



## Staff Paper

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Project	<b>Revenue Recognition</b>
Topic	<b>Existence of a contract and definition of a performance obligation</b>

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### Purpose and summary of staff recommendations

1. This paper considers improvements to the proposals on the existence of a contract and definition of a performance obligation in the Exposure Draft *Revenue from Contracts with Customers*.
2. The staff thinks that the proposals on the existence of a contract can be improved when drafting the final standard. The table in paragraph 7 of this paper lists the common concerns, and the staff's analysis of those concerns, raised in response to the proposed guidance on the existence of a contract. However, the staff does not plan on asking the Boards for specific decisions on those improvements.
3. The staff recommends revising the definition of a performance obligation to delete the word "enforceable" and clarify that performance obligations include promises that are implied by an entity's business practices, published policies, or specific statements if those promises create a valid expectation of the customer that performance of the entity will occur.
4. This paper is organized as follows:
  - (a) Proposed guidance in the Exposure Draft (paragraphs 5 and 6)
  - (b) Feedback on the proposed guidance and staff analysis

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- (i) Existence of a contract (paragraph 7)
- (ii) Definition of a performance obligation (paragraphs 8–13)

**Proposed guidance in the Exposure Draft**

5. A contract is an agreement between two or more parties that creates enforceable rights and obligations. The Boards proposed that a contract exists for the purpose of applying the proposed revenue requirements only if:
  - (a) the contract has commercial substance (that is, the entity's future cash flows are expected to change as a result of the contract);
  - (b) the parties to the contract have approved the contract and are committed to satisfying their respective performance obligations;
  - (c) the entity can identify each party's enforceable rights regarding the goods and services to be transferred; and
  - (d) the entity can identify the terms and manner of payment for those goods or services.
  
6. A contract does not exist for the purpose of applying the proposed revenue guidance if either party can terminate a wholly unperformed contract without penalty. A wholly unperformed contract is a contract under which the entity has not transferred any goods or services and the customer has not paid any consideration.

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**Feedback on the proposed guidance and staff analysis**

***Existence of a contract***

7. The following table lists common concerns, and the staff’s analysis of those concerns, raised in response to the proposed guidance on the existence of a contract. The staff does not plan on asking the Boards a separate question for each concern below because those concerns can be addressed in drafting the final standard.

<b>Principle</b>	<b>Common responses</b>	<b>Staff analysis</b>
A contract is an agreement between two or more parties that creates enforceable rights and obligations	Most respondents agree with the proposed definition of a contract. Three respondents, however, note that the definition of a contract under the proposed revenue recognition model differs from the definition of a contract in IAS 32, <i>Financial Instruments: Presentation</i> . Those respondents recommend that the Board adopt a single definition of a contract.	The Boards considered whether to adopt a single definition of a contract under IAS 32 and the proposed revenue guidance and decided not to, primarily because of the risk of unintended consequences in the accounting for financial instruments. Additionally, the Boards decided not to adopt the IAS 32 definition because it would be inconsistent with the Boards’ proposal that an arrangement must be enforceable by law for an entity to recognize the rights and obligations arising from that contract. As such, the staff recommends no change to the definition of a contract.
The contract has commercial substance (that is, the entity’s future cash flows are expected to change as a result of the contract)	A few respondents noted that it is not clear whether the gross or net cash flows should be considered when evaluating whether the cash flows are expected to change as a result of entering into a contract.	The Boards intent was that commercial substance would have the same meaning as the term is used in other financial reporting contexts (e.g. under nonmonetary exchange transactions guidance). Existing requirements in IFRSs and US GAAP do not specify whether the cash flows must be gross or net to evaluate commercial substance. The staff thinks that the meaning of commercial substance can be

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		clarified in the final standard by carrying forward some of the discussion from the Exposure Draft’s basis for conclusions.
The parties to the contract have approved the contract and are committed to satisfying their respective obligations.	Some respondents think oral and implied contracts may have difficulty meeting the requirement <i>that the parties to the contract have approved the contract</i> . Additionally, they believe that it may be difficult to verify the entity’s approval of an oral or implied contract and their commitment to satisfying their respective obligations. Those respondents prefer to retain the requirement from Staff Accounting Bulletin (SAB) Topic 13 that persuasive evidence of an arrangement must exist. That guidance specifies that if the entity’s customary business practice is to use written contracts, an arrangement may only exist by a fully executed contract.	With oral or implied contracts, it might be less clear whether the parties have approved and are committed to the contract. However, that in and of itself does not mean that the parties lack the intent or ability to honour the agreement. In addition, the Boards decided that this principle would be helpful when there is significant uncertainty about the customer’s ability to pay promised amounts. Hence, the staff recommends that the Boards retain the proposal but clarify that in some cases a written contract may be required to determine that the parties to the contract are committed (or have the intent and ability to fulfil their respective obligation).
The entity can identify each party’s enforceable rights regarding the goods and services to be transferred.	A few respondents questioned whether enforceable means legally enforceable.	The staff notes that the questions on the term “enforceable” have been addressed in the basis of conclusion in the Exposure Draft, that “enforceable” is referring to legally enforceable. The staff believes that majority of the constituents understood the Boards’ intent. As such, the staff does not believe any additional clarification is necessary in the final standard.
The entity can identify the terms and manner of payment for those goods or services.	Respondents from the construction industry questioned whether the entity can identify <i>the terms and manner of payment</i> for unpriced change orders (i.e. change orders	The staff thinks that the Boards’ intent was not to preclude revenue recognition for unpriced changes if the entity can enforce the rights. Hence, the entity would determine the transaction price based on the proposed guidance on

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	<p>for which the scope of work may be defined even though the specific amount of consideration for that work has not yet been agreed and may not be finally determined for a period of time).</p>	<p>determining the transaction price. The staff thinks that the Boards can clarify their intent by explaining that the price need not be fixed to identify the <i>terms and manner of payment</i>.</p>
<p>A contract does not exist for the purpose of applying the proposed guidance if either party can terminate a wholly unperformed contract without penalty.</p>	<p>Some respondents questioned how to apply this principle if the customer, but not the entity, can cancel the contract and the contract is onerous at inception.</p>	<p>The staff thinks the final standard should clarify that no accounting would be required only if both parties can cancel the contract without penalty.</p>

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***Definition of a performance obligation***

8. The Exposure Draft was clear that a performance obligation could arise from an implied promise created by the entity's past practice (e.g. Example 13 *Free on board shipping point and risk of loss*). However, because of the use of the word "enforceable" in the definition of a performance obligation, the Exposure Draft suggested that only those implied obligations that would be enforceable at law are performance obligations.
9. A few respondents questioned the definition of a performance obligation as to why it was limited to "an enforceable promise" to transfer a good or service. Those respondents believe that limiting the definition of a performance obligation to "enforceable" promises could result in an entity not accounting for promised goods or services that the customer reasonably expects to receive is willing to pay for.
10. For example, a software company may have an historical practice of delivering "when-and-if-available" upgrades even though it has no legal obligation to do so. They believe this historical practice should be viewed as giving rise to a performance obligation that should be evaluated under the contract.
11. As such, those respondents recommend expanding the definition of "performance obligation" to include constructive obligations where an entity's specific statements or past practices establish a valid expectation by the customer that performance will occur. They believe this is consistent with the current application of both U.S. GAAP and IFRSs (e.g., the definition of a constructive obligation in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), and would provide more meaningful information to financial statement users.
12. The notion of a constructive obligation has been a difficult area for the boards in the past—in particular the difficulty of trying to determine the existence of an obligation in the absence of legal enforceability. For that reason, the staff thinks that the most practical way to address respondents' concerns is to adopt some of the language from the IASB's proposed definition of a constructive obligation when describing which obligations can be performance obligations.

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13. Therefore, the staff recommends revising the definition of a performance obligation to delete the word “enforceable” and clarify that performance obligations include promises that are implied by an entity’s business practices, published policies, or specific statements if those promises create a valid expectation of the customer that performance of the entity will occur.

**Question for the Boards**

**Question 1**

The staff recommends revising the definition of a performance obligation to delete the word “enforceable” and clarify that performance obligations include promises that are implied by an entity’s business practices, published policies, or specific statements if those promises create a valid expectation of the customer that performance of the entity will occur.

Do the Boards agree?