

# STAFF PAPER

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Project	Revenue recognition		
Paper topic	Contract issues: Contract Combinations & Distribution Networks		
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## Purpose of this paper

1. This paper considers how to apply the 2011 Exposure Draft, *Revenue from Contracts with Customers* ('ED') to distribution arrangements under which an entity promises to transfer goods or services to its customer's customer. Under some of those arrangements:
  - (a) the promise to transfer goods or services to the customer's customer forms part of the original negotiated exchange between the entity and its customer; whereas in others
  - (b) the promise to the customer's customer is made subsequent to the original negotiated exchange (ie the date of contract inception).
2. Some respondents have questioned whether and how to apply the ED to those types of arrangements, specifically relating to:
  - (a) whether the contracts that make up those arrangements should be combined because they are economically-linked; and
  - (b) the identification of performance obligations in the contracts that make up those arrangements.
3. This paper discusses the proposed requirements as they would apply to distribution networks. Some respondents from the financial services industry had

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similar concerns about how the ED would apply to credit card rewards programs. The staff plan to discuss the application of the ED to those arrangements at a future joint board meeting.

## Summary of staff recommendations

4. The staff recommend the following:

- (a) The wording of paragraph 26 of the ED should be modified (see below, added text is underlined) to include the following in the listing of possible promises in a contract with a customer:

Depending on the contract, promised goods or services may include, but are not limited to, the following...

(g) Granting options to purchase additional goods or services (when those options provide the customer with a material right as discussed in paragraphs IG20 – IG22), including granting options that the customer can resell to its customer.

- (b) The Boards should reaffirm their previous tentative decision (as explained in paragraph BC65) that all goods or services promised to a customer as a result of a contract are performance obligations because they are part of the negotiated exchange between the entity and its customer.

## Structure of this paper

5. The remainder of this paper is structure as follows:

- (a) Distribution networks
- (i) Contract combinations (paragraphs 8 – 19)
  - (ii) Sales incentives

1. Promises made before or at contract inception  
(paragraphs 20 – 31)
  2. Promises made after the date of the contract  
(paragraphs 32 – 40)
- (b) Appendix A: Suggested wording changes to the ED
- (c) Appendix B: Example- accounting for sales incentives offered through a distribution network

## Distribution networks

6. Some entities frequently make promises to transfer goods or services to third parties (ie the customer's customer) to encourage movement of inventory through a distribution channel. In some cases those promises are made at contract inception; however, in other cases those promises are added later generally in response to changing market conditions. This fact pattern is common to the automotive industry.

'It is custom[ary] for vehicle manufacturers to provide incentives to the dealer's customer independently of the vehicle sales contract with the dealer. The incentives take the form of favorable financing provided by a captive finance company, cash rebates, and free services performed by unrelated third parties. The retail customer can often choose among the incentives offered; sometimes the incentives will come automatically with a particular brand or vehicle line. Incentives are generally announced and available for a quarterly period, and retail customers who purchase or lease a vehicle after the period are not entitled to receive the expired incentives. Regardless of the form of the incentive, the purpose is the same – to respond to conditions of the overall economy, enhance brand loyalty, respond to changes in retail consumer demand for a particular vehicle line and meet competitor actions.'  
(CL 153- Ford)

7. The main issues identified by respondents in accounting for these types of arrangements under the ED are as follows:
- (a) Contract combinations: The proposed requirements in paragraph 17 of the ED for combining contracts specify that contracts should be

combined only if they are entered into at or near the same time and with the same customer.

- (i) Some respondents commented (either in their comment letters or in outreach meetings) that the contracts making up distribution arrangements should be combined because they are economically-linked. Those respondents note that promises to provide additional goods or services under those arrangements are made to the same customer regardless of whether the promised goods or services transfer to that entity or to another party.
  - (ii) Other respondents commented that the Boards' intent about whether those contracts should be combined is unclear because they interpret that the promises to provide goods or services in those arrangement are made to different parties.
- (b) Sales incentives: Some respondents questioned whether the ED should apply to promised goods or services that they view as sales incentives. In their view, those promises should not be accounted for in the same manner as performance obligations. Those respondents also noted what they perceive to be an inconsistency in the proposals for accounting for sales incentives that transfer goods or services to the customer (which the ED would identify as performance obligations) compared with cash-based sales incentives (which the ED would account for as consideration payable to the customer).

## **Contract combinations**

### *Background information*

8. Entities sometimes structure arrangements so that promises are conveyed to a customer in a series of contracts instead of in a single contract. By doing so, the

entity might achieve a different accounting result than if the contracts were accounted for together. To prevent this outcome, U.S. GAAP and IFRS require entities to combine contracts in some situations. The most relevant existing requirements are as follows:

- (a) Subtopic 605-35-25, Revenue Recognition- Construction-Type and Production-Type Contracts

A group of contracts may be so closely related that they are, in effect, parts of a single project with an overall profit margin, and accounting for the contracts individually may not be feasible or appropriate. Under those circumstances, consideration should be given to combining such contracts for profit recognition purposes.

- (b) IAS 18, *Revenue*

The recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

9. In the 2010 ED, the Boards proposed that an entity should combine contracts if those contracts have interdependent prices. Many respondents to the 2010 ED agreed conceptually with this principle for combining contracts, but they commented that they did not believe it would be operational. In order to address the concerns of those respondents, the Boards modified the proposed requirements in the ED such that a group of contracts would be combined only if they meet specified criteria.
10. Paragraph 17 of the ED states the following:

An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts as a single contract if one or more of the following criteria are met:

- (a) the contracts are negotiated as a package with a single commercial objective;

(b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract;

(c) the goods or services promised in the separate contracts (or some goods or services promised in the contracts) are a single performance obligation in accordance with paragraphs 27–30.

### *Respondent feedback*

11. The Boards did not specifically ask a question about the contract combinations requirements in paragraph 17 of the ED. Relatively few respondents commented on this topic. However, of those who did, the staff noted that these respondents:
- (a) are unsure how they should interpret the proposed requirements as they would apply to some of their arrangements; and/or
  - (b) they oppose some interpretations of the proposed requirements that they believe would misrepresent the economics of some of their arrangements.
12. Most of the feedback about this topic was concentrated amongst a small group of respondents predominantly from the automotive and credit card sectors. Those respondents generally agree with the proposed requirements; however, they have heard differing interpretations of what those requirements would entail. They are therefore seeking clarification about how the Board intends for the requirements to be applied.
13. While making a broader point about whether promises to provide goods or services to parties other than the customer are performance obligations, one respondent commented as follows:

‘The requirement that only contracts with the same customer or related parties be combined might result in individual arrangements being accounted for separately even though they are economically linked. This could occur when goods or services

are provided directly to the customer of an entity's customer.' (CL 33- PricewaterhouseCoopers)

14. This interpretation would have significant ramifications for entities that sell through distribution networks. Generally, those respondents do not agree that contracts should be combined in those arrangements because they believe such promises are not made to the customer (ie they are instead made to the customer's customer) and they therefore would not satisfy the criteria in paragraph 17 of the ED.
15. Other respondents noted that the requirements for combining contracts should focus entirely on whether those contracts were negotiated as a package to achieve a single commercial objective. Those respondents noted generally that the criterion 17(a) from the ED should be elevated to the level of a principle and supported by indicators similar to the remaining criteria from paragraph 17 of the ED.
16. Broadly speaking, those respondents who commented that the proposed criteria for combining contracts should be modified note that the criteria are too restrictive because of the condition in paragraph 17 of the ED that only contracts entered into 'at or near the same time with the same customer' should be combined.

### *Staff analysis*

17. To address the concerns of some respondents, the Boards could choose to broaden the requirements for combining contracts. The staff think that the most viable way of doing so would be to elevate the criterion 17(a) from the ED to the level of a principle and supporting it with indicators. The remaining criteria from paragraph 17 of the ED, as well as the lead-in sentence to that paragraph would serve as viable indicators under this approach because the presence of these conditions would be indicative that the overall principle has been met. Under this approach, the staff envision that the requirements would be as follows:

An entity shall combine two or more contracts and account for the contracts as a single contract if those contracts were conceived as a package with a single commercial objective.

Indicators that provide evidence that the principle is met include:

A- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.

B- The goods or service in the contracts are closely interrelated or interdependent in terms of design, technology or function.

C- The contracts were entered into at or near the same time with the same customer (or related parties).

18. On balance, the staff acknowledge that there might be arrangements for which broader contract combinations criteria might result in a more faithful portrayal of the economics. For example, under Shariah law there are arrangements under which a single commercial objective is sought through the issuance of a number of contracts with different customers (ie to ensure that the economic financing component is compliant). Based on the existing criteria, these contracts would each have to be accounted for individually.
19. However, the staff think that the likelihood of unintended consequences would be too great to justify such a modification. The staff envision that there would be diversity in practice for many arrangements that consist of groups of contracts with the same customer. Particularly in the case of loss-leader type contracts, an argument could be made that all contracts with the same customer are made for the purpose of furthering a single commercial objective (eg entering into a less profitable contract in anticipation of a more profitable contract at a later date). Consequently, the staff do not think that the criteria for contract combinations should be modified.



**Question 1 for the Boards: contract combinations**

Do the boards agree that the criteria for combining contracts in paragraph 17 of the ED should **not** be modified?

**Sales incentives*****Promises made before or at contract inception***

20. In developing the ED, the Boards considered whether an entity should account for sales incentives and/or perfunctory or incidental performance obligations in a different manner than promises relating to the ‘primary’ goods or services in a contract. The Boards decided that an entity should not differentiate between these types of promises primarily because doing so would be arbitrary and would lead to inconsistent outcomes depending on whether the entity makes its determination based on its viewpoint or that of the customer. Paragraph BC65 states the following:

When a customer contracts with an entity for a bundle of goods or services, it can be difficult and subjective for the entity to identify the “main” goods or services for which the customer has contracted. In addition, the outcome of that assessment could vary significantly depending on whether an entity performs the assessment from the perspective of its business model or from the perspective of the customer. Consequently, the Boards decided that all goods or services promised to a customer as a result of a contract are performance obligations because they are part of the negotiated exchange between the entity and its customer.

21. A number of respondents disagreed with this notion. These respondents commented that some promises to provide goods or services under a contract (ie sales incentives) are fundamentally different from the promise to provide the ‘main’ product under the contract. These respondents generally commented that the accounting for sales incentives should be similar to current practice under U.S.

GAAP and IFRS (ie either record a cost accrual or defer revenue for the cost of providing the incentive).

- (a) These respondents view the additional promised goods or services as costs to sell the underlying assets instead of a revenue-generating activity. Feedback suggests that these entities are indifferent about whether they promise goods/services or cash, and that the form of the promise is determined by the entity's sales and marketing personnel in light of market and broader economic conditions.
- (b) Many of these respondents do not provide or perform the promised goods or services as part of their central ongoing operations. They argue that in this respect they do not promise a good or service to the third party; rather, they promise to pay cash to a third party on their behalf.
- (c) In cases where the entity does not provide or perform the promised good or service on its own, these respondents note that they have no basis for estimating a standalone selling price for the good or service. They therefore question whether the resulting margins would be reliable and believe the information would be misleading to users.

GM's ongoing major or central operations are to design, build, and sell vehicles, as well as service parts, to independent authorized retail dealers...

... Subsequent to sale by the dealer to the retail customer, GM is responsible to reimburse any participating dealer who provides a vehicle owner with any necessary warranty, maintenance and/or courtesy transportation, thereby reimbursing the dealer for services provided... Under these arrangements, GM incurs all the costs of providing such services but does not actually perform the underlying services. *If a retail customer does not have the services performed, no costs are incurred by GM...* In addition, GM offers many other cash incentives that are paid to the dealer, the retail customer, or a financial institution.

Under the Revised ASU, the... items [above] appear to be performance obligations... *As such, entities are required to allocate consideration, based on a standalone selling price that for all intents and purposes includes a profit margin, to all distinct*

*goods or services for purposes of revenue recognition since they are goods or services for which the customer ultimately pays, even though the entity considers those goods or services to be part of the cost of the product, marketing incentives or incentives to sell a product rather than separate revenue-producing activities. (CL 201- General Motors, emphasis added)*

### Staff analysis

22. In order to address the concerns of those respondents, the Boards could acknowledge that some promises to provide goods or services to customers are fundamentally different from others. Those promises (ie sales incentives) would not be identified as performance obligations; rather, they would be accounted for in a similar manner to consideration payable to a customer under paragraph 65 of the ED.
23. Paragraph 65 of the ED outlines how an entity should account for consideration payable to a customer, which is defined as follows:

Consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer (or to other parties that purchase the entity's goods or services from the customer) in the form of cash, credit, or other items that the customer can apply against amounts owed to the entity.

24. Those promises would be accounted for as a reduction of the transaction price under the ED. Conversely, promises by an entity to provide goods or services should be accounted for as performance obligations, meaning they should be allocated a portion of the transaction price and revenue should be recognized when or as the promise is satisfied.
25. Some respondents commented that the distinction between the proposed requirements for cash payments and promises to provide goods or services appears arbitrary in that the economics of promising a good or service are no different from those for making a cash payment of equal value. These respondents think that some promises to provide goods or services in a contract should be accounted for on the same basis as consideration payable to a customer.

26. The staff think that promises to transfer goods or services to a party other than the end customer are performance obligations because in making those promises the entity:
- (a) transfers to the customer a right to package the promise of goods or services with the entity's product as part of the customer's sale to its customer; and, as a consequence
  - (b) incurs an obligation to fulfill the promise to the end customer (the entity may arrange for another party to fulfill the promise).
27. In this sense, those promised goods or services attach to the product sold to the intermediary in the distribution channel (eg distributor, dealer, retailer) and should therefore be accounted for as part of the sale of a good or service. The staff think that the entity that receives the right to market, and therefore to benefit from the promise of those additional goods or services, is the customer in those types of arrangements.

### *Staff recommendation*

28. On balance, the staff acknowledge the concern of some respondents that, under the ED, promises to pay cash to the customer are accounted for differently than non-cash promises to the customer. The staff do not recommend any changes to the wording in paragraph 65 of the ED in order to address those concerns. The staff think that those promises (eg cash rebates) are fundamentally different from promises to provide goods or services because in those situations the entity and the customer have effectively not engaged in a revenue transaction (ie the parties simply exchange cash or agree to reduce the contract price).
29. Based on the feedback, the wording in the ED about whether all promises by an entity to provide goods or services are performance obligations is arguably unclear. Consequently, the staff think that the wording in the ED should be modified to reinforce the notion previously communicated by the Boards in paragraph BC65. The staff think this could be accomplished by modifying the wording in paragraph 26 of the ED as follows (added text is underlined):

Depending on the contract, promised goods or services may include, but are not limited to, the following...

(g) Granting options to purchase additional goods or services (when those options provide the customer with a material right as discussed in paragraphs IG20–IG22), including granting options that the customer can resell to its customer

30. The staff think that this recommended wording change would:
- (a) drive consistency in the accounting for promises made by an entity to transfer goods or services to a party other than the customer; and
  - (b) emphasize the Boards' reasoning as articulated in paragraph BC65.
31. The staff also recommend that the Boards reaffirm their previous tentative decision as noted in paragraph BC65. The Boards previously considered and rejected the notion that some promises in a contract should be accounted for differently than others. The staff think that an entity's view about the nature of its promises should not be considered in determining how to account for those promises; and, the most complete depiction of the economics of a contract with a customer is one that considers not only the 'main' promises in the contract but also those 'less significant' promises an entity made in order to secure that contract.

#### Questions 2 and 3 for the Boards: sales incentives

Do the Boards agree that paragraph 26(g) of the ED should be modified to include the following in the list of the entity's possible promises under a contract with a customer?

'granting options that the customer can resell to its customer'

Do the boards reaffirm their previous tentative decision that all goods or services promised to a customer as a result of a contract are performance obligations because they are part of the negotiated exchange between the entity and its customer?

***Promises made subsequent to the date of the contract***

32. Sometimes an entity sells a good or service to a customer but decides later to add a promise to provide goods or services to another entity. Generally, a promise would be added in this manner to encourage movement of stale or older inventory through a distribution channel. In some cases, the entity decides to later withdraw and/or change the nature of these promises based on the effectiveness of the particular promise.
33. For example, a manufacturer might sell a lawnmower to one of its dealers in the middle of the summer with the expectation that it will be sold to an end customer by the end of the season. If an end customer does not purchase the lawnmower within the expected timeframe, the manufacturer might add a promise to provide or arrange for another entity to provide ‘free’ maintenance services to any end customer who purchases the lawnmower.
34. In some cases, the ED requires the entity to account for only those promises that were promised explicitly in the contract. This view is consistent with the requirements of the ED so long as the entity has not provided the customer with a reasonable expectation that it will transfer some other goods or services that should be considered as part of the negotiated exchange. Any promises over and above those that were considered in the negotiated exchange between the entity and the customer would be considered to have been provided independently of the contract. That view would be consistent with paragraph BC65, which noted the Boards’ conclusion that these types of promises should be accounted for as marketing incentives instead of performance obligations. In this fact pattern, today’s accounting for sales incentives (ie generally an entity would accrue for the expected cost of fulfilling the promise) would largely be preserved.
35. The interpretation above would be consistent with the ED when, based on an evaluation of all relevant facts and circumstances, the entity determines that all promised good and services have been identified and transferred to the customer at the same time it transfers control of the ‘main’ good or service. The subsequent offering of another promise (ie a sales or marketing incentive) is a separate

transaction that should not impact the original transaction. If however, the entity's business policies and/or past practices provide customers with a reasonable expectation that the entity will at some point promise additional goods or services under the contract, then those additional promised goods or services should be considered as part of the negotiated exchange.

36. Paragraph 24 of the ED states:

Performance obligations include promises that are implied by an entity's customary business practices, published policies, or specific statements if those promises create a valid expectation of the customer that the entity will transfer a good or service.

37. In many distribution networks, sales and/or marketing incentives are offered to customers with such regularity that one could argue that the 'valid expectation' threshold is met. In those arrangements, the entity would be required to estimate the amount of consideration to allocate to the performance obligation (ie to provide additional goods or services that it views as sales incentives) and refrain from recognizing the corresponding revenue until it satisfies such obligation(s). The implication of this notion is that those contracts would remain open (ie only partially satisfied) until the 'main' good or service is sold onto an end customer.
38. In the event that the customer sells the product onto an end customer before the entity commits to the implied promise (ie which would make the promise invalid), the entity should account for a contract modification. Contract modifications of this type would generally be accounted for prospectively, resulting in a gain at the date of the modification (ie similar to breakage).
39. The staff note that there would be a difference between the accounting for (a) additional promises to provide goods or services that were implied at contract inception and (b) identical promises when those promises were not anticipated at contract inception. Despite the differential treatment, the staff think this outcome reflects a proper application of the model. If the Boards disagree, the staff could pursue changes to the proposed contract modifications requirements whereby closed contracts could be reopened in the event that an additional promised good

or service is added later. The staff do not think this is an appropriate pursuit as it could have significant unintended consequences.

*Staff recommendation*

40. Based on the fundamental notions in the ED about identifying performance obligations (ie as articulated in paragraphs 23, 24, and BC65), the entity would be required to evaluate all of the facts and circumstances at contract inception to ensure that it captures all promises in the contract, both explicit and implicit (these may not necessarily be specified at contract inception). For example, in many distribution networks, manufacturers regularly offer different packages of sales incentives to the customer. The staff do not believe that the wording in the ED should be modified; however, we will continue to assess the need to provide an illustrative example.

**Questions 4 and 5 for the Boards: promises to provide goods or services to a third party made after contract inception**

Do the Boards agree that the proposed requirements should not be modified as a result of the analyses performed above?

If not, what suggested changes do the Boards propose?



## Appendix A: Suggested wording changes to the ED

1. The following table lists the proposed requirements from the exposure draft that relate to the identification of performance obligations and identifies which of those proposals would change as a result of the staff recommendations in this paper.

Proposals from 2011 Exposure Draft	Suggested Improvements
<p>26. Depending on the contract, promised goods or services may include, but are not limited to, the following:</p> <p>(a) Goods produced by an entity for sale (for example, inventory of a manufacturer)</p> <p>(b) Goods purchased by an entity for resale (for example, merchandise of a retailer)</p> <p>(c) Providing a service of arranging for another party to transfer goods or services to the customer (for example, acting as an agent of another party as discussed in paragraphs IG16–IG19)</p> <p>(d) Standing ready to provide goods or services (for example, when-and-if-available software products)</p> <p>(e) Constructing, manufacturing, or developing an asset on behalf of a customer</p> <p>(f) Granting licenses or rights to use intangible assets</p> <p>(g) Granting options to purchase additional goods or services (when those options provide the customer with a material right as discussed in paragraphs IG20–IG22)</p> <p>(h) Performing a contractually agreed-upon task (or tasks) for a customer</p>	<p>The wording of paragraph 26 of the ED should be modified as follows (added text is <u>underlined</u>):</p> <p>(g) Granting options to purchase additional goods or services (when those options provide the customer with a material right as discussed in paragraphs IG20 – IG22), <u>including granting options that the customer can resell to its customer.</u></p>

## Appendix B: Example- accounting for sales incentives offered through a distribution network

- 1. Base Fact Pattern:** Manufacturer (M) sells a product to End Customer (EC) through Distributor (D) and promises in the contract to provide free maintenance services to EC. EC is entitled to receive these services from D once annually for 3 years. M has agreed to fully reimburse D for costs incurred in performing these services. EC can choose receive these services from any of M's 100 distributors under the same terms. Whichever distributor performs the maintenance services would be entitled to reimbursement from M.
- 2. How should M account for its promise to provide free maintenance services?** In this example, M should account for its offer to provide free maintenance services to EC as a performance obligation under the sales contract. M agreed as part of the negotiated exchange to provide these services to EC. The promise is of value to D because it can resell the promise together with the product to enhance the product's appeal to EC.
- 3. Variation 1:** Assume the base fact pattern except M's promise to provide free maintenance services is not explicit in its contract to sell its product to D. Instead, M notified all of its distributors by email one week after the sale to D (but before D had sold the product onto EC) that M would provide free maintenance services to ECs that purchase its product within the next 30 days. This type of promise was similar to promises made by M to D in the past, and in this respect D reasonably expected that M would make such a promise.
- 4. How should M account for its promise to provide free maintenance services?** In this example, M should account for its offer to provide free maintenance services to EC as a performance obligation under the sales contract. Although M did not explicitly promise in the contract to provide free maintenance services to EC, its business policies and/or past practices provided D with a basis for reasonably expecting that it would promise to provide those services. In this manner, M's promise was considered in the negotiated exchange with D. M's promise would meet the definition of 'performance obligation' under paragraphs 23 and 24 because the promise created a valid expectation that it would transfer the free maintenance services. The promise is of value to D because it can resell it together with the product to enhance the product's appeal to EC.
- 5. Variation 2:** Assume the base fact pattern except that M's promise to provide free maintenance services was made after D had already sold the product onto an end customer.
- 6. How should M account for its promise to provide free maintenance services?** In this example, M should account for its offer to provide free maintenance services as a marketing incentive (ie expense when incurred).