

# STAFF PAPER

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<b>Project</b>	<b>FASB-IASB Joint Transition Resource Group for Revenue Recognition</b>		
<b>Paper topic</b>	<b>Distinct in the Context of the Contract</b>		
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## Purpose

- Some stakeholders informed the staff that there may be different interpretations of the application of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15, *Revenue from Contracts with Customers* (collectively referred to as the “new revenue standard”), in determining whether goods or services are distinct in the context of the contract. This implementation question relates to Step 2 (identify the performance obligations in the contract) in the new revenue standard. The staff plans to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition for their input about their interpretations of the guidance applied to examples developed by the staff.

## Accounting Guidance<sup>1</sup>

- Paragraph 606-10-25-14 [22] states that:

At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall

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<sup>1</sup>Paragraph references in “[XX]” throughout this paper refer to IFRS 15.

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identify as a performance obligation each promise to transfer to the customer either:

(a) A good or service (or bundle of goods or services) that is distinct

(b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

3. The new revenue standard includes additional guidance on critierion (a) above in paragraph 606-10-25-19 [27] that:

A good or service that is promised to a customer is distinct if both of the following criteria are met:

(a) The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

(b) The entity's promise to transfer a good or service to the customer is separately identifiable from other promises in the contract (that is, *the good or service is distinct within the context of the contract*).

[Emphasis added.]

4. Paragraph BC105 states that the Boards observed that determining whether the entity's promise to transfer a good or service is separately identifiable requires judgment, taking into account all of the facts and circumstances. The Boards provided guidance to assist entities make the necessary judgments by including the factors in paragraph 606-10-25-21 [29].

5. Paragraph 606-10-25-21[29] provides several factors that indicate an entity's promise to transfer a good or service is separately identifiable:

(a) The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer

has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

(b) The good or service does not significantly modify or customize another good or service promised in the contract.

(c) The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide not to purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

6. Paragraphs 606-10-55-136 [IE44] through 55-150 [IE58] include illustrations of this guidance.
7. After determining whether goods or services are distinct, an entity considers whether those goods and services should be accounted for as a series of distinct goods or services in accordance with paragraphs 606-10-25-14(b) [22] and 606-10-25-15 [23]. A series of distinct goods or services are those that are substantially the same and have the same pattern of transfer to a customer. This paper focuses on the topic of determining whether a good or service is distinct in the context of the contract and does not address the series guidance.
8. In accordance with paragraph 606-10-25-22 [30], an entity combines that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct if it determines that a good or service is not distinct.
9. The identification of performance obligations affects later steps in the revenue standard in allocating the transaction price to performance obligations and recognizing revenue when (or as) the entity satisfies the performance obligation. For example, the entity would recognize revenue based on a single performance obligation if an entity determines that no goods or services are distinct in the context of the contract. The entity would allocate revenue to each performance

obligation and recognize revenue as each performance obligation is satisfied if it determines that there are multiple distinct performance obligations.

## **Potential Implementation Issue Reported by Some Stakeholders**

### ***Issue: How should entities assess whether a good or service is distinct in the context of the contract?***

10. The guidance in the new revenue standard in paragraph 606-10-25-19(a) [27(a)] about whether or not a good or service is capable of being distinct is similar to concepts in current accounting guidance, principally the notion of standalone value.
11. Stakeholders have noted that the “distinct in the context of the contract” notion in paragraph 606-10-25-19 (b) [27(a)] is a new concept and have raised questions about how to apply that guidance in practice.
12. Paragraphs BC102 through BC112 address the basis for conclusions related to the concept of distinct within the context of the contract. To illustrate the intent of the guidance, paragraph BC102 explains that construction-type and production-type contracts involve transferring many goods and services to a customer that are capable of being distinct, but identifying all of those individual goods and services as separate performance obligations would be impractical and would not be a faithful representation of the entity’s promise to the customer or provide useful information about the entity’s performance. For example, consider that a customer has contracted with an entity to construct a building. The underlying building materials, labor, and project management services may each be capable of being distinct, but recognition of each individual building component (for example, each brick) or each service would involve significant complexity for the preparer (that is, to identify each good and service and allocate a portion of the transaction price to each), while not providing useful information about the entity’s progress towards completing the single item the customer has contracted for (that is, the building).
13. Paragraph BC105 includes the notion that “separately identifiable” is based on the notion of separable risks, that is, whether the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised

goods or services. The factors in paragraph 606-10-25-21 [29] are based on this concept. Additionally, paragraph BC106 clarifies that the factors are not mutually exclusive and that because the factors are all based on the underlying principle of inseparable risks, in many cases, more than one of the factors might apply to the contract with a customer.

14. The basis for conclusions includes some explanation and examples of each of the factors in paragraph 606-10-25-21 [29] as follows.

- (a) Significant Integration Services

- (i) Paragraph BC107: In circumstances in which an entity provides an integration service, the risk of transferring individual goods or services is inseparable, because a substantial part of the entity's promise to a customer is to ensure the individual goods or services are incorporated into the combined output.
- (ii) Paragraph BC108: Some software development contracts with significant integration services will have promised goods and services that do not meet the criterion in paragraph 606-10-25-19(b) [27(b)]. However, the Boards did not intend for this factor to be applied too broadly to software integration services for which the risk that the entity assumes in integrating the promised goods or services is negligible (for example, a simple installation of software that does not require significant modification). Therefore, to provide some additional clarification for many software-type contracts, the Boards included the factor in paragraph 606-10-25-21(b) [29(b)] (significant modification or customization factor).

- (b) Significant Modification or Customization:

- (i) Paragraph BC109: If a good or service modifies or customizes another good or service in the contract, each good or service is being assembled together (that is, as

inputs) to produce a combined output for which the customer has contracted.

- (ii) Paragraph BC110: An entity may promise to provide a customer with existing software and also promise to customize that software so that it will function with the customer's existing infrastructure such that the entity is providing the customer with a fully integrated system. In this case, if the customization service requires the entity to significantly modify the existing software in such a way that the risks of providing the software and the customization service are inseparable, the entity may conclude that the promises to transfer the software and the customization service would not be separately identifiable and, therefore, those goods or services would not be distinct within the context of the contract.

(c) Highly Dependent or Highly Interrelated:

- (i) Paragraph BC111: The individual goods and services in the contract may still not be separately identifiable from the other goods or services promised in the contract. This may be because the goods or services are highly dependent on, or highly interrelated with, other promised goods or services in the contract in such a way that the customer could not choose to purchase one good or service without significantly affecting the other promised goods or services in the contract.
- (ii) Paragraph BC112: An entity agrees to design an experimental new product for a customer and to manufacture 10 prototype units of that product. The specifications for the product include functionality that has yet to be proven. Consequently, the entity will be required to continue to revise the design of the product during the

construction and testing of the prototypes and make any necessary modifications to in-progress or completed prototypes. The entity expects that most or all of the units to be produced may require some rework because of design changes made during the production process. In that case, the customer may not be able to choose whether to purchase only the design service or the manufacturing service without significantly affecting one or the other. This is because the risk of providing the design service is inseparable from the manufacturing service. Thus, although each promise may have benefit on its own, within the context of the contract, they are not separately identifiable. This is because the entity determines that each promise is highly dependent on, and highly interrelated with, the other promises in the contract.

15. Stakeholders have shared some scenarios in which the application of the distinct in the context of the contract guidance might require significant judgement.
16. The staff has drafted some examples illustrating stakeholders' questions to allow TRG members to discuss their interpretations of the guidance. The examples are purposely generic so the discussion is focused on the key factors to consider in the analysis.

***Example 1***

17. The customer provides the entity with a request to manufacture a product that is customized to the customer's specifications. The entity has ordered five units of the product. The five units will be delivered to the customer at various points in time. The plans and specifications are provided by the customer to the entity before manufacturing begins. The entity does not perform design work. All five units will have the same design. Does the existence of a customized design affect the determination of whether goods or services are distinct in the context of the contract?

18. Some stakeholders assert that the fact the units are customized indicate that the individual units may not be distinct in the context in the contract. Paragraph BC112 includes a scenario in which an entity is providing design and manufacturing services. In that example, the design and manufacturing are a single performance obligation because the risk of providing the design service is inseparable from the manufacturing service. However, questions arise when the manufacturing service is customized but the entity does not perform the design. In Example 1, although the design was provided by the customer, some stakeholders assert that it is possible that units could require rework even if not explicitly stated in the contract. This assertion may vary based on the degree of customization. For example, if the customized unit has a complex design, then it may be more likely that the risks in individual units are inseparable from each other than if the production is based on a simple design.
19. Consider a scenario in which an entity manufactured unit one of the five units based on the customer's design and delivered the one unit to the customer. After receiving unit one, the customer requires a change to the design based on flaws in its design that it identified in operating unit one. The change might be considered a design correction affecting a batch of units. Accordingly, some stakeholders might consider the manufacture of a customized product inherently to include the identification of design flaws and remediation of those flaws in all of the units. From a practical standpoint, the entity likely would modify the design for units two through five based on the change order (and possibly change unit one that was previously delivered), which some may think indicates the units are highly interrelated or the entity is performing a significant integration service (that is, integration of the design and the manufacturing).
20. Other stakeholders assert that the mere fact the product is customized does not result in a conclusion that the goods or services are not distinct in the context of the contract. Although the factor in paragraph 606-10-25-21(b) [29(b)] relates to significant modification or customization, the fact that the product is customized does not automatically lead to a conclusion that the five units are not separable. Paragraph 606-10-25-21(b) [29(b)] specifically states that the good or service does not customize *other* goods or services in the contract. Their interpretation would be



that if all of the units are customized to the same specifications, then the customization aspect of the product does not meet this factor. Because this is only one factor, the entity would consider the other factors in paragraph 606-10-25-21 [29] to assess if the promises are separately identifiable. These stakeholders observe that the factor in paragraph 606-10-25-21(c) [29(c)] is that goods or services are *highly* interrelated. The fact that the units might be interrelated to some extent does not automatically lead to a conclusion that there is a single performance obligation. Entities must apply judgment about the degree of interrelation to determine whether the goods or services are *highly* interrelated or not.

### ***Example 2***

21. A customer orders five units of the entity's product. The product is complex and it takes two years to manufacture each unit. Customers may order the product with different configurations offered by the entity, but the product is not customized to unique specifications of a particular customer. Although the product is complex, it is a standardized product and the entity has extensive experience manufacturing this product. Does the existence of a complex design affect the determination of whether goods or services are distinct in the context of the contract?
22. A difference between Example 1 and Example 2 is that the product in Example 1 is customized to the customer's specifications and the product in Example 2 is not customized to unique specifications of a customer.
23. Some stakeholders' view that the five units in Example 2 are not distinct in the context of the contract is similar to their view on the five units in Example 1. In contrast, other stakeholders assert that each of the five units are distinct (consistent with the reasons discussed within Example 1 above) because complexity itself does not cause the units to be inseparable.

### ***Example 3***

24. An entity recently launched a new product. The entity expects the manufacturing cost per unit will decline over time as efficiencies are gained in the manufacturing process. Accordingly, the cost of the first unit delivered to the customer is expected to be higher than the cost of the fifth unit delivered to the customer. The entity priced the contract for the five units to achieve an overall target profit margin for

the contract in total. Does the existence of a learning curve affect the determination of whether goods or services are distinct in the context of the contract?

25. Paragraphs BC312 through BC316 address the concept of a learning curve. A learning curve is the effect of efficiencies realized over time when an entity's costs of performing a task (or producing a unit) decline in relation to how many times an entity performs the task (or produces the unit).
26. A learning curve may exist if a product or service is customized to a particular customer or also if a product or service is not customized to a particular customer. This example is intended to isolate the effect of learning curve on the assessment and is not intended to address the customization aspect.
27. Some stakeholders assert that the existence of a learning curve is an indicator that the goods or services are not distinct in the context of the contract. They assert that the existence of a learning curve may indicate the goods or services are highly interrelated with one another and, therefore, the five units should be accounted for as a single performance obligation. This is because, the pricing for all of the goods or services in the contract are highly interrelated and dependent on the volume if a learning curve exists. Those stakeholders assert that because the pricing is interrelated the units are considered to be highly interrelated in accordance with the guidance in paragraph 606-10-25-21(c) [29(c)]. They observe that in this example if the customer ordered one unit instead of five, the price for that single unit might be higher than the average per unit price in the contract for five units.
28. Other stakeholders assert that the existence of a learning curve should not affect the identification of performance obligations. Those stakeholders note that paragraph BC313 states that the new revenue standard addresses the accounting effect for a learning curve *if* (a) an entity has a single performance obligation to deliver a specified number of units and (b) the performance obligation is satisfied over time. Some interpret this paragraph to mean that the learning curve effect is not a factor in identifying performance obligations, but instead is an output of the accounting after that determination is made. That is, the entity would probably select a method (for example, cost-to-cost) that results in the entity recognizing more revenue and expense for the early units produced relative to the later units if the single

performance obligation is delivered over time. Additionally, the factors in paragraph 606-10-25-21 [29] do not include any discussion of the effect on pricing. Instead, the guidance is focused on whether the goods or services are interrelated or interdependent, and not necessarily focused on the pricing.

***Example 4***

29. The customer is planning to use the five units that it has ordered in a new manufacturing facility. The units are based on a standard design and are not customized. The customer requires a minimum of five units to begin using the new manufacturing facility. The customer will not be able to open its facility if it receives less than five units. In assessing whether goods or services are highly dependent or highly interrelated, are entities required to consider the customer's motivation for purchasing the goods or services?
30. Some stakeholders assert that a customer's motivation (or what the customer perceives they are purchasing—individual units versus a group of units) should not affect the determination of whether a good or service is distinct in the context of the contract. Those stakeholders observe that it is not reasonable for the entity to know its customer's planned end use of the units. They think the view might create diversity in accounting for similar transactions if the determination of whether the goods are distinct in the context of the contract varies based on whether the entity *knows* the customer's motivation or does *not know* the customer's motivation. Those stakeholders cite paragraph BC101, which states that the Boards observed that it would be difficult, if not impossible, for an entity to know the customer's intentions in a given contract. Additionally, those stakeholders assert that the units do not affect each other and, accordingly, would be considered to be separable based on the guidance in 606-10-25-21(c) [29(c)]. For example, assume that the entity delivers three of the units to the customer. The remaining two undelivered units do not *affect* the three units that the customer has already received.
31. Other stakeholders assert that the customer's motivation with respect to the contract *should* affect the analysis of determining whether the goods are distinct in the context of the contract. In this example, the customer would not be able to run its facility if it received any less than five units. If it is clear that the customer could

not choose to purchase less than the five units without significantly affecting its ability to benefit from the units, then it would appear to be an indication that the units are highly interrelated or interdependent in this contract. Depending on other facts and circumstances, including evaluation of the other indicators in paragraph 606-10-25-21 [29] about “distinct in the context of the contract,” some stakeholders may conclude that the five units are a single performance obligation. Those stakeholders note that there are numerous instances within the new revenue standard under which the analysis appears to consider the customer’s perspective (for example, whether the customer can benefit, whether the customer has obtained control, and whether the customer has been provided a material right).

32. Furthermore, those stakeholders note that the discussion in paragraph BC101 should not be interpreted to mean that an entity *cannot* consider the customer’s motivation. They interpret the guidance to mean that an entity is *not required* to consider the motivation, but if the entity knows the customer’s motivation, then the information might be relevant in assessing whether the goods or services are distinct in the context of the contract.

***Example 5***

33. The customer ordered five units of the product and installation services. The installation services are not specialized; however, the customer is not capable of installing the units by itself. There are several different suppliers that are able to perform installation. However, the contract stipulates that the customer must use the entity for installation services of the five units. Do contractual restrictions affect the determination of whether the units and installation are distinct in the context of the contract?
34. Different stakeholders have different views about whether a contractual restriction should affect the identification of performance obligations based on their interpretations of paragraph 606-10-25-21(c) [29(c)], which is the indicator about whether the good or service is highly dependent on, or highly interrelated with, other goods or services promised in the contract. The second sentence in that factor states:

For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or service.

35. Some stakeholders think that the contract restriction about requiring the customer to use the entity's installation services impacts the customer's ability to *decide* which entity will provide the installation service. Under this view, the restriction would cause the products and services to be highly interrelated (and accounted for as a single performance obligation). The customer is not permitted contractually to hire another party to perform the installation and the customer cannot use the products without installation.
36. Other stakeholders think that although the contract includes a restriction on which party can install the product, the existence of other service providers that can perform the installation is an indicator that the product and installation are not highly interrelated or highly dependent on one another. Although the customer is required to have the entity perform the installation services, it is a condition that the parties agreed to in the contract. Additionally, paragraph BC100 states that the assessment of whether the "customer can benefit from the goods or services on its own" should be based on the characteristics of the goods or services themselves instead of the way in which the customer may use the goods or services. Consequently, the entity would disregard any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity.

### ***Example 6***

37. In Example 6, the fact pattern is different from Examples 1 through 5. In this example, an entity sells a base product and one unit of a consumable product to a customer. The base product and consumable product are delivered to the customer on different dates. The consumable product (for example, a filter or a cartridge) is required to operate the base product. The consumable product must be replaced periodically after it is consumed. No other entities manufacture the consumable

product. The consumable product does not customize or modify the base unit. The entity sells its consumable product through standalone sales to other parties that own the base unit (for example, refill orders or to customers that obtained the base unit through resale). How should an entity assess whether goods and services are highly interrelated when one good or service is not functional without another good or service?

38. Some stakeholders assert that the contract would be accounted for as a single performance obligation because the base unit and consumable product are highly dependent/ highly interrelated with one another. The unit will not operate without the consumable product.
39. Other stakeholders first consider the guidance in paragraph 606-10-25-19(b) [27(b)] to determine whether the base product and consumable product are separately identifiable. Those stakeholders assert that the goods are separately identifiable because the base unit and the consumable could have been entered into as two separate contracts given that customers and other entities that own the base unit are able to purchase replacement consumables on a standalone basis. The fact that both products are in one contract does not change what the customer is receiving (a product and a consumable). Additionally, those stakeholders assert that while the base unit and consumable product may be interrelated, they are not *highly* interrelated. The fact that the products might be interrelated to some extent does not automatically lead to a conclusion that there is a single performance obligation, especially if the other two indicators are not present (that is, that the entity is providing a significant integration service or that one good significantly modifies or customizes the other). Entities must apply judgment about the degree of interrelation to determine whether the goods or services are *highly* interrelated or not. The base unit has standalone value and could be resold for more than scrap value and the replacement consumables can be purchased separately from the base unit, which those stakeholders think supports their view that this arrangement could include two performance obligations. Furthermore, if the customer had chosen to purchase only the base product, rather than a base product plus a consumable, that decision would not significantly affect the base product because it is the same base product regardless of whether the consumable was purchased.

**Questions for the TRG Members**

1. In the examples described in the paper, how would you apply the distinct in the context of the contract concept? In your response, consider whether the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. In considering if the goods or services are separately identifiable, refer to the following factors in paragraph 606-10-25-21 [29]:

(a) The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted.

(b) The good or service does not significantly modify or customize another good or service promised in the contract.

(c) The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract.

2. Are there any related potential interpretation issues about distinct in the context of the contract that are not included in this paper?