Project	**Revenue Recognition**
Topic	**Scope**

Purpose

1. The boards are requested to decide how an entity should account for a contract that includes some performance obligations that are within the scope of the revenue model and other performance obligations that are within the scope of other standards.

Summary of recommendations

2. A performance obligation or other component of a contract might be within the scope of another standard (eg leases, insurance, financial instruments and guarantees). The staff recommends that an entity should apply the following hierarchy to separate and measure such performance obligations or other components:

   (a) *Level A*—If the other standard addresses both separation and measurement of a component of a contract, apply that standard to separate the contract and measure that component.

   (b) *Level B*—If the other standard addresses only separation but not measurement, apply that standard to identify the separate component within that contract and use the revenue model to measure that component (ie by allocating transaction price to it on the basis of relative standalone selling prices).

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.

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(c) *Level C*—If the other standard does not address separation or measurement, apply the revenue model.

Previous discussion in February 2010

3. The boards previously discussed this issue in February 2010 as part of their deliberations on the scope of the proposed standard. The boards tentatively decided that the proposed revenue standard would apply to an entity's contracts with customers, except for:

    (a) lease contracts within the scope of IAS 17 *Leases*, or FASB Accounting Standards Codification™ Topic 840 *Leases*;

    (b) insurance contracts within the scope of IFRS 4 *Insurance Contracts*, or Topic 944 *Financial Services—Insurance*;

    (c) contracts within the scope of IFRS 9 *Financial Instruments*; IAS 39 *Financial Instruments: Recognition and Measurement* or Topic 825 *Financial Instruments*; and

    (d) guarantees (other than product warranties) within the scope of IFRS 4, IAS 39, or Topic 460 *Guarantees*.

4. However, the boards asked the staff to analyse further how an entity should account for a contract that includes some performance obligations that are within the scope of the revenue model and other performance obligations that are within the scope of other standards. This paper contains that analysis.

Structure of this paper

5. The remainder of the paper is structured as follows:

    (a) Background on the revenue model

    (b) Accounting for a contract with performance obligations in both the revenue model and other standards

    (c) Separating and measuring components of a contract

(d) Potential concerns with the implications of the hierarchy on measurement requirements

(e) Accounting for contingent consideration

(f) Summary of staff recommendations

Background on the revenue model

6. It is helpful to begin by summarising how the revenue model separates a contract. In the revenue model, a contract is separated in two steps:

   (a) Step 1: an entity might segment a single contract into more than one contract, and

   (b) Step 2: an entity identifies separate performance obligations in each contract identified in (a).

Step 1: Segmenting a contract

7. The first step in applying the revenue model is to identify the contract. Typically, an entity will apply the model to a single contract. However, in some cases, an entity might segment a single contract into more than one contract (this segmentation principle is the mirror of the combination principle in which an entity accounts for two or more contracts as one contract).

8. The principle for segmenting (or combining) contracts is price interdependence. That is, a contract is segmented into separate contracts if some goods or services in the contract are priced independently of other goods or services in the contract. Goods or services in a contract are priced independently of other goods or services in the same contract only if:

   (a) the entity, or another entity, regularly sells the goods or services on a standalone basis, and

   (b) the price for all goods or services in the contract approximates the sum of the *standalone selling price* of each good or service (i.e. the customer does not receive a discount for buying a bundle of goods or services).

9. The above segmentation principle is particularly relevant when assessing scope. This is because if some goods or services in the contract are priced independently and are within the scope of other standards, the contract segmentation principle would segment the contract into *separate contracts*. Each of those contracts would be accounted for separately in accordance with the relevant standard. This simplifies assessments of scope because the revenue model will not apply to any contracts that are outside its scope (eg financial instrument, insurance, and leases contracts).

> **Example 1**
> An entity enters into a contract with a customer to provide a lease and a service. The lease and the service are priced independently of each other. The contract segmentation principle would require an entity to account for the lease as one contract and the service as another contract. Each contract would be assessed for scope separately.
>
> Based on the boards' decision on scope in February, the leases standard would apply to the lease contract and the revenue model would apply to the service contract.

10. Appendix A discusses the contract combination and segmentation principle in more detail. It also compares the concept of price independence / interdependence that is used in the revenue model to separate contracts with the cash flow independence / interdependence concept that is being recommended for use in unbundling an insurance contract.

Step 2: Identifying separate performance obligations in the contract

11. The revenue model requires an entity to evaluate all goods or services promised in a contract and identify which of those performance obligations should be accounted for separately. An entity should account for a promised good or service as a separate performance obligation if it is *distinct*.

12. A good or service is distinct if it is sold separately. If a good or service is not sold separately, a performance obligation may be distinct if it:

    (a) is identified separately in the contract,

(b) has a distinct profit margin (for instance, the resources required to provide the good or service are managed separately by the entity, or the entity can separately identify the costs of providing the good or service),

(c) has a distinct function (for instance, although the good or service is not sold separately, it provides utility either on its own or together with other available goods or services), and

(d) is transferred to the customer at a different time.

13. A separate performance obligation has to result in the *transfer* of a good or service to the customer (otherwise it would not be a performance obligation). This means that the revenue model would not recognise revenue from any activities undertaken by the entity that do not transfer distinct goods or services to the customer.

> **Example 2**
> A bank has a contract with a customer to provide a loan. The contract requires the customer to pay an upfront non-refundable fee for loan establishment costs (ie activities the bank will perform to make the loan funds available to the customer).
>
> The financial instruments standards apply to account for the loan.
>
> The act of establishing a loan is not a separate performance obligation. It does not provide a service to the customer separate from the provision of loan funds. It is an activity that needs to be undertaken to allow the customer to access the funds. As there is no separate performance obligation, both the loan and establishment fee would be accounted for in accordance with the financial instruments standard.

Accounting for a contract with performance obligations in both the revenue model and other standards

14. Clearly, if a separate contract is entirely in the scope of another standard, an entity would apply that other standard. A separate contract includes a contract identified in accordance with the contract segmentation principle discussed in paragraphs 7–10.

15. However, if a contract is partly in the scope of another standard, it is less clear which standard an entity should apply. In February, the staff recommended that

an entity should apply the requirements of the other standard to make that determination. An entity would apply the revenue model to any performance obligations not captured by the other standard (similar to existing U.S. GAAP).

16. In applying the staff's recommendation to contracts with customers, the staff notes that the separation (and measurement) requirements in other standards can differ from those in the revenue model. For example, the insurance contracts project's unbundling requirements might differ from the revenue model's allocation of transaction price to separate performance obligations. Because of that, the boards asked the staff to clarify which standard an entity would consider first, and how the entity would apply the staff's recommendations.

17. For this reason, the staff thinks that the revenue model should specify a hierarchy to help an entity account for a contract with performance obligations in both the revenue model and another standard(s). This hierarchy would be similar to the hierarchy in U.S. GAAP (issued initially in EITF Issue No. 00-21 and carried forward in EITF Issue No. 08-1).

18. The staff recommends the following hierarchy for separating and measuring a component of a contract (this component might be a performance obligation or some other component that is defined by the other standard):

    (a) *Level A*—If the other standard addresses both separation and measurement of a component of a contract, apply that standard to separate the contract and measure that component.

    (b) *Level B*—If the other standard addresses only separation but not measurement, apply that standard to identify the separate component within that contract and then use the revenue model to measure that component (ie by allocating transaction price to it on the basis of relative standalone selling prices).

    (c) *Level C*—If the other standard does not address separation or measurement, apply the revenue model.

19. The following section considers the implications of applying the separation and measurement requirements of other standards to contracts with customers.

Implications of the hierarchy on separation requirements

20. In Levels A and B, an entity would identify separate components of a contract in accordance with other standards. In those situations, the component identified by the other standard may not be a separate performance obligation. For instance, as noted in Example 2 above, a requirement to establish a loan for a customer is not a performance obligation because it does not provide that customer with a service that is separate from the loan. Moreover, because fees for establishing loans are within the scope of the financial instruments standards, those standards apply to account for those fees.

21. In Level C, an entity would apply the revenue model to identify the separate performance obligations in the contract and allocate the transaction price to them.

Implications of the hierarchy on measurement requirements

22. In Level A, the transaction price should be initially allocated to those components that are in the scope of other standards at an amount equal to the initial measurement basis prescribed by those standards. The transaction price that remains would be allocated to:

    (a) those components that are identified in Level B of the hierarchy;

    (b) the remaining performance obligations that are identified in Level C; and

    (c) the performance obligations that are within the scope of the revenue model.

    That allocation would be performed on a relative standalone selling price basis.

23. To illustrate how an entity would use the proposed hierarchy, consider the following example:

> **Example 3**
> An insurance provider enters into a contract to provide insurance coverage and investment management services to a policyholder.

> Assume that in accordance with the insurance contracts model, the entity determines that the investment management services can be unbundled from the insurance coverage. If the insurance model specifies the initial measurement of the unbundled components, the entity would apply those requirements. If the insurance contracts model does not specify the initial measurement basis, the entity would allocate the transaction price to those components in accordance with the revenue model.

Potential concerns with the implications of the hierarchy on measurement requirements

24. In February 2010, a board member expressed concern about allocating a transaction price on the basis of the initial measurement prescribed by another standard (as per the hierarchy approach discussed above and as recommended by the staff) for the following reasons:

    (a) it is inconsistent with the principle of the revenue model that any discount in a contract should be allocated to all performance obligations in the contract; and

    (b) any discount in a contract would be allocated only to those performance obligations that are measured at cost (eg transaction price or an allocated amount), which would include all performance obligations that remain in the revenue model. This would place greater stress on the onerous test in the revenue model. For instance, it could have the seemingly anomalous result of a performance obligation being considered onerous even though the contract as a whole is still profitable.

25. Therefore, it was suggested that in all cases the transaction price should be allocated to the underlying goods or services on the basis of their standalone selling prices.

26. The staff agrees that allocating transaction price based on the initial measurement prescribed by another standard places stress on the onerous test, but disagrees with this alternative. The staff's view is that precedence should be given to the more specific standard by measuring the performance obligation in

that standard at the amount prescribed by that standard. In other words, if in a particular standard the boards decided on a specific measurement attribute for a specific item, this alternative preserves that intention by measuring the item in accordance with that measurement attribute rather than at an amount that is determined by the revenue model. In practical terms, this is an issue only if the measurement attribute is fair value or some other current value measurement. In all other cases, the staff agrees that allocating transaction price on a relative standalone selling price basis is appropriate.

Accounting for contingent consideration

27. In February 2010, a board member expressed concern about the lack of clarity on how an entity would allocate a change in the transaction price (eg from contingent consideration) to performance obligations, some of which are in the scope of the revenue model and others in the scope of other standards. The staff thinks the revenue model addresses this issue, but thinks that the exposure draft could provide some application guidance on this topic.

28. The revenue model requires an entity to allocate changes in the transaction price to all performance obligations relative to the standalone selling prices of the promised goods or services at *contract inception*. If performance obligations in the scope of other standards are subsequently remeasured for changes in circumstances (eg a change in the expected costs to satisfy the performance obligation), that remeasurement of the performance obligation does not affect any subsequent allocation of changes in the transaction price.

29. Consider the following example:

> **Example 4**
> A lessor grants a lessee the right to use equipment for a specified period. The lessor also promises to provide distinct maintenance services for the equipment throughout the lease term. The amount of consideration the lessee pays (for both the right to use and the services) is based on usage of the equipment.
>
> At contract inception, the lessor would determine the transaction price and allocate it to both the lease component and to the services

> component on a relative standalone selling price basis. As the transaction price changes throughout the contract due to the uncertain amount of consideration, the revenue model would reallocate the transaction price across the lease and the services components in accordance with the allocation basis at contract inception.[1]

30. If a contract includes a component that is subsequently remeasured (eg at fair value) in accordance with another standard, an entity similarly would allocate changes in the transaction price to all components on the same basis as at contract inception. However, any amount allocated to a component remeasured at fair value would be recognised as revenue (or a reduction in revenue) in the current reporting period because that component would be measured in accordance with a measurement model rather than an allocation model. Consequently, revenue (or gains or losses) will be recognised as the component is remeasured as well as when goods or services are provided.

Summary of staff recommendations

31. The staff recommends that an entity should apply the hierarchy outlined in paragraph 19 to account for contracts with customers that are partly within the scope of other standards.

32. The hierarchy is consistent with the staff view that the accounting for contracts (or performance obligations within those contracts) within the scope of other standards should be determined by the requirements of those other standards. In other words, if a particular standard requires a particular measurement attribute for a particular item, that requirement should be preserved by using that measurement basis rather than applying the revenue model.

[1] The staff on the leases project has prepared IASB agenda paper 10C / FASB memo 68C, which addresses accounting for arrangements with service and lease elements. This paper includes an example of a contract for a lease and services that has contingent consideration. In that paper, the leases staff recommends that the contingent consideration is allocated on the same basis as the revenue model.

Question 1:
The staff recommends that an entity should apply the following hierarchy to separate and measure a component of a contract that is within the scope of another standard (eg leases, insurance, financial instruments and guarantees): (a) Level A—If the other standard addresses both separation and measurement of a component of a contract, apply that standard to separate the contract and measure that component. (b) Level B—If the other standard addresses only separation but not measurement, apply that standard to identify the separate component within that contract and use the revenue model to measure that component (ie by allocating transaction price to it on the basis of relative standalone selling prices). (c) Level C—If the other standard does not address separation or measurement, apply the revenue model. Do the boards agree?

Appendix A
Contract combination and segmentation principle

A1. Combining or segmenting contracts is based on whether the goods or services to be provided under the contract are price independent or price interdependent. This independence or interdependence of pricing relates to how the contract has been negotiated. For example, a price interdependency exists if:

(a) the customer receives a discount for purchasing a bundle of goods or services in a single transaction (ie a discount that is applied to the total transaction price); or

(b) the customer receives a discount in the nature of a cross subsidy in the pricing of the goods or services acquired in a single transaction (ie a discount that is offered on one good or service to provide the customer with an incentive to purchase additional goods or services in the contract).

A2. In either of these examples, the price interdependency would mean that the contract is not segmented into separate contracts. Therefore, the whole contract would be assessed against the scope of other standards.

A3. In contrast, if no discount applies to the goods or services, this would indicate that there is price independence within the contract and therefore that the contract could be segmented. For those contracts that are segmented into separate contracts (for the purposes of the revenue model), each separate contract resulting from the segmentation would be separately assessed against the scope of other standards.

Independence and interdependence in insurance contracts

A4. The notion of independence and interdependence in the insurance contracts project is different. The focus in insurance is on whether an insurance contract should be unbundled into separate components (eg into an insurance component, financial instrument component and a service component) and those components accounted for separately under the applicable standard. One of the options identified by insurance staff was that an insurance contract should be unbundled

when the components are independent and not unbundled when the components are interdependent. In this context, independence and interdependence relates to the cash flows to satisfy the performance obligations—that is, cash flows are interdependent if the cash flows relating to satisfying one performance obligation affect the cash flows for satisfying another performance obligation and vice versa. The focus on cash flows to fulfil the insurance contract means that the notions of independence and interdependence extend beyond establishing the transaction price at the inception of the contract. Whereas, in the revenue model, identifying independence or interdependence between performance obligations is based on the pricing of the underlying goods or services and therefore it is relevant only at contract inception.

A5. The different meanings given to independence and interdependence in both projects can produce different outcomes. It would be possible under the insurance contracts model for an insurance contract to unbundle a service component (because it has independent cash flows) but for the revenue standard to not treat the service component as a *separate contract* because the insurance component and service component have interdependent prices (ie they were sold as a bundle with a discount). In other words, the staff thinks that it is possible for a contract for insurance coverage and services to be treated as a single contract under the revenue model because of price interdependence and for the insurance contracts model to then unbundle that contract into separate insurance and services components because those components are cash flow independent. In contrast, the staff thinks that in situations in which insurance coverage and services are priced independently, they would also have cash flow independence. Therefore, both models would separate the services components from the insurance coverage. In accordance with the abovementioned steps, it would be the revenue model that would segment the insurance coverage and services into separate contracts.

A6. The revenue standard and the insurance contracts standard will need to avoid using the same language to describe different things. The staff on the respective projects will resolve this problem when drafting the exposure drafts.