Staff Paper

Project **Revenue recognition**

Topic **Identifying separate performance obligations**

Purpose of this paper

1. At their January 2011 meeting, the boards discussed the attributes of a good or service that is distinct and therefore should be accounted for as a separate performance obligation. The boards asked the staff to:

   (a) clarify the meaning of a 'distinct good or service' by analysing further the attributes of a distinct good or service; and

   (b) prepare some examples that identify the distinct goods or services in various contracts.

2. This paper has been prepared in response to that request.

Structure of this paper

3. This paper is organised into the following parts:

   (a) requirements for identifying separate performance obligations;

   (b) examples; and

   (c) the rationale for identifying separate performance obligations and distinct goods or services.

Part A: Requirements for identifying separate performance obligations

4. This part of the paper outlines how the staff envisages the requirements for identifying the separate performance obligations in a contract with a customer. These requirements are based on a combination of the proposals in the exposure draft and the staff's recommendations in agenda paper 6C / FASB memo 135C from the January 2011 joint board meeting.

5. Paragraphs 6-14 below are presented in the style of a standard. Please note that the drafting presented in these paragraphs is preliminary and therefore is not necessarily how the final requirements would be drafted.

Objective for identifying separate performance obligations

6. The objective of identifying separate performance obligations in a contract with a customer is to faithfully depict an entity's performance by recognising revenue at an amount that reflects the profit margin[1] that is attributable to the goods or services that have been transferred to the customer.

Separate performance obligations

7. An entity shall evaluate the terms of the contract and its customary business practice to identify all promised goods or services and determine whether to account for each promised good or service as a separate performance obligation.

8. An entity shall account for a promised good or service, or a bundle of goods or services, as a separate performance obligation if:

   (a) the good or service is distinct, and

[1] Whether the entity realises that profit margin will depend on the entity's performance in managing the risks and resources associated with providing the customer with that good or service. It will also depend on other factors, such as supply and demand, which influence the selling price of the good or service—and therefore the profit margin that could be realised. The objective of the revenue recognition model is not to prescribe the accounting for the margin; however, by prescribing the accounting for the revenue, that margin will be revealed.

(b) either of the following conditions is met:

  (i) the good or service is transferred to the customer at a different time from the transfer of other goods or services promised in the contract; or

  (ii) for contracts in which two or more services are transferred continuously to the customer over the same period of time, the entity selects different methods to best depict the transfer of those services to the customer; and

9. A good or service, or a bundle of goods or services, is distinct if:

   (a) it has a distinct function; and

   (b) is subject to separate risks.

Distinct function

10. A good or service has a distinct function if:

   (a) the entity sells the good or service separately; or

   (b) the customer can use the good or service either on its own or together with resources that are readily available to the customer. Resources that are readily available to the customer include resources obtained by the customer from previous transactions or events, goods or services that the customer has already received under the contract, and goods or services that the customer could purchase separately from the entity or another entity.

Separate risks

11. An entity should use judgment and consider all facts and circumstances when determining whether a good or service is subject to separate risks.

12. A good or service is subject to separate risks if the risks the entity assumes in providing the good or service to the customer are largely independent of the risks of providing the customer with the other goods or services promised in the contract.

13. Indicators that a good or service is subject to separate risks include:

    (a) the entity sells the good or service separately;

    (b) the entity and the customer negotiated the sale of good or service separately from the other goods or services promised in the contract; and

    (c) the entity manages its promise to provide the good or service to the customer independently from its promise to provide other goods or services to the customer.

An indicator that risks are inseparable

14. An indicator that a good or service is subject to risks that are not separate from the risks of providing the other promised goods or services in the contract is that the promised goods or services are highly interrelated and the entity is required to integrate all of those goods or services into a single item that the entity provides to the customer.

Question for the boards
The staff recommends that the revenue standard should: (a) specify that an entity should account for a promised good or service as a separate performance obligation if: (i) the pattern of transfer of the good or service is different from other promised goods or services; and (ii) the good or service is distinct. *(as illustrated in paragraph 8 above)* (b) allow judgment by specifying that an entity should assess whether a good or service is distinct according to whether that good or service: (i) has a distinct function, and (ii) is subject to separate risks. *(as illustrated in paragraphs 9-12 above)* (c) specify indicators to assist an entity in assessing whether a good or service is subject to separate risks. *(as illustrated in paragraphs 13-14 above)* Do the boards agree?

Part B: Examples

15. The following examples are provided to test the application of requirements suggested in paragraphs 6-14 for identifying separate performance obligations.

16. For the purposes of illustrating the identification of separate performance obligations and the assessment of distinct goods or services, the examples are analysed on a bottom-up basis (ie by initially assessing whether the promised goods or services are distinct). In practice, the staff expects that entities could perform the analysis on a top-down basis, consistent with paragraph 8.

Example 1: Pay TV set-top box and subscription

A customer subscribes to a pay TV service for 2 years. The pay TV company supplies the customer with a set-top box to access the pay TV channels. The customer does not pay separately for the set-top box. The contract states that the customer owns the set-top box.

The set-top box is not compatible with any other pay TV service. After the 2 year subscription period expires, the customer can re-subscribe for pay TV services on a month-to-month basis at the same rate using the same set-top box.

The set-top box has no functionality on its own.

Distinct function

17. The set-top box has no function that can be distinguished from the subscription service. This is because the set-top box can be used only in conjunction with pay TV services that are not readily available on a standalone basis to *new* customers.

Separate risks

18. Because the set-top box and the subscription service do not have distinct functions, the entity does not need to assess whether the box and the subscription have separable risks.

Conclusion

19. The set-top box and the subscription service would be accounted for as one performance obligation—which would be a service—because the set-top box and the subscription service are not distinct.

First variation to the facts of example 1

During the subscription period, a customer decides to use a 'pay-per-view' service to watch particular sporting matches and latest release movies.

20. Each viewing of the sporting match or movie would be distinct because it is capable of being used together with the pay TV service that the customer has already received. Consistently with the staff recommendation in agenda paper 4C / FASB memo 137C (about contract modifications), each pay-per-view purchase made by the customer would be treated as a separate contract (assuming that each purchase is made at the standalone selling price of that item) and, consequently, would be accounted for separately. In most cases, the timing of purchase, and therefore the creation of a new contract, would coincide with timing of transfer.

Second variation to the facts of example 1

Assume the same facts as above except that the set-top box enables the customer to watch additional free-to-air TV channels and to record TV shows onto a hard disk in the set-top box. That additional functionality is available to the customer regardless of whether they continue to subscribe to the pay TV service. (Assume that additional functionality has substantial standalone value to the customer.)

Distinct function

21. Under the change to that fact pattern, the set-top box and the pay TV service would have distinct functions because the customer could use the box

independently from the pay TV service. The fact that a particular customer may not use that functionality is irrelevant. As suggested in paragraph 49 below, the assessment should be based on whether a typical customer would be expected to use that additional functionality.

Separate risks

22. The risks that the entity assumes in providing the set-top box and the pay TV services are separate because:

    (a) the risks of providing the set-top box largely relates to whether the box operates as promised (ie it can connect to and display the pay TV content); and

    (b) the risks of providing the pay TV services largely relates to sourcing the content, packaging that content into programs on the TV channels and transmitting that content to subscribers.

23. In addition, the following indicators support the conclusion that the set-top box and the pay TV services are subject to separate risks:

    (a) the entity sells pay TV services separately to *existing* customers that already have the set-top box;

    (b) the entity (presumably) has separate business processes for connecting new subscribers to the service and the ongoing provision of the pay TV service to all subscribers; and

    (c) the risks to the entity of integrating the set-top box and the pay TV service are insignificant (because it is a commoditised product and service that had been designed—and presumably proven—to integrate well).

Conclusion—are the goods or services distinct?

24. Yes. The set-top box (with the ability to watch free-to-air channels and record TV shows) and the pay TV service are both distinct.

Conclusion—should the entity recognise separate performance obligations for the promised goods or services?

25. Yes. The entity's promises to provide the set-top box and the pay TV service should be recognised as separate performance obligations because they transfer to the customer at different times and are distinct.

Example 2: Supply and installation of specialised equipment

An entity has a contract to supply and install a specialised weapons system into a squadron of fighter planes. Only the entity can supply and install the system. The entity has previously sold and installed similar systems into similar fighter planes owned by other customers.

Distinct function

26. The weapons systems does not have a distinct function because it does not have utility without the installation service and that installation service cannot be purchased separately from the entity (or any other entity).

Conclusion—are the goods or services distinct?

27. No. (Because the weapons system and installation services do not have distinct functions, the entity does not need to assess whether that good and service are subject to separate risks).

Conclusion—should the entity recognise separate performance obligations for the promised goods or services?

28. No. The promise to provide the weapons system and the installation services should be recognised as one separate performance obligation—which would be a service.

29. The entity would recognise revenue by selecting a measure of performance that faithfully depicts the transfer of the weapons system and installations services to the customer. That measure of performance would determine the timing of

revenue recognition. Revenue would be recognised at a constant margin because there is only one separate performance obligation identified for the contract.

Example 3: Computer game with online functionality

> The entity sells a computer game that is playable on a standalone basis (as a single player experience) or online (as a multiplayer experience).
>
> A customer can play the game online when their games console is connected to the internet. The online gameplay is a substantial component of the product.
>
> The game and the online component are not sold separately.

Distinct function

30. The game has a distinct function because the customer can play the game on their games console without the online gameplay features.

31. The online component of the product provides additional features that the customer can use when playing the game on their games console. Consequently, the online component of the product has a distinct function.

Separate risks

32. The risks that the entity assumes in providing the game and the online functionality are largely independent of each other because:

    (a) the risks of providing the game largely relate to whether the game operates on the customer's games console; and

    (b) the risks of providing the online functionality largely relate to whether the online gaming environment is maintained and available for customers to use.

Conclusion—are the goods or services distinct?

33. Yes. The computer game and the online component are both distinct.

Conclusion—should the entity recognise separate performance obligations for the promised goods or services?

34. Yes. The entity should recognise separate performance obligations for the promise to provide the computer game and the online component because the computer game transfers to the customer at the time of sale and the online component transfers to the customer over the expected life of that online service.

Example 4: Software with post contract support services

A customer enters into a contract with a software provider to purchase a new accounts receivable system.

As part of that contract, the software provider will:

- supply the software;
- provide consultancy services for an expected period of 3 months to integrate the accounts receivable system with the customer's existing accounting system;
- for a period of 2 years, provide software maintenance services including on-demand helpdesk support and when-and-if available software updates.

The entity sells the software separately.
A separate business unit of the entity provides the consultancy services. That business unit also provides consultancy services separately, although the scope of the consultancy contracts typically differs from customer to customer. Other entities also provide similar consultancy services.
The entity also sells maintenance services separately on a yearly renewal basis. Those services provide the customer with ongoing helpdesk support and access to software updates (on a when-and-if available basis).

Analysis

Do the goods or services have a distinct function?	
Software	Yes, because the entity sells the software separately.
Consultancy services	Yes, because the integration services can be used in conjunction with the software the customer has received under the contract.
Maintenance services (ie helpdesk support and software updates)	Yes. The helpdesk support and software updates each have separate functions because they can be used with the software. Specifically: • the helpdesk provides the customer's staff with on-demand support when using the software; and • the software updates enhance the functionality of the customer's software.
Are the goods or services subject to separate risks?	
Software	Yes. The fact that the entity also sells the same software separately supports the conclusion that the risks of providing the software should be largely independent of the risks of providing other services to the customer.
Consultancy services	Yes. The risks assumed by the entity in integrating the software into the customer's systems should be largely independent of the risks of providing the software and the other services to the customer because: • a separate business unit is providing those services to the customer; and • the entity (and other entities) sell similar integration services separately.
Maintenance services (ie helpdesk support and software updates)	Yes—the maintenance services (ie the bundle of helpdesk support and software updates) are subject to separable risks. This conclusion is supported by the fact that the maintenance services are also sold separately by the entity. In addition, assume for this example that the helpdesk support and the software updates are each subject to separate risks.

Conclusion	
Are the goods or services distinct?	The entity has promised to provide 4 goods and services that are distinct—(i) software, (ii) consultancy services, (iii) helpdesk support and (iv) software updates.
Should the entity recognise separate performance obligations?	The entity should recognise 3 separate performance obligations: • the software, which is a good that transfers to the customer at a discrete point in time; • the consultancy services, which transfer over 3 months; and • the maintenance services, because (i) the helpdesk support and the access to software updates are services that the entity stands ready to provide for a period of 2 years; and (ii) the same method can be used to measure the entity's performance of those services (eg a time based measure).

Example 5: Construction contracts

An entity enters into a contract with a health authority to design and build a hospital.

The health authority specifies the functionality the hospital must have—how many patients, which specialist departments, minimum and maximum temperatures in each area. The entity is responsible for the design and for the selection of materials and mechanical and electrical (M&E) equipment.

The entity is the prime contractor and is responsible for the overall management of the project. The entity identifies the following activities to be completed:

• detailed design	*subcontractor to perform*
• site clearance	*subcontractor to perform*
• foundations	*entity to perform*
• construction of shell and core	*subcontractor to perform*
• acquisition of M&E equipment	*subcontractor to perform*
• fit out	*subcontractor to perform*

> Different divisions of the entity sell separately design services, site clearance services and construction services.
>
> During the construction, the entity discovers that, as a result of an error in the building design, the foundations were not made strong enough for the M&E equipment ordered. The entity resolves that problem by ordering different M&E equipment that can provide the same functionality.

Distinct function

35. Each of the tasks to be undertaken by the entity and by the subcontractors could be considered to have distinct functions because each activity (or service) would be capable of being used in conjunction with other resources readily available to the customer.

Separable risks

36. Each task is highly interrelated and the entity—as prime contractor—is required to manage and co-ordinate those tasks. The entity also assumes the risks that the tasks it has performed and that have been performed by the subcontractors are not in accordance with the contract specifications or do not integrate with the other work that has been completed to construct the hospital. This is illustrated in the example, whereby the entity is responsible for resolving the error it made in the design process by ordering different equipment for use in the hospital.
37. In summary, the risks associated with the individual tasks are not separable.

Conclusion—are the goods or services distinct?

38. No.

Conclusion—should the entity recognise separate performance obligations for the promised goods or services?

39. No. The entity should recognise the construction contract as one separate performance obligation—which would be a service.

Part C: Rationale for identifying separate performance obligations

Objective

40. The objective of the revenue recognition model is for the recognition of revenue to faithfully depict the entity's performance in a contract with a customer. A faithful depiction of the entity's performance should result in the entity recognising revenue:

    (a) when the goods or services are transferred to the customer; and

    (b) at an amount that reflects the profit margin that is attributable to the goods or services that have been transferred to the customer.

41. A separate performance obligation is the unit of accounting that is relevant both for describing the goods or services that transfer to the customer and for allocating transaction price to those goods or services. That unit of accounting may be a single good or service or a bundle of related goods or services. The exposure draft proposed that an entity should identify a separate performance obligation for each promise to provide a good or service that is distinct (subject to consideration of the timing of transfer).

What is a distinct good or service?

42. The primary attributes of a distinct good or service are:

    (a) distinct function; and

    (b) separate risks.

43. Consistently with the staff's recommendation in the agenda paper 6C / FASB memo 135C from the January 2011 meeting, a good or service must possess both of those attributes to be distinct. The next section explains why function and risks are relevant to the identification of a distinct good or service.

44. In those January 2011 agenda papers, the staff also suggested that 'distinct timing of transfer to the customer' should be the third attribute of distinct. Strictly speaking, the timing of transfer is not an attribute of distinctness; rather

it is a practical expedient to indicate that an entity need not account separately for goods or services that would otherwise be distinct *if* those goods or services transfer to the customer at the same point in time or over the same period of time. In contrast to the January 2011 agenda papers (which recommended treating the timing of transfer as an attribute of distinct), the staff now suggests that timing of transfer should be considered only when identifying separate performance obligations. This is discussed further at paragraphs 59-60.

Distinct function

Why is distinct function relevant?

45. The purpose of identifying whether a promised good or service has a distinct function is to determine whether, in fact, the customer has acquired one good or service or more than one goods or services. This is relevant because a good or service that has a distinct function should be capable of being transferred to the customer separately from the other goods or services in the contract. Therefore, for the purposes of faithfully depicting the pattern of transfer of goods or services to the customer, a prerequisite for accounting for a promised good or service separately is that the good or service has a separate function.

What is a distinct function?

46. A distinct function is a use or purpose that can be identified separately from the use or purpose of other goods or services. In concept, any good or service that is sold separately should therefore have a distinct function. However, some respondents to the exposure draft considered that the experience of other entities, including entities operating in other markets or other jurisdictions, was not relevant for determining whether a good or service is distinct. In the light of that feedback, the staff recommends:

    (a) specifying that goods or services sold separately by the entity have a distinct function; and

(b) developing additional criteria to determine whether other promised goods or services have a distinct function (see paragraphs 48-54).

47. This is a slightly different approach from the exposure draft, which automatically deemed a good or service to be distinct (ie it has a distinct function and is subject to distinct risks) if it was sold separately by the entity or another entity. Under this approach, the fact that a good or service is sold separately would only determine that the good or service has a separate function. The entity would also need to determine that good or service is subject to separate risks before identifying that good or service as distinct.

Distinct function should be assessed from the customer's perspective

48. For goods or services that are not sold separately by the entity, the staff thinks that distinct function should be assessed from the perspective of the customer. This is because, in many cases, an entity will consume goods or services (ie materials and other resources) to produce a good or to provide a service to the customer. Those materials and resources might have a distinct use before the entity uses them to fulfil its performance obligation to the customer. However, once the entity is using those materials to provide the good or the service to the customer, the materials may be indistinguishable from the goods or services that the customer receives.

49. The customer perspective should not focus on how a particular customer might intend to use the promised goods or services because, as paragraph BC52 explained, "It would be difficult, if not impossible, for an entity to know the customer's intentions in any given contract". Instead, the staff thinks the assessment of distinct function should be made from the perspective of that particular class of customer in general—in other words, what is the functionality provided by the goods or services that a typical customer would be expected to use?

Good or service can be used on its own

50. Clearly a good or service has a distinct function if it can be used on its own by the customer. However, the staff thinks that this criterion could be interpreted obtusely—for instance, a fridge has no use unless it is connected to a power supply and a car has no use unless it has petrol in the tank. More importantly, the staff thinks that the criterion by itself is too narrow. Consider the following example:

> An entity sells coffee machines that use capsules of ground coffee to make a cup of coffee. The machine can be used only with the coffee capsules sold by the entity. The entity sells the machine and the coffee capsules separately.

51. In this example, customers can use the coffee machine only if they also purchase the coffee capsules. Based on the above criterion, neither the coffee machine nor the coffee capsule would have a distinct function on their own. However, that clearly seems to be the wrong answer. Most people would regard the machine and the capsules to be separate items because:

    (a) the machine is the device that makes cups of coffee from the capsules; and

    (b) the capsules are consumables that customers must purchase whenever they would like a cup of coffee from the machine.[2]

Good or service can be used together with other items

52. To overcome that problem, the staff thinks that a good or service should also be considered to have a distinct function if it is capable of being used together with other items that are readily available to the customer because, for instance, the customer could acquire those other items in a separate transaction with the entity

[2] This example can be even analysed more simply. The fact that the customer acquires the machine and the capsules in separate transactions indicates that they must be distinct, and therefore capable of being accounted for separately. However, this example is useful for illustrating that the test for distinct function must look beyond the good or service only being capable of being used on its own.

or another entity. In other words, an item has value on a standalone basis if the customer could readily obtain other goods or services that are needed to use that item. This is directionally consistent with existing US GAAP, which indirectly refers to distinct function in the context of assessing whether an item in a multiple element arrangement has 'value to the customer on a standalone basis'. FASB ASC paragraph 605-25-25-5(a) explains that a (delivered) item has value on a standalone basis if it is sold separately by any vendor or the customer could resell the item on a standalone basis.

53. If that test of distinct function is applied to the above example, coffee machine and the capsules each would be considered to have distinct functions. That is because the customer can use the machine by buying the capsules from the entity in a separate transaction.

Customer's ability to resell a good

54. For various reasons, the staff thinks that it is not necessary to include the customer's ability to resell a good on a standalone basis as an additional criterion for determining whether the good has a distinct function. The staff thinks that nearly any item could be resold by the customer (although possibly only for scrap value). In addition, there are instances in which an item would have a distinct function but the customer may not have the ability to resell that item because of contractual restrictions (e.g. those that protect the intellectual property of the entity). Moreover, the staff thinks that an ability to resell an item is comparable to the criteria suggested in paragraph 10(b) of this paper, which considers distinct function from the perspective of whether the good or service has a use on its own or together with other goods or services that the customer could purchase separately from the entity or another entity.

Separable risks

Why are separable risks relevant?

55. A faithful depiction of an entity's performance in a contract with a customer should result in the entity recognising revenue at an amount that reflects the profit margin that is attributable to the goods or services that have been transferred to the customer.

56. In theory, the profit margin for a good or service is the compensation (ie return) to the entity for the risks it assumes and the capital and other resources it consumes in transferring that good or service to the customer. If the risks and resources of providing a good or service can be determined independently from the risks and resources of other goods or services, then those goods or services should have a profit margin that can be accounted for separately. However, if the risks associated with transferring the good or service to the customer are inseparable from the risks associated with other goods or services being transferred to the customer, then a faithful depiction of the entity's performance would require those goods or services to be accounted for as a single bundle (with a single profit margin).

What are separate risks?

57. Some respondents to the exposure draft requested guidance on the identification of separate (or distinct) risks because they were concerned that the concept could be difficult to apply in practice. For that reason, the staff thinks that the revenue standard should include a series of indicators for an entity to consider when determining whether a promised good or service is subject to separate risks.

58. Paragraphs 13 and 14 list some indicators of whether a promised good or service is subject to risks that are separable or inseparable from the promise to provide other goods or services. Tables 1 and 2 below explain why those particular indicators are useful.

Table 1: Indications of *separable* risks

Suggested indicators	**Why this indicator is relevant?**
The entity sells the good or service separately.	The fact that an entity sells a good or service separately indicates that the risks assumed by the entity in providing that good or service must be largely independent of the risks of providing other goods or services to the customer.
The entity and the customer negotiated the sale of a good or service separately from the other goods or services promised in the contract.	Similarly, the willingness of the entity to negotiate the sale of a good or service separately from the rest of the contract indicates that the good or service is subject to risks that can be managed separately by the entity.
The entity manages its promise to provide the good or service to the customer independently from its promise to provide other goods or services to the customer.	The fact that parts of a contract are managed independently by the entity, especially if they are managed by different business units, could indicate that the good or service has separate risks.

Table 2: An indication of *inseparable* risks

Suggested indicator	**Why this indicator is relevant?**
The promised goods or services are highly related and the entity is required to integrate all of those goods or services into a single item that the entity provides to the customer. (This indicator is based on the 'significant contract management service' concept that was explained in example 11 and paragraphs BC56-BC58 of the ED. Most respondents from the construction industry agreed with this concept and suggested it should be incorporated directly into the	The existence of a significant contract management service means that the risks in undertaking one part of the contract are not separable (or independent) from the risks that apply to other parts of the contract.

tests for determining whether a good or service is distinct.)	

Identifying a separate performance obligation

59. The staff thinks that it is not necessary for an entity to account for (ie recognise and measure) distinct goods or services separately if:

    (a) those goods or services are transferred to the customer either at the same time or over the same period of time; and

    (b) for services that transfer continuously to the customer, the same method is used to measure the entity's progress in transferring those services to the customer.

    In other words, separate performance obligations do not need to be identified if the pattern of transfer of the underlying distinct goods or services to the customer is the same. That is because accounting for those performance obligations either separately or as a single performance obligation would not change the pattern of revenue recognition.

60. This is not a new idea. It was proposed in paragraph 24 of the exposure draft, however it seemed to have been overlooked by some respondents who raised concerns about the concept of distinct goods or services potentially requiring separate performance obligations to be identified at a level that would not be necessary to faithfully depict the economics of the transactions. Paragraph 8[3] above illustrates how this point can be made more prominently in the draft standard.

---

[3] This footnote repeats the text of paragraph 8:
"An entity shall account for a promised good or service, or a bundle of goods or services, as a separate performance obligation if:

(a) either of the following conditions are met:
  (i) the good or service is transferred to the customer at a different time from the transfer of other goods or services promised in the contract; or
  (ii) for contracts in which two or more services transfer continuously to the customer over the same period of time, the entity selects different methods to best depict the transfer of those services to the customer; and
(b) the good or service is distinct."