IFRS FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	FASB-IASB Joint Transition Resource Group for Revenue Recognition		
Paper topic	Partial Satisfaction of Performance Obligations Prior to Identifying the Contract		
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Purpose

1. Some stakeholders have informed the staff that there are different interpretations of how revenue and costs are recognised in accordance with IFRS 15 *Revenue from Contracts with Customers* and Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* (collectively referred to as the 'new revenue Standard'), for work done prior to the contract meeting the criteria in the new revenue Standard to apply the general revenue recognition model. This paper summarises the potential implementation questions reported to the staff.

Background

2. Entities sometimes commence activities on a specific anticipated contract either:

    (a) prior to agreeing the contract with the customer; or

    (b) prior to the contract with the customer satisfying the criteria in the new revenue Standard to apply the general revenue recognition model.

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For convenience, in this paper the date on which the criteria in paragraph 9 [606-10-25-1] [1] are satisfied is referred to as the 'Contract Establishment Date (CED)' and the activities that an entity performs prior to the CED are referred to as 'pre-CED activities'.

3. These pre-CED activities may be:

   (a) activities, such as administrative tasks that neither result in the transfer of a good or service to the customer, nor fulfil the anticipated contract;

   (b) activities to fulfil the anticipated contract but which do not result in the transfer of a good or service, such as set-up costs; or

   (c) activities that transfer a good or service to the customer at or subsequent to the CED.

The question that arises is how to account for the revenue and costs from the pre-CED activities *that result in the transfer of a good or service to the customer as at the CED*. The analysis in this paper is relevant only when the entity concludes that a contract has not been identified for the purposes of the new revenue Standard prior to the CED.

Examples

4. The following examples are among those that were brought to the attention of the staff.

Example 1: Contract manufacturer
A manufacturer enters into a long-term contract with a customer to manufacture a highly customised good. The customer issues purchase orders for 30 days of supply on a rolling calendar basis (that is, every 30 days a new purchase order is issued). Purchase orders are non-cancellable and the manufacturer has a contractual right to payment for all work in process for goods once an order is received. The manufacturer will pre-assemble some goods in order to meet the anticipated demand from the customer based on a non-binding forecast provided by the customer. At the time the customer issues a purchase order,

[1] Paragraph references within '[XX]' are from the FASB *Accounting Standards Codification*.

the manufacturer has some goods on hand that are completed and others that are partially completed.

The entity has determined that each customised good represents a performance obligation satisfied over time in accordance with paragraph 35(c) [606-10-25-27(c)] because the customized goods have no alternative use and the manufacturer has an enforceable right to payment once it receives the purchase order.

Example 2: Real estate developer

An entity begins constructing an apartment building and pre-sells 60% of the units. In this particular territory, the contracts satisfy the criteria for a performance obligation satisfied over time in accordance with paragraph 35(c) [606-10-25-27(c)]. The remaining 40% of the units are constructed for inventory. At a later date, after construction of the common areas and the shell of the rooms of all floors of the apartment building have been completed, the entity enters into a new contract with a customer to sell one of the remaining units on the same terms as the original contracts. Thus, at inception of the new contract, a portion of the new customer's unit is already constructed.

Accounting guidance

5. The core principle of the new revenue Standard is that an entity shall recognise revenue so as to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

6. Costs incurred in fulfilling a contract that are not within the scope of another Standard are recognised as an asset and amortised on a systematic basis if they satisfy certain criteria.

7. The specific provisions in the new revenue Standard regarding the recognition of revenue and accounting for fulfilment costs are set out in Appendix A to this paper.

Potential implementation issues

8. The practical issues and different interpretations that have been brought to our attention are explained below.

Issue 1 – How should revenue arising from pre-CED activities be recognised?

9. The staff are aware of two alternative methods of recognising revenue arising from pre-CED activities:

   (a) *Alternative A*. Revenue should be recognised on a cumulative catch-up basis, reflecting the performance obligation(s) that are partially satisfied or satisfied as at the CED.

   (b) *Alternative B*. Revenue should be recognised on a prospective basis beginning on the CED.

Alternative A, 'Cumulative catch-up'

10. Proponents of Alternative A believe a cumulative catch-up adjustment is consistent with the overall principle of recognising revenue to depict an entity's performance in transferring control of goods or services to the customer (ie the satisfaction of an entity's performance obligation). Hence, if the entity concludes, in accordance with the new revenue Standard, that the pre-CED activities have resulted in progress towards satisfying a performance obligation as at the CED, it would recognise the revenue to which it expects to be entitled for that progress. A cumulative catch-up adjustment reflects the fact that control of a portion of the good or service has transferred to the customer as at the CED. In assessing whether the pre-CED activities result in the transfer of control of a good or service, an entity would consider the requirements in paragraphs 31–38 [606-10-25-23 through 25-30].

11. Proponents of Alternative A point to paragraph 43 [606-10-25-35], which states that 'As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate…'. Changes in accounting estimate are recognised in the

period of change unless they affect future periods in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* [Topic 250, *Accounting Changes and Error Corrections*].

12. Proponents of Alternative A also note BC48, where the Boards noted that the requirements in paragraph 15 [606-10-25-7] are 'similar to the 'deposit method' that was previously included in US GAAP and that was applied when there was no consummation of a sale'. Under current US GAAP, entities recognise revenue (and interest income) on a cumulative catch-up basis when they subsequently apply the full accrual method after applying the deposit method [Paragraph 360-20-55-17]. Proponents analogise from this guidance that an entity applying IFRS 15 [Topic 606] could recognise revenue as at the CED arising from pre-CED activities on a cumulative catch-up basis.

13. Proponents of Alternative A believe that, when the subject matter of a contract is established between the entity and the customer, the underlying performance obligations do not differ depending on whether the entity commences activities, for example manufacturing or constructing goods, prior to or after the CED. The extent of progress towards satisfying the performance obligation(s) for which the customer has contracted is the same.

14. Opponents of Alternative A believe the performance obligation in the contract relates only to the *remaining* effort to transfer the good or service to the customer. Thus, it is inappropriate to recognise revenue immediately at the CED for work performed prior to meeting the criteria in paragraph 9 [606-10-25-1].

Alternative B, 'Prospective basis'

15. Proponents of Alternative B believe that 'immediate' revenue recognition by means of a cumulative catch-up adjustment at the CED is inconsistent with the principles of recognising revenue over time. They believe that, when the criteria in paragraph 9 [606-10-25-1] are met, an entity should allocate the transaction price only to the *remaining* goods or services in the contract because the performance obligation that must be satisfied relates only to the *remaining* goods or services at that time.

16. Proponents of Alternative B note that one contract might involve requisitioning and assembling raw materials into a combined output while another contract for a

similar good might involve taking a partially completed good and completing its assembly. Proponents of Alternative B do not believe the performance obligation is the same in both of these circumstances.

17. For performance obligations that are satisfied over time, proponents of Alternative B assert that an entity should commence measuring progress toward complete satisfaction of the performance obligation only *after* meeting the criteria in paragraph 9 [606-10-25-1] and it should not consider efforts expended prior to meeting the criteria.

18. Proponents of Alternative B point to paragraph 16 [606-10-25-8], which discusses a situation in which cash is received prior to meeting the contract criteria. Paragraph 16 [606-10-25-8] states that '…Depending on the facts and circumstances relating to the contract, the liability recognised represents the entity's obligation to either transfer goods or services *in the future* or refund the consideration received' (emphasis added). Proponents of Alternative B believe the reference to transferring 'goods or services *in the future'* suggests that the Boards intended that revenue recognition should be on a prospective basis after the CED. That is, non-refundable cash may be collected as the entity performs prior to the CED, but the liability for the cash received is for the transfer of future, not past, goods or services.

19. Opponents of Alternative B believe the performance obligation is the same regardless of whether the entity begins performing work (such as beginning to manufacture a good) prior to the CED, because the ultimate promise to the customer is the same.

20. Opponents of Alternative B note, from a practical standpoint, that applying Alternative B to Example 1, in particular, may be burdensome as it would require tracking the amount of remaining effort to satisfy each purchase order based on whether the related goods were partially or fully completed prior to receiving the purchase order.

Staff analysis

21. The staff note that the core principle of the Standard as set out in paragraph 2 [606-10-10-2] is to 'recognise revenue to *depict the transfer* of promised goods or services to customers…' (emphasis added). If an entity has transferred promised goods or services within a performance obligation to the customer as at the CED, the staff think that it is appropriate and consistent with that core principle that the entity should recognise revenue to reflect the promised goods or services already transferred to the customer at the CED (ie Alternative A).

22. The staff note that applying Alternative A to a contract which does not satisfy the criteria in paragraph 9 [606-10-25-1] until the CED would result in the same cumulative recognition of revenue at the CED and in future periods, and hence the same contract asset or contract liability position, as a contract that had met the criteria in paragraph 9 prior to the CED. From the CED, the two projects will be identical and hence economically equivalent. Therefore Alternative A will better reflect the contract and so provide users of the financial statements with more decision-useful information than Alternative B. Under Alternative B, the pattern of revenue recognition would be different subsequent to the CED, despite the two contracts being economically equivalent.

23. Further, the staff think that the proponents of Alternative B are reading the phrase 'in the future' in paragraph 16 [606-10-25-8] out of context. The staff think that the phrase 'in the future' refers to the date that the 'liability' for the consideration received is established and does not refer to the date at or the period over which the goods or services are transferred. The staff therefore think 'in the future' should be interpreted with reference to the date the cash is received, rather than to the date the criteria in paragraph 9 [606-10-25-1] are met. The staff do not see an inconsistency in considering that some of the goods or services prior to the CED may transfer to the customer for the purposes of the new revenue Standard *at the point* of the CED, rather than relate only to the remaining performance obligation(s) *after* the CED.

24. The staff consider that the Boards' intention on this point is more clearly demonstrated in the reference quoted in Alternative A to BC48 referring to the

guidance in the new revenue Standard being similar to the ‘deposit method’ under current US GAAP, where revenue is recognised on a cumulative catch-up basis.

25. The staff therefore considers that Alternative A, cumulative catch-up, best satisfies the core principle in paragraph 2 [606-10-10-2] that ‘an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services’ and is therefore the appropriate method of measuring progress at the point paragraph 9 [606-10-25-1] is satisfied, ie the CED.

26. In applying Alternative A, an entity should consider the requirements in paragraphs 31–45 [606-10-25-23 through 25-37] to determine the goods or services which the customer controls and therefore what portion of pre-CED costs should be included in any measure of progress towards satisfaction of a performance obligation that is used to calculate the cumulative catch-up adjustment. For example, if the pre-CED costs relate to uninstalled materials that the customer does not control, the inclusion of those costs in determining how much revenue to recognise might not be appropriate.

Issue 2 – How should an entity account for fulfilment costs incurred prior to the CED?

27. The staff is aware of three views on how to account for fulfilment costs arising from pre-CED activities that are not within the scope of another Standard which (i) transfer a good or service to the customer as at the CED; and (ii) satisfy the criteria in paragraph 95 [340-40-25-5]:

    (a) *Alternative A*. Such costs are capitalised as costs to fulfil an anticipated contract. These costs would be expensed immediately at the CED if they relate to progress made to date because the goods or services constituting a performance obligation have already been transferred to the customer. The remaining asset would be amortised over the period over which the goods or services to which the asset relates will be transferred to the customer.

(b) *Alternative B*. Such costs are capitalised as costs to fulfil an anticipated contract and amortised as the entity transfers the *remaining* goods or services under the contract, ie on a prospective basis.

(c) *Alternative C*. Such costs *cannot* be capitalised as costs to fulfil an anticipated contract because they relate to progress made prior to obtaining the contract and not to satisfying performance obligations in the future. Therefore, such costs should be expensed as incurred unless they qualify for capitalisation under other guidance (eg inventory guidance).

Alternative A

28. Proponents of Alternative A believe that such costs incurred prior to the CED are costs to fulfil an anticipated contract and would be recognised as an asset under the new revenue Standard. This is because such costs relate directly to an anticipated contract, they are expected to be recovered and they create a resource that will satisfy a performance obligation as at the CED.

29. These stakeholders think that a performance obligation is established only on the CED and the requirements in paragraph 98 [340-40-25-8] support recognition of these costs incurred prior to the CED as an asset. Paragraph 98 [340-40-25-8] states that:

> 98. An entity shall recognise the following costs as expenses when incurred:
>
> (a) …
>
> (c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and

(d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

30. Proponents of Alternative A also point to paragraph 99 [340-40-35-1], which states that capitalised costs to fulfil a contract 'shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates'. Accordingly, at the CED, any element of the capitalised asset that related to progress made to date, ie goods or services constituting a performance obligation already transferred to the customer, would be expensed. The remaining asset would be amortised over the period over which the goods or services to which the asset relates will be transferred to the customer.

Alternative B

31. Proponents of Alternative B also believe the costs incurred prior to the CED are costs to fulfil an anticipated contract that would be recognised as an asset for the reasons described above. However, proponents of Alternative B believe such costs should be amortised as the entity transfers the *remaining* goods or services under the contract (ie on a prospective basis). They believe the guidance in paragraph 99 [340-40-35-1] refers to the transfer of *remaining* goods or services *after* the CED (ie there is no immediate transfer as at the CED).

32. Proponents of Alternative B also note that such costs may be similar to the 'set up' costs described in B51 [606-10-55-53] which states, 'If those setup activities do not satisfy a performance obligation, the entity should disregard those activities (and related costs) when measuring progress'. Proponents of Alternative B believe that costs incurred prior to the CED do not relate to a satisfied performance obligation because the performance obligation can only comprise the *remaining* activities after the CED. They believe recognising expenses on a prospective basis more faithfully depicts the entity's progress in satisfying its performance obligation.

Alternative C

33. Proponents of Alternative C note that costs incurred prior to meeting the criteria in paragraph 9 [606-10-25-1] may qualify for capitalisation under other IFRS or U.S. GAAP guidance (such as inventory guidance). However, they believe such costs will likely *not* qualify for capitalisation as costs to fulfil an anticipated contract because they will not be used to satisfy a performance obligation *in the future* as required by paragraph 95(b) [340-40-25-5(b)].

34. Proponents of Alternative C point to paragraph 98 [340-40-25-8], which requires entities to expense when incurred 'costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)'. They believe costs that relate to partial satisfaction of a performance obligation and do not relate to future performance should therefore be expensed as incurred, unless they qualify for capitalisation under other guidance. For example, in Example 1 above, the costs to perform the service prior to the CED relate to activities that transfer goods to the customer and do not relate to satisfying a *future* performance obligation. These costs would therefore be expensed as incurred if they cannot be capitalised under other guidance.

35. Proponents of Alternative C distinguish the costs incurred in Examples 1 and 2 above from set-up costs or costs to fulfil incurred at or near contract inception. In Examples 1 and 2, they consider that the costs relate to a good or service that *has transferred* to the customer (ie partial satisfaction of a performance obligation). Accounting for the costs as a cost to fulfil an anticipated contract would suggest that the performance obligation only includes efforts to be expended after CED.

Staff analysis

36. The staff note that the evaluation of the alternatives under Issue 2 will depend on which alternative in Issue 1 is considered appropriate.

37. In Issue 1, the staff consider that Alternative A is consistent with the requirements in the new revenue Standard. Accordingly in Issue 2, Alternative B would not be appropriate. This is because Issue 1 established that prospective treatment would not be consistent with the requirements in the new revenue Standard. Therefore, the analysis below considers only Alternatives A and C.

38. The staff note that applying Issue 2 Alternative A to a contract which does not satisfy the criteria in paragraph 9 [606-10-25-1] until the CED would result in the same cumulative recognition of costs and hence margin at the CED and in future periods as a contract that had met the criteria in paragraph 9 from the inception of the contract. The two contracts will be identical and hence economically equivalent from the CED. The staff therefore considers that Issue 2 Alternative A will more accurately reflect the economics of the contract and therefore provide users of the financial statements with more decision-useful information than Issue 2 Alternative C. Under Issue 2 Alternative C, the pattern of cost and hence margin recognition would be different subsequent to the CED, despite the two contracts being economically equivalent.

39. Issue 2 Alternative C considers that paragraph 95(b) [340-40-25-5(b)] precludes capitalisation of such costs as costs to fulfil an anticipated contract because they will not be used to satisfy a performance obligation *in the future*, rather they are costs under paragraph 98(c) [340-40-25-8(c)] 'that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance)'. However the staff consider that, in the context of IFRS 15 [Subtopic 340-40], the performance obligation cannot come into existence before the CED, and therefore cannot be considered as satisfied prior to the CED, but may be satisfied as at the CED.

40. The staff therefore consider that Issue 2 Alternative A, capitalisation as costs to fulfil an anticipated contract, subject to satisfaction of the criteria in paragraph 95 [340-40-25-5], with immediate expense of those costs at the CED if they relate to progress made to date or services already transferred to the customer, is the most appropriate method of accounting for such costs.

41. However the staff note that certain costs may not satisfy the criteria in paragraph 95 [340-40-25-5] for recognition as an asset, for instance general and administrative costs that are not explicitly chargeable to the customer under the contract or costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract. In accordance with paragraph 98(a) [340-40-25-8] such costs are expensed when incurred.

Question for the TRG Members
1. For each of the questions above the staff have provided in this paper the applicable guidance in the new revenue Standard, including the Basis for Conclusions. Are there other considerations not included in the staff's analysis that might be helpful to stakeholders' understanding of how to apply the new revenue standard?

Appendix A

Extracts From the New Revenue Standard

Objective

1 [606-10-10-1] The objective of this Standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

Meeting the objective

2 [606-10-10-2] To meet the objective in paragraph 1, the core principle of this Standard is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Identifying the contract

9 [606-10-25-1] An entity shall account for a contract with a customer that is within the scope of this Standard only when all of the following criteria are met:

(a) the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;

(b) the entity can identify each party's rights regarding the goods or services to be transferred;

(c) the entity can identify the payment terms for the goods or services to be transferred;

(d) the contract has commercial substance (ie the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and

(d) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

16 [606-10-25-8] An entity shall recognise the consideration received from a customer as a liability until one of the events in paragraph 15 occurs or until the criteria in paragraph 9 are subsequently met (see paragraph 14). Depending on the facts and circumstances relating to the contract, the liability recognised represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability shall be measured at the amount of consideration received from the customer.

Performance obligations satisfied over time

35 [606-10-25-1] An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs B3–B4);
b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or
c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date.

Measuring progress towards complete satisfaction of a performance obligation

39 [606-10-25-31] For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation).

43 [606-10-25-35] As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity's measure of progress shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Costs to fulfil a contract

95 [340-40-25-5] If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example IAS 2 *Inventories*, IAS 16 *Property Plant and Equipment* or IAS 38 *Intangible* A*ssets*), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria:

(a) the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);

(b) the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and

(c) the costs are expected to be recovered.

98 [340-40-25-8] An entity shall recognise the following costs as expenses when incurred:

a) general and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 97);

b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

c) costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (ie costs that relate to past performance); and

d) costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations (or partially satisfied performance obligations).

Amortisation and impairment

99 [340-40-35-1] An asset recognised in accordance with paragraph 91 [340-40-25-1] or paragraph 95 [340-40-25-5] shall be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract (as described in paragraph 95(a) [340-40-25-5(a)]).

340-40-35-2 [100] An entity shall update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates. Such a change shall be accounted for as a change in accounting estimate in accordance with IAS 8 [Subtopic 250-10] on accounting changes and error corrections.

Application guidance - Non-refundable upfront fees (and some related costs)

B51 [606-10-55-53] An entity may charge a non-refundable fee in part as compensation for costs incurred in setting up a contract (or other administrative tasks as described in paragraph 25). If those setup activities do not satisfy a performance obligation, the entity shall disregard those activities (and related costs) when measuring progress in accordance with paragraph B19. That is because the costs of setup activities do not depict the transfer of services to the customer. The entity shall assess whether costs incurred in setting up a contract have resulted in an asset that shall be recognised in accordance with paragraph 95 [340-40-25-5].

Basis for Conclusions

BC48 The requirements in paragraph 15 are consistent with the boards' rationale for paragraph 9 of IFRS 15, which is to filter out contracts that may not be valid and that do not represent genuine transactions, and therefore recognising revenue for those contracts would not provide a faithful representation of such transactions. The requirements therefore

preclude an entity from recognising any revenue until the contract is either complete or cancelled or until a subsequent reassessment indicates that the contract meets all of the criteria in paragraph 9 of IFRS 15. The boards noted that this approach is similar to the 'deposit method' that was previously included in US GAAP and that was applied when there was no consummation of a sale.