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Staff Paper

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Project **Revenue Recognition**

Topic **Allocating the transaction price**

Please note this paper was originally posted as IASB Agenda paper 10F / FASB Memo 140F for the March 21-23,2011 IASB/FASB joint meeting. No changes have been made.

Purpose and summary of the staff's recommendations

1. This paper considers improvements to the Exposure Draft's proposed requirements on how an entity should allocate the transaction price to separate performance obligations in a contract.

2. The core principle in the Exposure Draft states that an entity should allocate to each separate performance obligation the amount of consideration the entity expects to receive in exchange for satisfying that performance obligation.

3. To apply the core principle, the staff recommends that an entity should allocate the transaction price (or change in the transaction price) on a relative standalone selling price basis except in the following circumstances when an entity should be permitted to use an alternative allocation method:

   (a) If an entity transfers a significant good or service to the customer at the beginning of a contract and the price for that good or service is highly variable (e.g. a software license), the entity should be permitted to allocate the transaction price to the remaining performance obligations in a contract at an amount equal to the standalone selling prices of the goods or services underlying those remaining performance obligations (i.e. a residual method).

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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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(b) If a relative selling price allocation results in a loss on one or more performance obligations, an entity should be permitted to allocate the transaction price to the performance obligations in a contract using either a residual method or by allocating the discount in the contract in proportion to the individual profit margin on each separate performance obligation (i.e. a profit margin method).

(c) If a change in the transaction price relates entirely to one performance obligation, an entity should be permitted to allocate the change in the transaction price entirely to that performance obligation. That would be the case if both of the following conditions are met:

(i) The contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or a specific outcome from satisfying that separate performance obligation; and

(ii) The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

4. This paper is organized as follows:

(a) Background (paragraphs 5-10)

(b) Estimating standalone selling prices (paragraphs 11-22)

(c) Allocating a discount within a contract (paragraphs 23-40)

(d) Allocating subsequent changes in the transaction price (paragraphs 41-52)

Background and feedback

Standalone selling price and relative selling price allocation

5. The Exposure Draft states that:

    (a) An entity should allocate the transaction price to all separate performance obligations in proportion to the standalone selling price of the good or service underlying each of those performance obligations at contract inception (that is, on a relative standalone selling price basis).

    (b) The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately. A contractually stated price or a list price for a good or service would not be presumed to represent the standalone selling price of that good or service. If a standalone selling price is not directly observable, an entity would estimate it.

    (c) After contract inception, an entity would allocate any changes in the transaction price to all performance obligations on the same basis as at contract inception. Amounts allocated to satisfied performance obligations would be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes. An entity would not reallocate the transaction price to reflect changes in standalone selling prices after contract inception.

6. Most respondents to the Exposure Draft agreed with the proposal to allocate the transaction price at contract inception on a relative standalone selling price basis. The Exposure Draft is consistent with recent changes (ASU 2009-13) to US GAAP to account for a revenue contract with multiple-deliverable revenue arrangements.

7. As a consequence of the relative standalone selling price allocation:

(a) Any discount in the contract is allocated to all separate performance obligations, and

(b) Any change in the transaction price is allocated to all separate performance obligations.

Allocating discounts and changes in the transaction price

8. The Exposure Draft acknowledged that in some cases, it would not be appropriate to allocate a discount (or change in the transaction price) to all separate performance obligations. Hence, the Exposure Draft included a "contract segmentation" principle that would ringfence allocations of discounts and changes in the transaction price on the basis of goods or services that are priced independently. In accordance with the Exposure Draft, goods or services in a contract are priced independently of other goods or services in the same contract only if both of the following conditions are met:

   (a) The entity, or another entity, regularly sells identical or similar goods or services separately; and

   (b) The customer does not receive a significant discount for buying some goods or services together with other goods or services in the contract. (application of this guidance is discussed in paragraphs 29 and 30)

9. Many respondents to the Exposure Draft agreed with the objective of contract segmentation (i.e. using the principle of "price independence" to ringfence allocations of some changes in the transaction price). However, most respondents thought that the criteria for determining whether goods or services are priced independently were too strict. In addition, most respondents thought that it was not necessary for the revenue model to require contract segmentation when the same outcome could be achieved by clarifying how an entity should allocate changes in the transaction price.

10. In January 2011, the Boards agreed with those respondents and decided to eliminate the requirement to segment a contract in addition to identifying separate performance obligations. The basis for that decision was that the Boards would reconsider how an entity would achieve the objective of contract segmentation through the allocation of the transaction price.

Estimating the standalone selling price

11. As noted above, most respondents to the Exposure Draft agreed with the proposal to allocate the transaction price at contract inception on a relative standalone selling price basis. However, many respondents asked the Boards to clarify the following:
    (a) How an entity would estimate a selling price,
    (b) Whether an entity should consider a hierarchy of evidence to determine a standalone selling price, and
    (c) How an entity would apply the residual technique in estimating a selling price.

How an entity would estimate a selling price

12. The Exposure Draft noted that the best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately. If an entity does not have an observable price from selling a good or service separately, the entity would be required to estimate the standalone selling price. Paragraph 52 of the Exposure Draft stated the following regarding estimates of selling prices:

    When estimating standalone selling prices, an entity shall maximize the use of observable inputs and shall apply estimation methods consistently for goods or services and customers with

similar characteristics. Suitable estimation methods include the following:

(a) expected cost plus a margin approach—an entity could forecast its expected costs of satisfying a performance obligation and then add the margin that the entity would require for that good or service; and

(b) adjusted market assessment approach—an entity could evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

13. Some respondents requested clarification as to whether an entity should consider both market conditions and entity-specific factors in estimating a selling price. Those respondents believe that it would be inappropriate to apply the cost plus margin approach and ignore market conditions or apply the market assessment approach and ignore entity specific factors such as the entity's pricing strategy.

14. The staff thinks that an entity would need to consider all reasonably available information when estimating selling prices. Because of recent changes to US GAAP on accounting for multiple-deliverable revenue arrangements, many entities may already have robust processes for determining selling prices on the basis of reasonably available data points and the effects of market considerations and entity-specific factors. Other entities may need to develop processes for estimating selling prices of goods or services. When developing those processes, an entity would consider all reasonably available information based on the entity-specific facts and circumstances. That information might include the following:

    (a) Reasonably available data points (e.g., standalone sales price of the good or service, the costs incurred to manufacture or provide the good or

service, related profit margins, published price listings, third-party or industry pricing, and the pricing of other goods or services in the same contract),

(b) Market conditions (e.g., supply and demand for the good or service in the market, competition, constraints and trends),

(c) Entity-specific factors (e.g. business pricing strategy and practices),

(d) Information about the customer or class of customer (e.g., type of customer, geography, distribution channel).

Specifying a hierarchy of evidence to determine the standalone selling price

15. Most respondents were supportive of a revenue standard not prescribing a hierarchy of evidence for estimating standalone selling prices. However, some respondents (primarily users) recommend that the Boards specify a hierarchy of evidence to determine the standalone selling price of a separate performance obligation similar to the following hierarchy in Subtopic 605-25:

    (a) If Vendor Specific Objective Evidence (VSOE) of a selling price is available, it would be used to determine the selling price of a promised good or service;

    (b) If VSOE is not available, an entity would determine the selling price using Third Party Evidence (TPE) if available;

    (c) If TPE is not available, then an entity would use an estimated selling price.

16. Those respondents think that specifying a hierarchy of evidence for determining standalone selling prices (and requiring disclosures using that hierarchy) would enhance the quality and reliability of an entity's reported revenues.

17. Paragraph BC121 in the Exposure Draft provided the Boards' basis for not specifying a hierarchy when estimating selling prices:

> The Boards decided against specifying a hierarchy of acceptable estimation methods. The Boards observed that even if there is 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, rather than identical, good or service) or (b) pricing strategies between the third party and the entity. Hence, there is little distinction between TPE and best estimate in the hierarchy in Subtopic 605-25. The Boards concluded that it was important to emphasize that when using estimates, an entity should maximize the use of observable inputs.

18. In addition to that basis, the staff notes that the standard still would require an entity to use observable prices when a good or service is sold separately by the entity (similar to a VSOE notion). It is only when a good or service is not sold separately that an entity would estimate selling prices. The staff thinks that there is little distinction between third-party evidence (Level 2) and a best estimate of selling price (Level 3). Hence, the staff recommends that the Boards affirm their proposal in the Exposure Draft and not specify a hierarchy.

How an entity would apply the residual technique in estimating a selling price

19. A few respondents to the Exposure Draft requested clarification on the use of a residual technique of estimating a selling price. The Exposure Draft's basis of conclusion (paragraph BC 125) states:

> the Boards confirmed their view that the residual method should not be used to allocate the transaction price to separate performance obligations. However, the Boards noted that a residual (or reverse residual) technique may be an appropriate method for estimating a standalone selling price if there is a directly observable price for one performance obligation but not the other.

20. Respondents generally agreed with using a residual technique when estimating a selling price (as described in the basis for conclusions and as illustrated in the example below). However, those respondents thought that the final standard (rather than the basis) should clarify (a) that an entity could use that estimation technique and (b) how an entity would use that estimation technique. The staff thinks it would be appropriate in situations similar to the following:

> An entity has a consistent practice of selling support services on a standalone basis at 20% of the selling price of the product to which the services relate. Hence, if the entity sells a product and related support services as a bundle for CU120, the entity would estimate the selling prices as follows:
>
> Product CU100 (CU120 × CU100/CU120)
> Service CU 20 (CU100 × 20%)

21. In this example, the entity would consider the amount allocated to the product of CU100 using a residual method as one of the data points identified in considering reasonably available data. Additionally, the entity would consider other reasonably available data, market and entity-specific factors when estimating the selling price of the product.

Staff recommendation

22. The staff thinks that the final revenue standard should carry forward the guidance in the Exposure Draft on estimating selling prices and should clarify that an entity should consider all reasonably available information (including market and entity-specific factors) and maximize the use of observable inputs when estimating selling prices.

FASB-IASB Staff paper

Allocating a discount within a contract

Feedback on the Exposure Draft

23. Most respondents to the Exposure Draft agree that an entity should allocate any discount on a bundle of goods or services to all those promised goods or services on a relative standalone selling price basis. Some respondents, however, think that in some circumstances the revenue standard should permit an entity to allocate a discount in the contract to (a) only a satisfied performance obligation or (b) in proportion to the individual profit margin on each performance obligation, in order to reflect the economic substance of a transaction. Those respondents request a "residual method" and "profit margin method" of allocating the transaction price.

    (a) *The residual method*: under this method, an entity would allocate consideration to the remaining performance obligations in a contract at an amount equal to the standalone selling prices of the goods or services underlying those remaining performance obligations. The amount of revenue recognized for past performance would be the difference between the total transaction price and the selling price of the remaining performance obligations. Hence, any discount in the contract would be allocated entirely to the satisfied performance obligations.

    (b) *The profit margin method*: under this method, an entity would allocate the discount in a contract in proportion to the individual profit margin on each performance obligation. Individual profit margin for each performance obligation is the difference between the standalone selling price and direct costs for each separate performance obligation.

24. The FASB recently eliminated the residual allocation method for contracts in the scope of the guidance on multiple- deliverable revenue arrangements in Subtopic 605-25. Some companies have found it difficult to apply the recently revised guidance. One respondent noted:

> Due to our experiences of applying the recently revised multiple-element arrangements guidance, we suggest some form of the residual method (which provides that revenue for undelivered performance obligations would be measured at their estimated stand alone selling prices while revenue for the delivered items would be recognised based the remaining transaction consideration) should be an available accounting policy election as a practical expedient to allocating the transaction price across multiple performance obligations. [CL#419]

25. Some respondents think a residual or the profit margin method would be appropriate for the following reasons:

    (a) It is simpler in a contract that contains many performance obligations and most of those obligations are satisfied at contract inception. The entity would need only to determine the standalone selling prices for the remaining goods or services

    (b) It can ease the significant practical difficulties in determining standalone selling prices especially for items (e.g. software licenses and rights to use intellectual property) with highly variable pricing. In addition, requiring an entity to allocate the transaction price on a relative standalone selling price has systems limitations when the same product has multiple standalone selling prices.

    (c) It results in an allocation that some think is more intuitive. A relative standalone selling price allocation could result in a loss on one part of the contract when the contract as a whole is profitable (e.g. when the contract contains both a high margin item and a low margin item).

    (d) It results in an entity allocating a discount only to the part of the contract to which the discount relates.

26. Some respondents (primarily telecommunications and cable television operators) have requested that the Boards carry forward the "contingent revenue" allocation

guidance from Subtopic 605-25. That guidance specifies that "the amount allocable to the delivered unit or units of accounting is limited to the amount that is not contingent upon the delivery of additional items or meeting other specified performance conditions (the noncontingent amount)." The application of this guidance would in effect result in the telecommunication companies recognizing revenue as the entity bills the customer for each month of service. At a future meeting, the Boards will discuss the effects of the proposed revenue model on companies requesting contingent revenue cap. Moreover, Agenda paper 10E / FASB Memo 140E on constraining revenue recognition considers whether to limit the amount of consideration allocated to satisfied (or partially satisfied) performance obligations.

Staff analysis

27. The staff agrees with the respondents' concerns in paragraphs 23-25 that it is not appropriate in all circumstances to allocate a discount to all performance obligations in a contract. The staff sees the following alternatives to address those concerns:

    (a) Retain and clarify the proposal in the Exposure Draft; or

    (b) Allow methods other than the relative selling price method.

Alternative 1: Retain and clarify the proposal in the Exposure Draft

28. Under this alternative, the Boards would retain the proposal in the Exposure Draft to require an entity to allocate any discount on a bundle of goods or services in the contract to all those promised goods or services on a relative standalone selling price basis. In addition, the final standard would retain the concept of contract segmentation (i.e., using price interdependence) from the Exposure Draft to allocate the discount inherent in the contract to only some goods or services if the price of some goods or services in the contract is independent of the price of other goods or

services in the contract. See paragraphs 41-52 on "Allocating subsequent changes in the transaction price" for the respondents' feedback on criteria for determining price independence. The staff recommends revising the criteria in the Exposure Draft for allocating changes in the transaction price.

29. The staff thinks that by retaining the concept of price independence, an entity would allocate the discount in the contract only to some goods or services in the contract. Consider the following example:

> An entity enters into a contract with a customer to sell Products A, B, and C for CU36. The entity regularly sells Products A, B, and C separately for CU9, CU11, and CU20, respectively. It also regularly sells Products A and B together for CU16.

30. In this example, it would be inappropriate for the entity to conclude the discount relates to all Products A, B and C. That is because the entity regularly sells Products A and B together at CU16 and Product C at CU20, and the customer does not receive a discount for buying Products A and B together with Product C (the total price for all of the products in the contract CU36). As such, the entity would allocate the CU4 discount for purchasing Products A and B together to only Products A and B.

31. Proponents of Alternative 1 think that it would result in consistent allocation of the transaction price across various transactions, would result in comparability across various transactions, and rigor and discipline around the allocation process. In addition, this alternative would be consistent with the recently revised guidance on multiple- deliverable revenue arrangements (EITF Issue No. 08-1). Opponents of Alternative 1 think that the approach works well in most contracts, but in some circumstances this approach could result in losses on parts of profitable contracts.

Alternative 2: Allow methods other than relative selling price method

32. The proposed model requires an entity to recognize revenue *in the amount of consideration received from the customer in exchange for transferring goods and services*. To achieve that objective, the Exposure Draft prescribes a single method (i.e. a relative standalone selling price method) to allocate the transaction price to all separate performance obligations. Some respondents think that a relative standalone selling price method of allocation is an appropriate method for most cases. In some cases, however, they believe that it would result in an inappropriate allocation because it would not result in a faithful application of the core principle and would therefore not faithfully depict the amount allocable to goods or services transferred at different times.

33. The following are the circumstances when it may be appropriate for an entity to apply an allocation method other than a relative selling price allocation:

    (a) Some goods or services are priced independently of other goods or services in the contract (i.e. contract segmentation achieved through allocation). See paragraphs 29 and 30.

    (b) The entity transfers a significant good or service to the customer at the beginning of the contract and the price for that good or service is highly variable (e.g. a software license). Some believe that an entity can more easily (and reliably) estimate the selling price of the delivered item by using the technique discussed in paragraphs 20 and 21 of this paper. However, the respondents believe that a residual method would be more practical to apply because the entity would not be forced to estimate a selling price and then apply the relative standalone selling price allocation. Rather, an entity would be able to allocate consideration directly using the residual method.

(c) The relative selling price allocation results in a loss on one or more performance obligations. A loss on a performance obligation could be on a delivered or undelivered goods or services.

34. The following example illustrates a situation in which the relative selling price approach results in a loss on a *remaining* performance obligation:

An entity provides design services, resells third party Product X and related support services on the third-party product X for CU1,050. The entity promises to transfer Product X to a customer upon completion of the design services. Support services commence upon delivery of Product X. The observable standalone selling prices for design services, Product X and support services are CU600, CU500 and CU50, respectively. Direct costs for design services, Product X and support services are CU200, CU470 and CU40.

Calculation of individual profit margin:

	Selling Price	Costs	Margin
Design services	600	200	400
Product X	500	470	30
Support services	50	40	10

Residual method

Under the residual method, the entity would allocate CU500 to the Product X and CU50 to the support services and the remaining transaction price of , CU500 to the design services.

Relative standalone selling price method

Under the relative selling price method, the allocation would be as follows:

	Selling Price	Ratio	Allocation
Design services	600	52%	548
Product X	500	43%	457
Support services	50	4%	46
	1,150	100%	1,050

Profit margin method

Under the profit margin method, the discount inherent in the contract of CU100 would be allocated as follows:

	Margin	Ratio	Allocation
Design services	400	91%	91
Product X	30	7%	7
Support service	10	2%	2
	440	100%	100

Comparison under alternative methods

Allocation using the profit margin method would be as follows:

	Design services	Product X	Support service	Total
Selling price	600	500	50	1,150
Discount	(91)	(7)	(2)	(100)
Allocated Revenue	509	493	48	1,050
Costs	200	470	40	
Margin	61%	5%	17%	

The margin calculated under the residual and relative selling price bases are as follows:

	Residual			Relative selling price		
	Design services	Product X	Support Services	Design services	Product X	Support Services
Allocated	500	500	50	548	457	46
Costs	200	470	40	200	470	40
Margin	60%	6%	20%	64%	-3%	13%

35. In this example, either the residual allocation method or the profit margin allocation method would be permitted because the discount inherent in the contract relates primarily to the design services (i.e. the entity is merely procuring and reselling Product X and related services).

36. The following example illustrates a situation in which the relative selling price approach results in a loss on a *satisfied* performance obligation:

An entity sells Product A and provides one year of related support services for a total price of CU1,200. The entity has observable standalone selling prices for Product A and the related support services of CU1,100 and CU200, respectively. Direct costs for Product A are CU1,045 and the expected costs of the support services are CU100.

Calculation of individual profit margin:

	Selling Price	Costs	Margin
Product A	1,100	1,045	55
Support Services	200	100	100

Relative standalone selling price method

Under the relative selling price method, the consideration would be allocated as follows:

	Selling Price	Ratio	Allocation
Product A	1,100	85%	1,015
Support services	200	15%	185
	1,300	100%	1,200

Profit margin method

Under the profit margin method, the discount inherent in the contract of CU100 would be allocated as follows:

	Margin	Ratio	Allocation
Product A	55	35%	35
Support Services	100	65%	65
	155	100%	100

Allocation using the profit margin method would be as follows:

	Product A	Support Services	Total
Standalone selling price	1,100	200	1,300
Discount	(35)	(65)	(100)
Allocated Revenue	1,065	135	1,200

Comparison under alternative methods

The margin on support services calculated under the residual and relative selling price bases are as follows:

	Relative selling price		Profit Margin approach	
	Product A	Support	Product A	Support
Allocated	1,015	185	1,065	135
Costs	1,045	100	1,045	100
Margin	-3%	46%	2%	26%

37. In this example, the profit margin method would be permitted because the relative selling price allocation results in a loss on Product A.

38. Proponents of Alternative 2 think that an allocation based on a relative selling price is a technique and not the principle when allocating the transaction price. As such, they believe that the residual method should also be permitted in allocating the transaction price. In addition, it would be more practical to apply in many circumstances.

39. In addition, proponents of Alternative 2 highlight the results of outreach as part of EITF Issues No. 08-1 and 09-3. Many users (in particular software analysts) thought that a residual method should be permitted because of the significant variability in pricing of intellectual property and other intangible products.

Staff recommendation

40. To apply the core principle, the staff recommends that an entity should allocate the transaction price on a relative standalone selling price basis (using estimated selling prices if necessary) except in the following circumstances in which an entity should be permitted to use an alternative allocation method:

    (a) If an entity transfers a significant good or service to the customer at the beginning of a contract and the price for that good or service is highly variable (e.g. a software license), the entity should be permitted to allocate the transaction price to the remaining performance obligations in a contract at an amount equal to the standalone selling prices of the goods or services underlying those remaining performance obligations (i.e. a residual method).

    (b) If a relative selling price allocation results in a loss on one or more performance obligations, an entity should be permitted to allocate the transaction price to the performance obligations in a contract using either a residual method or by allocating the discount in the contract in proportion to the individual profit margin on each separate performance obligation (i.e. a profit margin method).

Question for the Boards

Question
Do the Boards agree with the staff's recommendation in paragraph 40?

FASB-IASB Staff paper

Allocating subsequent changes in the transaction price

Respondents feedback

41. Many respondents to the Exposure Draft thought that some changes in the transaction price should be allocated only to a part of the contract rather than to all parts of the contract. As noted above, the Exposure Draft would have achieved that outcome through the contract segmentation principle of price independence.

42. Respondents generally supported the principle of price independence for determining how to ringfence allocations of changes in the transaction price. However, those respondents thought that the proposed criteria for determining price independence were too strict. In other words, they think that in some contracts, goods or services are priced independently in a contract even though both of the following criteria are not met.

    (a) The entity, or another entity, regularly sells identical or similar goods or services separately; and

    (b) The customer does not receive a significant discount for buying some goods or services together with other goods or services in the contract.

Staff analysis

43. The staff agrees with respondents' concerns that the criteria for determining price independence are too strict and could result in an entity allocating changes in the transaction price to all performance obligations in the contract rather than only to the performance obligation to which the change relates. Hence, the staff recommends revising the criteria in the Exposure Draft for allocating changes in the transaction price by utilizing some of the concepts from Subtopic 605-28, *Revenue Recognition - Milestone Method*.

44. The staff thinks that a change in the transaction price would relate entirely to one performance obligation, rather than to more than one performance obligation, if both of the following conditions are met:

    (a). The contingent payment terms of the contract relate to the entity's performance to satisfy a separate performance obligation or a specific outcome from that separate performance obligation; and

    (b). the amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) within the contract.

45. The following example illustrates a construction contract where it may be appropriate to allocate the change entirely to a particular performance obligation:

> An entity has entered into a contract for the design and construction of a combat ship for a price of CU100. The contract is cost-reimbursable, with a 5% fee for the design services, and a 15% fee for the construction services. The entity determines that there are two separate performance obligations consisting of the design and construction services.
>
> The estimated standalone selling prices are CU25 for design and CU75 for construction. The design phase is substantially complete and the construction effort is approximately 25% complete when it is determined there is an expected 15% overrun on the construction work. Based on the terms of the contract the adjusted contract price is CU111 [CU25 + CU86 (CU75*1.15)].

46. Applying the concept in paragraph 44 to this example, the entity would allocate the change in the transaction price of CU11 entirely to the construction services because the payment provision relates specifically to the entity's performance to satisfy that performance obligation. In addition, the amount attributable to the construction services is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) within the contract.

47. The following example illustrates another contract (for the sale of products) where it may be appropriate to attribute the change entirely to a particular performance obligation:

> An entity enters into a contract to sell two fire engines: one vehicle containing the water tank (Product A) and the other being a ladder truck (Product B) for CU250. Product A is to be delivered in 60 days and Product B is to be delivered in 90 days. Product A and B are regularly sold separately at the stand-alone selling prices of CU100 and CU150 respectively. If Product B is not delivered in 90 days the contract price is reduced by CU10. Product A is delivered within 60 days and Product B is delivered in 110 days.

48. In this example, it would be appropriate for the entity to allocate the reduction in the transaction price of CU10 entirely to Product B because the change in consideration relates specifically to the entity's performance to satisfy that performance obligation. In addition, the amount attributable to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms within the contract.

49. The staff thinks that if the conditions in paragraph 44 are not met, the entity should allocate the contingent payment or changes in estimated transaction price on a relative standalone selling price basis to all performance obligations.

50. Consider the following example:

> An entity enters into a contract to sell Product X and Service Y. The payment terms for Product X is a fixed amount of CU60 and variable consideration of CU75 based on whether Product X can process at least one million transactions per month for a period of 12 months at the customer's location. Service Y is provided evenly over a three-year period for a total fixed amount of CU15 (CU5 payable at the beginning of year 1, year 2 and year 3).
>
> The standalone selling price of Product X and Service Y are CU120 and CU80, respectively.

51. In this example, even though the contingent payment of CU75 relates to the specific outcome from Product X, it is not appropriate to attribute the contingent payment entirely to Product X. That is because the amount attributable to that performance obligation is not reasonable relative to all of the performance obligations and payment terms within the contract because that would result in over allocation for Product X and under allocation for Service Y (i.e. the pricing of Product X in the contract is not independent to the pricing for Service Y). As such, the total transaction price of CU150 (fixed consideration of CU80 and variable consideration of CU70) must be allocated to Product X and Service Y on a relative standalone selling price basis.

Staff Recommendation

52. The staff recommends that an entity should allocate changes in the transaction price on a relative standalone selling price basis to all performance obligations in the contract, except when a change in the transaction price relates entirely to one performance obligation. That would be the case if both of the following conditions are met:

    (a). The contingent payment terms of the contract relate specifically to the entity's efforts to satisfy that performance obligation or a specific outcome from satisfying that separate performance obligation; and

    (b). The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

Question for the Boards

Question
Do the Boards agree with the staff's recommendation in paragraph 52?