IASB/FASB Meeting January 2011

IASB Agenda reference	6D
FASB Agenda reference	135D

Staff Paper

Project	**Revenue recognition**
Topic	**Perfunctory obligations, incidental obligations and marketing incentives**

Background and objective of this paper

1. Question two of the exposure draft asked respondents to consider guidance on identifying performance obligations based on whether the goods and services are distinct. In answering this question some respondents suggested including two types of specific guidance to identify separate performance obligations:

    (a) guidance on inconsequential and perfunctory performance obligations as currently defined by topic ASC 605-10-S99 (formerly SAB Topic 13 *Revenue Recognition*), and

    (b) guidance on the use of an entity's own business model to distinguish 'incidental' obligations and 'marketing incentives' from performance obligations.

Summary of recommendations

2. The staff recommends that the revenue standard should not include guidance on inconsequential or perfunctory obligations nor should it develop guidance to distinguish incidental obligations or marketing incentives from performance obligations.

Inconsequential and perfunctory obligations

3. The exposure draft did not include any guidance similar to that in US GAAP on inconsequential and perfunctory obligations. A few respondents suggested retaining that guidance. They thought this would simplify the application of the model by reducing the number of separate performance obligations to which an entity would allocate consideration.

Background

4. ASC 605-25 (formerly EITF Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables*) provided guidance on identifying separate performance obligations within a contract. In accordance with that guidance, a delivered item would be accounted for as a separate performance obligation if all of the following are met:

   (a) the delivered item has value to the customer on a standalone basis,

   (b) there is objective and reliable evidence of the fair value of the undelivered item(s), and

   (c) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor.

5. After applying those separation criteria, an entity would recognise revenue in accordance with other requirements. The SEC guidance on when to recognise revenue indicates that if an entity's remaining performance obligation is inconsequential or perfunctory, the entity can still conclude it has met the delivery or performance criterion necessary to recognise revenue for the delivered item(s). Hence, the entity recognises revenue for both delivered and undelivered items, and recognises the costs of fulfilling the remaining performance obligations as an expense, on delivery.

6. Under this SEC guidance a remaining performance obligation cannot be considered inconsequential or perfunctory if:

   (a) it is essential to the functionality of a delivered item,

   (b) the vendor's failure to fulfill the remaining performance obligation would result in the customer receiving a full or partial refund or rejecting the delivered item, or

   (c) the vendor does not have a demonstrated history of fulfilling the remaining performance obligations in a timely manner and reliably estimating its remaining costs.

7. The EITF recently changed the guidance (summarised in paragraph 4 of this paper) on separating performance obligations to allow greater use of judgment when separating a contract. Rather than requiring objective and reliable evidence of fair value of an undelivered item, entities now are allowed to estimate selling prices for purposes of separating a contract and allocating consideration.

8. Respondents have mixed views on the effect of those changes on the guidance on 'perfunctory' obligations. Some respondents think that the changes reduce the need for guidance on perfunctory obligations because of the similarity of the criteria for a separate deliverable with the criteria for an obligation that cannot be deemed inconsequential or perfunctory. On the other hand, others believe there is a greater need for the guidance on inconsequential and perfunctory obligations because contracts will now be broken up into more performance obligations than previously.

Staff analysis

9. The staff have reviewed the characteristics of inconsequential and perfunctory obligations (summarised in paragraph 6 of this paper) to assess whether they would be helpful to an entity when identifying performance obligations.

10. *Essential to functionality* originated in ASC 985-605 (formerly SOP 97-2 *Software Revenue Recognition*) to refer to a situation in which a delivered item cannot be used for its intended purpose until another item is also delivered. When an undelivered item is essential to the functionality of the delivered item, the delivered item may not have standalone value to the customer as defined by ASC 605-25. The staff thinks that this idea of separate functionality and standalone value is similar to the articulation of 'distinct function' in the proposed model. Hence, it is not necessary to duplicate this consideration in the revenue standard.

11. The remaining indicators in paragraph 6 (relating to a potential refund depending on delivery or performance of undelivered items and the entity's ability to estimate remaining costs based on its history of successful performance) also seem to relate to the determination of whether a good or service is distinct. The staff thinks the boards could consider using some of those concepts when describing when a good or service has a distinct function and is subject to separable risks. The staff thinks, however, it would not be necessary or useful to carry forward existing guidance on perfunctory obligations because of the risk of unintended consequences.

Materiality

12. Some respondents appear to consider 'inconsequential and perfunctory' to be the equivalent of immaterial, and nearly forty respondents specifically refer to materiality in relation to identifying performance obligations.

13. The staff do not recommend adding specific guidance on materiality to the individual draft standard. The staff recommend preparers continue to rely on individual judgement and existing guidance, such as the definition of material provided by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and ASC 250 *Accounting Changes and Error Corrections*.

The entity's business model as a basis of excluding performance obligations

Marketing incentives

14. A few respondents suggested that an entity should not identify separate performance obligations for goods and services provided as marketing incentives. Each respondent gave indicators of how they would distinguish marketing incentives from performance obligations in accordance with their own business model.

15. One respondent accepted that customer loyalty programmes were separate performance obligations although they contend their marketing incentives are not. They distinguished loyalty programmes (and performance obligations) from marketing incentives in three respects:

    (a) The offers of free or subsidised goods are short term, often less than a few months

    (b) The customer implicitly pays for the cost of the customer loyalty programme as part of the selling price of goods and services. The respondent does not increase the price of specific products to cover the costs of related specific short term marketing incentives.

    (c) The respondent considers customer loyalty programmes to be contractual, based on the terms of the loyalty programme. The respondent considers vouchers for free goods to be outside the contract terms.

16. Another respondent did not accept that customer loyalty programmes should be identified as performance obligations. They consider loyalty points should be accounted for as either free goods or as a sales discount depending on the expected method of redemption by the customer.

17. Marketing incentives were also distinguished from performance obligations by some respondents if the good provided was manufactured by a third party (but only

in some, unspecified, cases) or where it contained an obvious advertisement bearing the entity's name.

18. The accounting treatment proposed for marketing incentives also varies by respondent. For example, one respondent considers promises to deliver future goods and services made as part of a contract with a customer to be brand building activities. That respondent believes these marketing expenses should be accrued when the goods are promised. Another considers a promised discount on future sales, included with one contract, to be a pricing decision accounted for as part of the future transaction.

19. One of the core principles of the model is that all goods and services provided to the customer give rise to performance obligations because they are part of the negotiated exchange with the customer. Even if a conceptual justification could be found to distinguish marketing incentives from performance obligations it is difficult to see how the differing suggestions provided by respondents can be developed into separation criteria that could be applied consistently across a range of business models.

Incidental obligations

20. A few respondents, principally in the telecommunications sector, suggested incidental obligations, ie those that are incidental to the entity's main trading activity, should be excluded when identifying performance obligations.

21. The respondents all quoted subsidised handsets as an example of an incidental good. They contend mobile phones are incidental to the provision of network services which these entities believe to be their main operating activity.

22. Within individual entities this distinction between performance obligations and incidental obligations is not always consistent. One respondent, for example, stated that providing a given good might be a performance obligation in one business

stream, but could be an incidental obligation in another business stream of the same entity, based on management's interpretation.

23. A respondent in the telecommunications sector also suggested specific factors that could identify subsidised handsets as marketing incentives and distinguish them from goods or services which give rise to performance obligations. Indicators that the subsidies are marketing incentives would include:

    (a) The subsidy is granted in order to sign up a customer

    (b) The subsidies are managed as costs

    (c) The subsidies are granted on goods and services that are not mainstream.

24. Depending on their business model, telecommunication entities can interpret subsidised handsets as either obligations incidental to the core deliverable or as a marketing incentive. Either interpretation is troubling to many:

    (a) The handset is a distinct good in the contract.

    (b) It clearly has stand alone value, particularly as the free or subsidised handsets themselves become more expensive and have increasing levels of standalone functions.

    (c) The customer implicitly pays for the handset which is recovered through the service revenue. There is a clear link between the amount of the service subscription and the level of subsidy granted.

25. This conclusion is supported by US GAAP and the respondents' own accounting. At present the handset is recognised as a separate deliverable but the amount of revenue recognised on these handsets on delivery is limited to the actual amount received.

26. The key issue raised by the telecommunications sector is the proposed allocation of some of the service revenue to the subsidised handset noted above. This issue will be brought to the boards at a future meeting (currently scheduled for March). In

addition the overall effect of the model on this sector will be considered by the boards in April.

Staff recommendation

27. The staff recommend that all distinct goods and services be identified as separate performance obligations and that no exemptions be granted for an individual entity's business model.

Question
Do the boards agree with the staff's recommendations with regard to the identification of performance obligations: a. not to include an exemption for inconsequential and perfunctory obligations in the standard b. not to provide any guidance on marketing incentives (other than the proposals on accounting for options) c. not to allow a general exemption for incidental obligations based on the entity's own business model?