards have proposed that an entity should allocate the total consideration (or transaction price) to each performance obligation in proportion to the stand-alone selling price of the good or service underlying each performance obligation.

4. The stand-alone selling price of a good or service is the price at which the entity would sell that good or service if it was sold separately. The best evidence of that price is the stand-alone selling price when the entity actually sells that good or service separately. However, in some cases, neither the entity nor another entity sells the good or service separately and stand-alone selling prices are not observable. In those cases, the Boards proposed that the entity should estimate the stand-alone selling prices.

5. The staff's recommendation in Agenda Paper 3B/Memo 122B would modify the proposed model in that an entity would allocate the consideration to each *segment* of the contract instead of to each performance obligation. Therefore, in some cases an entity would need to estimate the stand-alone selling price of a segment.

Key issues and structure of paper

6. Most respondents to the proposed model agree with the Boards' proposed allocated transaction price approach in the Discussion Paper. However, they raised issues related to the following topics:

(a) Use of estimates (paragraphs **Error! Reference source not found.**–13)

(b) Specifying a hierarchy for the basis of allocation (paragraphs 14–22)

(c) Use of the residual method as a basis for allocation (paragraphs 23–29)

(d) The allocation of a discount within a contract (paragraphs 33–34).

Use of estimates

7. The majority of respondents agree that if a good or service is not sold separately, an entity should estimate its selling price. However, respondents note the following:

   (a) Allowing management to estimate stand-alone selling prices could result in arbitrary accounting and could reduce comparability in financial reporting. For example, two entities providing the same good or service might determine different estimates depending on the inputs used and judgement involved.

   (b) Estimates might be subject to manipulation by management and may be structured to accelerate or defer revenue.

   (c) Determining estimates could be time consuming and lead to increased costs on reporting, particularly if stand-alone selling prices are volatile.

   (d) Estimates of selling prices would be required less frequently if the Boards specify larger units of accounting. For instance, less exhaustive guidance on arriving at estimated selling prices would be needed for continuous-transfer service contracts if the Boards do not require unnecessary unbundling of performance obligations in the contract.

(e) If a stand-alone selling price is not observable or cannot be reasonably estimated, performance obligations should be combined for purposes of allocating consideration.

Staff analysis

8. Respondents' concerns seem to relate primarily to two issues:

   (a) The practicability of the proposed approach of estimating stand-alone selling prices of *individual* performance obligations (i.e. the level at which estimates would be required to determine the amount of revenue to be recognized).

   (b) The appropriateness of recognizing revenue on the basis of an estimated stand-alone selling price.

Practicability of the proposed approach

9. The staff thinks that its recommendations in the October Board papers would reduce, but not eliminate, the need for estimates in the proposed model. That is because:

   (a) Estimates of stand-alone selling prices would be required for a segment rather than individual performance obligations (although a segment in some cases will consist of a single performance obligation).

   (b) Estimates of a stand-alone selling price for a segment would be required only if the entity has evidence of a market for the segment (see Agenda Paper 3B/Memo 122B).

   (c) Within a segment, an entity would be able to use various methods to determine the amount of revenue to be recognized as it satisfies performance obligations, rather than only by reference to stand-alone selling prices (Agenda Paper 3D/Memo 122D).

Recognizing revenue only on the basis of estimated stand-alone selling prices

10. If an entity allocates consideration only to those performance obligations (or segments) for which the entity has directly observable prices, then the entity might fail to recognize revenue when goods and services are transferred to the customer. That would contradict the objective of the proposed revenue recognition model. As the Boards noted in the Discussion Paper, "failing to account for the satisfaction of a performance obligation would impair the depiction of an entity's financial position and performance in a contract with a customer."

11. More generally with respect to the use of estimates, the staff notes that since the Discussion Paper was issued, FASB ASC Subtopic 605-25 on recognizing revenue in multiple element arrangements (originally issued as EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables") has been revised to require an entity to estimate stand-alone selling prices to measure performance obligations if neither vendor-specific objective evidence ("VSOE") nor third-party evidence ("TPE") of a stand-alone selling price is available. Hence the only significant revenue recognition requirements that now preclude the use of estimates are ASC Subtopic 985-605, *Revenue Recognition—Software*.

12. Historically, concerns about the use of estimated prices seem to be heightened for software transactions. Those concerns were not particularly evident in the responses to the Discussion Paper, although one software company argued that a performance obligation should be combined with other performance obligations if its selling price cannot be reasonably estimated. However, those concerns have been more evident in outreach to users associated with software companies as part of the revisions to ASC Subtopic 605-25. In response, the staff notes that its recommendations in the October Board papers should ease some of those concerns. The recommendations in Agenda Paper 3B/Memo 122B should result in less segmentation of a contract than proposed in the Discussion Paper. For instance, software licences that cannot be sold without related post-contract support services would not be identified as a separate segment but combined

with the post-contract support (with revenue likely recognized over the license term).

13. The Discussion Paper did not consider disclosure for revenue contracts. The staff thinks that disclosures of the significant factors, inputs, assumptions, and methods used to determine selling price for the segments of a contract may mitigate some of the concerns of respondents with respect to use of estimates. The EITF considered disclosure requirements along these lines in revising the requirements of ASC Subtopic 605-25. Such disclosure alerts users to the extent of estimates used in determining the amounts of recognized revenue. The staff plans to recommend similar disclosure requirements at a future Board meeting.

Staff recommendation and question for the Boards

Question 1 – Use of estimates
In the proposed model, an entity allocates the transaction price to each segment in the contract on a relative stand-alone selling price basis. The staff recommends that if the stand-alone selling price of a segment is not directly observable, an entity should estimate it for purposes of allocating the transaction price. .Do the Boards agree?

Hierarchy for allocation

Boards' preliminary views

14. In the Discussion Paper, the Boards explained that they do not intend to preclude or prescribe any particular method for estimating a stand-alone selling price so long as it is consistent with the basis of a stand-alone selling price (i.e. the price at which the entity would sell the segment if it was sold separately). Hence, the Boards stated that an entity could use various methods to estimate a stand-alone selling price and gave examples of two suitable estimation methods (expected cost plus a margin approach and an adjusted market assessment

approach). The Boards emphasized that observable inputs should be maximized regardless of the estimation method.

Respondents' views

15. As discussed above, the majority of respondents support the use of estimates when determining stand-alone selling prices. However, some respondents recommend that the Boards specify a hierarchy of estimation methods. For example, some respondents suggest a hierarchy similar to that developed by the EITF in its revisions to ASC Subtopic 605-25, namely:

    1 VSOE of selling price, if it exists.

    2 Otherwise, TPE of selling price.

    3 If neither VSOE nor TPE of selling price exists for a deliverable, best estimate of the selling price for that deliverable.

16. Respondents who support a hierarchy argued that it would:

    (a) Provide guidance to entities on how to determine stand-alone selling price.

    (b) Maximize the use of observable prices before the use of estimates.

    (c) Result in more reliable or verifiable information.

    (d) Increase the comparability of information among entities.

17. Some respondents request further clarification on how to determine estimated stand-alone selling prices and allowable methods for doing so.

Staff analysis

Hierarchy

18. At one stage in deliberations leading to the Discussion Paper, the Boards considered a hierarchy similar to that recently introduced by the EITF. However, the Boards observed that once an entity is determining a selling a price for a good or service that it does not sell separately itself, it would have to use estimation techniques. That is because the objective is to determine the

price at which the *entity* would have sold the good or service to its customer on a stand-alone basis. Hence, even if there is a third-party evidence of a selling price, that price might require adjustments to reflect differences either in (a) the good or service (because the third-party price could be for a *similar* good or service) or (b) pricing strategies between the third party and the entity. That means that in reality there is little distinction between Level 2 in the above hierarchy (TPE) and Level 3 (best estimate of selling price).

19. Furthermore, the staff is recommending in Agenda Paper 3B/Memo 122B that a contract should be segmented only if there is evidence of a market for the segments. Hence, the estimated price of a segment would be based on some observable inputs.

20. Therefore, the staff thinks that the key point to emphasize in determining selling prices is that entities should maximize the use of observable inputs.

21. The staff considered whether a hierarchy would assist the Boards in developing the disclosure requirements relating to selling prices. A hierarchy might allow the Boards to focus some disclosures on those cases in which an entity has used estimates. However, the staff is thinking in terms of a general disclosure requirement (see paragraph 13) that, similarly to ASC Subtopic 605-25, would not require different disclosures for different levels of estimates.

Additional guidance

22. As noted above, the Boards did not preclude or prescribe any method for estimating a stand-alone selling price in the Discussion Paper. The staff thinks that the Boards should continue to articulate a clear objective for the basis of the allocation (i.e. stand-alone selling price). An Exposure Draft could then describe various methods that could be consistent with that objective.

Staff recommendation and question for the Boards

Question 2 – Guidance on estimated selling prices
The staff recommends that when estimating selling prices, an entity should maximize the use of observable inputs. The Exposure Draft should provide a clear objective for estimation and describe acceptable estimation methods. However, the Exposure Draft should not prescribe or preclude any particular method of estimating a stand-alone selling price. Do the Boards agree?

Residual method

Boards' preliminary views

23. In the Discussion Paper, the Boards eliminated the use of the residual method as a basis of allocating the transaction price to the performance obligations. With the residual method, remaining performance obligations in a contract are measured directly using objective and reliable evidence of selling prices of those items. Any difference between that measurement and the total transaction price is recognized as revenue for the delivered items. (Note that the total amount of revenue recognized in a contract does not differ using the residual method compared with the relative selling price method. Only the basis of allocation differs.)

Respondents' views

24. Some respondents think that in some cases, the residual method should be used as a basis for allocating the transaction price for the following reasons:

    (a) The residual method should be considered as an alternative to estimated selling prices when directly observable measures are not available for all items.

    (b) The residual method is less complex and, hence, less costly than determining estimates. In some cases it would mean that the Boards' proposed model could be implemented without significant system changes.

(c) It is more practical in a contract that contains many performance obligations but in which most of those obligations are satisfied at contract inception. The entity needs only to determine stand-alone selling prices for the *remaining* goods and services.

Staff analysis

25. In US GAAP, the residual method has largely been used in revenue recognition requirement as a means of permitting revenue recognition when it otherwise would have been precluded because of the absence of an observable selling price for satisfied performance obligations. That is, in an arrangement with two performance obligations (A and B)for which there is no observable selling price for A but there is for B, the residual method allows revenue to be recognized on the satisfaction of A, despite it having no observable selling price. (Revenue recognition would not be permitted on satisfaction of A if there was an observable price of A but not B.) With the residual method, any discount in the contract is allocated in its entirety to the items delivered first.

26. Arguably, the residual method is unnecessary if an entity is allowed to estimate stand-alone selling prices. In other words, its elimination is a consequence of the decision to require the use of estimates. That was a factor in the EITF's decision to eliminate the use of the residual method when amending ASC Subtopic 605-25 to require the use of estimates. (In that regard, the staff notes that some respondents to the EITF's consensus for exposure also expressed support for the residual method similar to the comments above in response to the Discussion Paper.)

27. Arguably, a residual method results in a more relevant measure of the remaining performance obligations because it is a (selling) *price* rather than an allocated amount. However, in principle the residual method is not consistent with an allocation model. It can result in the discount in the contract being allocated to a single segment. That may not reflect the economics of the transaction, for

instance, in some cases it could result in a loss on that segment when the contract as a whole is profitable. Introducing the residual method into the proposed model would also increase its complexity because the Boards would need to specify when it should be used in preference to estimating selling prices.

28. Therefore, the staff thinks the Boards should not introduce the residual method into the proposed model as a basis of allocating consideration to each segment of a contract. That said, the staff thinks that in cases in which entities have directly observable prices for one segment of a contract but not the other, an entity might use residual (or reverse residual) techniques as an input for estimating a stand-alone selling price..

29. For example, consider an entity that has a CU20 contract with two segments for products A and B. Assume product B has an observable stand-alone selling price of CU15 but product A does not have an observable stand-alone selling price. In some cases it might be appropriate for the entity to use a residual method to estimate the stand-alone selling price of CU5 for product A (total transaction price of CU20 less the CU15 stand-alone selling price for product B).

Staff recommendation and question for the Boards

Question 3 – Elimination of residual method
The staff recommends that an entity should not use the residual method as a basis to allocate the transaction price to segments of a contract. However, an entity might consider a residual method as an input when estimating a stand-alone selling price. Do the Boards agree?

Allocation of discount

Boards' preliminary views

30. The Boards proposed that an entity should allocate the total consideration (or transaction price) to each performance obligation in proportion to the stand-

alone selling price of the good or service underlying each performance obligation. Consequently, any discount in the contract is allocated to all performance obligations.

Respondents' views

31. Few respondents commented on this topic. However, there were two main comments:

    (a) Management should exercise judgement in determining where to allocate the discount. For example, assume that the selling price for product A on a stand-alone basis is CU10; however, the price for two As is CU16. Further assume that the selling price of product B is CU20. Suppose an entity enters into a contract for two As and one B for CU36. Some argue that the discount of CU4 should not be applied to product B.

    (b) Some telecommunication companies want to allocate on the basis of prices as stated in the contract rather than relative stand-alone selling prices. For instance, if the contract is for a "free" handset plus 12 months service for CU25 per month, some would not allocate any of the transaction price to the handset.

Staff analysis

32. The staff thinks that its recommendations in the October Board papers would give an intuitive answer to the example in paragraph 31(a) above. In accordance with the segmentation principle in Agenda Paper 3B/Memo 122B, if product A is sold in a bundle of two, those products would be combined into a single segment because there is evidence of a market for them as a bundle and they have the same margin. Therefore, there is no discount associated with the contract because CU16 is an observable price for that segment and CU20 is an observable price for the other segment.

33. More generally, the staff notes that the transaction price of a contract is determined based on the contract as a whole and not based on the price of each

segment individually. Therefore, any discount in the contract is attributable to the contract as a whole and should be allocated proportionally to each segment.

34. With respect to the phone contracts, the staff does not think that recognizing revenue on the basis of how an entity markets its products would result in a robust model. If the customer has obtained control of the handset, then that handset is clearly an asset being provided to the customer in a contract for which the entity has charged. Accordingly, even if the stated contract price for the handset is zero, some of the transaction price should be allocated to it on a relative stand-alone selling price basis. The contractually-stated price for individual segments in a contract cannot be presumed to represent the selling price for those segments in a contract.

Staff recommendation and question for the Boards

Question 4 – Allocation of discount
The staff recommends that an entity should allocate a discount in a contract to all segments of the contract in proportion to the relative stand-alone selling prices of the segments. Do the Boards agree?