

STAFF PAPER

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Purpose

1. Some stakeholders informed the staff that there are questions about 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’), regarding when to apply the guidance on a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer (the series provision), which is part of Step 2, Identifying Performance Obligations.
2. The TRG previously discussed questions related to Step 2, Identifying Performance Obligations, on October 31, 2014 (Distinct in the Context of the Contract) and January 26, 2015 (Identifying Promised Goods or Services). At a joint Board meeting on February 18, 2015, the Boards discussed the issues in identifying promised goods or services and determining whether promised goods or services are distinct and the Boards decided to make some improvements to the guidance in those areas.
3. The questions discussed in this paper relate only to the applicability of the series provision. That is, when are the criteria in paragraph 606-10-25-15 [23] met, and do any other considerations affect whether the series provision applies beyond those criteria? In order to determine whether or not the series provision applies, an

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entity must have already identified the promised goods or services in the contract with the customer and determined that two or more of those goods or services are distinct because otherwise the goods and services would be accounted for as a single performance obligation.

Accounting Guidance

4. The new revenue standard defines a performance obligations as follows:

606-10-25-14[22] At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

- a. A good or service (or a 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 (see paragraph 606-10-25-15[23]).

5. The standard also provides criteria for determining applicability of the series provision as follows:

606-10-25-15[23] A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27[35] to be a performance obligation satisfied over time.
- b. In accordance with paragraphs 606-10-25-31[39] through 25-32[40], the same method would be used

to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Background

6. The series provision is a concept that was introduced by the new revenue standard and does not exist in current GAAP or IFRS revenue guidance. As described in paragraph BC113, the purpose of the series guidance is to simplify the application of the revenue model and to promote consistency in identifying performance obligations.

7. The series provision *requires* goods or services to be accounted for as a single performance obligation, in certain instances, even though the underlying goods and services are distinct. That is, in applying the guidance on identifying performance obligations there are two ways that an entity may determine that two or more goods or services are a single performance obligation:
 - (a) The first way is if the entity determines that the goods or services are not distinct from each other. In this case, the guidance in paragraph 606-102-25-22 [30] requires those goods or services to be bundled into a single performance obligation.

 - (b) The second way, which is the subject of this paper, is if the entity determines the goods or services are distinct, but they meet the criteria in paragraph 606-10-25-15 [23] to be accounted for as a single performance obligation under the series provision.

8. Before examining the question of when the series provision applies to a bundle of distinct goods or services, the staff thinks it is important to remember why it matters whether two or more goods or services are a single performance obligation because of (a) or (b) in the paragraph above. There are three primary areas in which the accounting treatment may vary for the performance obligation depending on whether an entity determines its promise is a single performance

obligation comprised of a series of distinct goods or services (606-10-25-14b [22b]) or a single performance obligation comprised of goods or services that are not distinct from each other.

- (a) *Allocation of Variable Consideration:* Paragraph 606-10-32-40 [85] states that an entity shall allocate a variable amount entirely (i) to a performance obligation or (ii) to a distinct good or service that forms part of a single performance obligation in accordance with 606-10-25-14(b) if certain criteria are met.

Example:

An entity is providing 5 years of service to a customer. The contract includes a performance bonus to be paid upon completion of a milestone which the entity expects to complete in year 2.

If the entire service period is considered to be a single performance obligation comprised of non-distinct services, then the performance bonus is included in the initial transaction price (subject to the constraint on variable consideration) and recognized based on the measure of progress determined for the contract (i.e., input method or output method). This would result in recognition of the bonus throughout the 5 year term. For example, if the bonus becomes part of the transaction price at the end of year 2, a portion of the bonus would be recognized at that date based on performance completed to-date and a portion would be recognized as the remainder of the performance obligation is satisfied.

In contrast, assume the service above is determined to be a single performance obligation comprised of a series of distinct services in accordance with 606-10-25-14(b). Also assume the performance bonus relates to the entity's efforts for distinct services performed through the date the milestone is achieved. The entity would conclude that, because the performance bonus relates specifically to the entity's efforts for distinct services performed through the date the milestone is achieved, the performance bonus would be recognized at the end of year 2 (that is, allocated entirely to the year 1 and year 2 distinct service periods).

- (b) *Contract Modifications:* The accounting for contract modifications differs significantly depending on whether, at the date of modification, the remaining undelivered goods and services are distinct from those

already transferred to the customer. In general, if the remaining undelivered goods or services are distinct (even if part of a single performance obligation under the series provision), the entity will account for the modified contract on a prospective basis. In contrast, if the remaining goods or services are not distinct from those already provided, there will be a cumulative effect adjustment resulting from the modification.

Example:

Assume that at the end of year 2 of the contract in the example above, the parties negotiate a price reduction, reducing the price of the services in years 3-5 by CU100/year. Thus, the customer paid CU500/year in years 1 and 2, but will only pay CU400/year in years 3-5.

If the service period is considered to be a single performance obligation comprised of non-distinct services, the entity would take the total, modified, transaction price of CU2,200, and adjust its revenue recognition based on its measure of progress. Assuming the services are performed evenly over the 5-year term, the entity would recognize a cumulative effect adjustment reducing revenue by CU120 at the date of modification (that is, at the end of year 2), and would recognize CU440/year for its services in each of the final 3 years of the contract.

If the single services performance obligation is a series of distinct services in accordance with 606-10-25-14(b), the entity would allocate the change in transaction price entirely to the distinct services that will be provided subsequent to the modification. Therefore, the entity would not record a cumulative effective adjustment and would recognize CU400/year for its services each of the final 3 years of the contract.

- (c) *Changes in Transaction Price:* The changes in transaction price guidance in paragraphs 606-10-32-42 [87] through 32-45 [90] applies differently, in some cases, to a single performance obligation comprised of non-distinct goods or services than it does to a single performance obligation resulting from the series provision.

9. The remainder of this paper evaluates questions specifically about when the series provisions applies to promised goods or services that have already been determined to be distinct.

Question 1- In order to apply the series provision, must the goods be delivered or services be performed consecutively?

10. Some stakeholders have questioned whether goods or services must be delivered or performed *consecutively* in order to apply the series provision. That is, they question whether the series provision applies when there is a gap or an overlap in the entity’s delivery of goods or performance of services. Consider the following examples:

Example A: An entity has contracted with a customer to provide a manufacturing service in which it will produce 1,000 units of a product per month for a 2-year period. The service will be performed evenly over the 2-year period with no breaks in production. The units produced under this service arrangement are substantially the same and are manufactured to the specifications of the customer. The entity does not incur significant up-front costs to develop the production process. Assume that its service of producing each unit is a distinct service in accordance with the criteria in paragraph 606-10-25-19 [27]. Additionally, the service is accounted for as a performance obligation satisfied over time in accordance with paragraph 606-10-25-27 [35] because the units are manufactured specific to the customer (such that the entity’s performance does not create an asset with alternative use to the entity), and if the contract were to be cancelled, the entity has an enforceable right to payment (cost plus a reasonable profit margin). Therefore, the criteria in paragraph 606-10-25-15[23] have both been met.

Example B: Assume the same facts as the example above, except that different from Example A, the entity does not plan to perform evenly over the 2-year service period. That is, the entity does not produce 1,000 units a month, continuously. Instead, the entity plans to perform the manufacturing service over the 2-year period, but in achieving the production targets, the entity produces 2,000 units in some months and zero units in other months.

11. Although the term “consecutively” is not used in the new revenue standard, this term is included in the Basis for Conclusions in various paragraphs. This has led some stakeholders to question whether they must assess whether the goods and

services are delivered or performed consecutively. The following is an excerpt from the Basis for Conclusions.

BC113. ...The Boards decided to include this [series] notion as part of the definition of performance obligation to simplify the application of the model and to promote consistency in the identification of performance obligations in circumstances in which **the entity provides the same good or service consecutively over a period of time** (for example, a repetitive service arrangement). To be accounted for as a single performance obligation, each of those promised goods or services must be performance obligations satisfied over time in accordance with paragraph 606-10-25-27. (emphasis added)

BC116. In their redeliberations, the Boards observed that paragraph 606-10-25-14(b) **applies to goods or services that are delivered consecutively**, rather than concurrently. The Boards noted that Topic 606 would not need to specify the accounting for concurrently delivered distinct goods or services that have the same pattern of transfer. This is because, in those cases, an entity is not precluded from accounting for the goods or services as if they were a single performance obligation, if the outcome is the same as accounting for the goods and services as individual performance obligations. (emphasis added)

12. The term “consecutively” was used in previous drafts of the standard, but was removed from the guidance prior to issuance of the final standard. This term also appeared in staff papers prepared during the redeliberations process for the 2011 Exposure Draft that were available to the public. Some stakeholders assert that the removal of that term in the final standard indicates that the Boards did not intend to require delivery or performance to be consecutive. That is, those stakeholders assert that the series provision still applies despite gaps in performance or

overlapping performance (as long as the criteria in paragraph 606-10-25-15 [23] are met).

13. In reviewing fact patterns with stakeholders, it seems that some may be over analyzing the use (or lack of use) of the term “consecutively” in the standard. That is, those stakeholders are viewing whether the goods or services are delivered or performed consecutively as a determinative factor in assessing whether the series provision should be applied. In the examples above, those stakeholders appear to think that Example A would result in a single performance obligation (because they would view the entity as transferring the series of distinct manufacturing services consecutively because it is performing the services evenly in producing 1,000 units *each* month of the 2-year contract period), while Example B would not be a single performance obligation because the entity is not consecutively performing the services (that is, because of the gaps in performance during the 2-year contract period).
14. The staff note that the Boards provided two criteria to determine if the series provision should be applied in paragraph 606-10-25-15[23]. Those criteria focus on whether each distinct good or service meets the criteria to be satisfied over time and whether the same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation. While an entity may consider the pattern of performance in determining the measure of progress towards satisfying a performance obligation, the consideration of whether the pattern of performance is consecutive or not is not explicit in the criteria. The staff, therefore, do not think whether or not the pattern of performance is consecutive is determinative to whether the series provision applies.
15. The staff further note, in response to references of some stakeholders to the Basis for Conclusions, that BC113 does not state the series provision was intended to apply *only* to “circumstances in which the entity provides the same good or service consecutively over a period of time (for example, a repetitive service arrangement).” Other stakeholders note the term “consecutively” is used in BC 116. The context of the statement in BC116 is in relation to comments received on paragraph 30 in the 2011 ED. In response to that proposed guidance in the 2011 ED, some stakeholders *questioned* whether that proposed guidance applied *only* to

concurrently delivered goods or services or both concurrently and consecutively delivered goods or services. BC116 is intended to communicate that it was the Boards' intent, even in the 2011 ED, for the series provision to apply to consecutively transferred goods or services, largely because the Boards do not think any explicit guidance is necessary for concurrently delivered goods or services that have the same pattern of transfer. BC116 was not, in the staff's view, intended to suggest that the series provision *only* applied to consecutively delivered or performed goods or services.

16. The staff observes that if the consecutively notion were determinative then stakeholders might reach different judgments about what constitutes a consecutively delivered series of goods or services. For example, assume an entity agrees to perform a manufacturing service which results in the production of 100 widgets *each month* for 2 years, similar to Example A earlier in this section. Some might say that, in this scenario, the entity will consecutively perform the manufacturing service *each* month during the contract period. However, if 100 widgets are well below the entity's manufacturing capacity, such that it produces the 100 widgets in Month 1 on the first day of the month, another entity might conclude that there is no consecutive performance because the entity does not perform any manufacturing service during the rest of Month 1. *Requiring* that a series apply only to consecutively delivered goods or performed services might result in inconsistent application between entities with similar arrangements based solely on how each entity applies the *consecutively* notion.
17. In conclusion, the staff do not think a series of distinct goods or services that meets the requirements in paragraph 606-10-25-15 [23] must be transferred consecutively for the series provision to apply. Therefore, the staff think that the fact patterns outlined in both Example A *and* Example B earlier in this section of the paper would be accounted for as single performance obligations in accordance with the series provision (provided the two criteria in paragraph 606-10-25-15 [23] are met).

Question 2 – In order to apply the series provision (that is, account for an arrangement as a single performance obligation), does the accounting result need to be the same as if the underlying distinct goods and services each were accounted for as a separate performance obligations?

18. Some stakeholders do not think that it would be appropriate to apply the series provision when it would result in a different pattern of revenue recognition for the single performance obligation than would result as compared to the pattern of revenue recognition that would result for the goods or services if they were each accounted for as separate performance obligations. Other stakeholders point out that the standard does not require the accounting result to be the same regardless of whether the arrangement was treated as a single performance obligation or as multiple performance obligations. Consider the following example:

Example C: An entity contracts with a customer to perform a manufacturing service that results in the production of 10 widgets. The manufacturing service will be performed over a 3-year period. The contract price is CU100 million and the standalone selling price for each widget is CU10 million.

Total expected costs are anticipated to be CU80 million. The service the entity will provide to the customer in producing each widget is substantially the same, but the design is new, so the entity expects a decline in production costs over time. Production of the first five units is expected to cost CU9 million/widget. The costs to produce the other five widgets are expected to be CU7 million/widget.

For the purposes of this example, assume the entity determines that each service the entity will provide in producing 1 of the 10 widgets is distinct, meets the criteria to be satisfied over time, and that the same cost-based measure of progress would be used for each service the entity provides to produce 1 unit (thus, both of the series provision criteria in paragraph 606-10-25-15 [23] are met). The following demonstrates the difference in accounting that results from concluding the series provision applies as compared to the accounting that would result if it was determined that the contract is for 10 separate performance obligations.

	Total Contract	Series Provision (1PO)		10 Separate POs	
		units 1-5	units 6-10	units 1-5	units 6-10
Revenue	100	56	44	50	50
Costs	80	45	35	45	35
Margin	20	11	9	5	15

Although CU20 million in margin is recognized for the contract under both scenarios, there is a timing difference in terms of revenue recognition (and margin) because more revenue is recognized in relation to the service to produce the first 5 widgets (and less in relation to its service to produce the final 5 widgets) when the series is accounted for as a single performance obligation using a single measure of progress towards complete satisfaction.

19. As previously noted with respect to Question #1, the Boards included two criteria in paragraph 606-10-25-15 [23] to determine whether the series provision should be applied. Those criteria do not include a requirement to assess if applying the series provision would result in a different amount of revenue in a period than the amount of revenue in a period that would result from accounting for each unit as a separate performance obligation. Requiring an entity to compare recognition patterns in a “with and without” type manner would seem to be onerous and negate much of what the Boards’ intent appears to have been in establishing the series provision. The Basis for Conclusions (BC113 and BC114) explains that the purpose for including the series provision was, largely, to simplify an entity’s accounting and make it more operational. A requirement to have to prove whether or not application of the series provision results in a difference in the revenue recognition result would be counter to that objective.
20. Accordingly, the staff do not think application of the series provision requires an entity’s revenue recognition to be substantially the same with or without the series provision. Such a requirement would almost certainly make it more difficult for entities to meet the requirement, and since the series provision is not optional, it likely would *require* entities to undertake a “with and without” type analysis in a large number of circumstances to prove whether the series provision applies or not. Therefore, in the staff’s view, the series provision would apply to Example C because the fact pattern meets the criteria in paragraph 606-10-25-15 [23]), despite the difference in the timing of revenue recognition between the two conclusions (single performance obligation versus 10 separate performance obligations).

Question for the TRG Members

1. Do the TRG members agree with the staff's views in this paper?