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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Identifying Promised Goods or Services in a Contract with a Customer

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Purpose

1. Some stakeholders have informed the staff that there are questions about 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") about how an entity identifies promised goods or services in a contract with a customer. This paper incudes a summary of the implementation questions that stakeholders reported to the staff in this area. The staff plan to ask the members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) for their input about the implementation issue.

Background

2. Step 2 of the model in the new revenue standard requires an entity to identify the performance obligations in a contract with a customer. A performance obligation is a promised good or service that is distinct *or* a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. If a promised good or service is not distinct, it is combined with other

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promised goods or services until a bundle of promised goods or services is considered distinct.

3. BC87 in the Basis for Conclusions logically explains that, in general, an entity needs to identify those goods or services promised in the contract before it can *then* evaluate whether those items are distinct. This does not mean, however, that an entity would *necessarily* have to identify each and every promise in a contract if it was clear that the end result in terms of identifying the performance obligations in the contract would not be affected by that exercise (for example, in order to properly account for a contract to build a building, it is likely not necessary to identify whether there are 10,000 or 100,000 component goods and services that will be provided as part of satisfying that single performance obligation).

4. The topic of identifying performance obligations was discussed at the October 31, 2014 TRG meeting (refer to Memo No. 9), but the discussion focused on determining when a promised good or service is distinct, rather than on identifying the promises in the contract. This paper does not further address when a promised good or service is, or is not, distinct. Instead, this paper focuses on identifying the promised goods or services in a contract, each one of which may, or may not, be performance obligations.

5. Some stakeholders have questioned whether an entity would identify items or activities as promised goods or services that are not identified as “deliverables” under the existing revenue guidance. Many of those stakeholders have suggested that they did not think it was the Boards’ intent that an entity should identify a significant population of items or activities as promised goods or services under the new revenue standard that are not identified as deliverables under existing revenue guidance. However, some stakeholders have indicated that the guidance in the new revenue standard, excluding the discussion in the Basis for Conclusions (BC84), does not make clear that the Boards thought “promised good or service” and “deliverable” were similar notions.

6. Stakeholders also note that the Boards’ decisions not to carry forward the current U.S. GAAP guidance on inconsequential or perfunctory performance obligations to the new revenue standard (see BC90) might significantly change current practice

for some entities. Some stakeholders have asserted that some entities applying current U.S. GAAP effectively "bypass" any consideration as to whether an item or activity is a deliverable if they know they would be able to conclude that the item would be inconsequential or perfunctory in any event.

Accounting Guidance

7. The new revenue standard includes guidance that is applicable to the implementation question discussed in this paper. The standard includes the following language about identifying the promises in contracts with customers:

> **606-10-25-16 [24]** A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.
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> **606-10-25-17 [25]** Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.
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> **606-10-25-18 [26]** Depending on the contract, promised goods or services may include, but are not limited to, the following:

a. Sale of goods produced by an entity (for example, inventory of a manufacturer)

b. Resale of goods purchased by an entity (for example, merchandise of a retailer)

c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)

d. Performing a contractually agreed-upon task (or tasks) for a customer

e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides

f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)

g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)

h. Constructing, manufacturing, or developing an asset on behalf of a customer

i. Granting licenses (see paragraphs 606-10-55-54 through 55-65)

j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

8. In addition to the guidance in the new revenue standard above, there is some discussion of the topic of identifying promised goods or services in the Basis for Conclusions. The relevant Basis paragraphs follow:

> **BC84.** Topic 606 distinguishes between obligations to provide goods or services to a customer and other obligations by defining those obligations to provide goods or services as performance obligations.[1] The notion of a performance obligation is similar to the notions of deliverables, components, or elements of a contract in previous revenue guidance. Although the notion of a performance obligation is implicit in previous revenue guidance, the term performance obligation has not been defined previously.
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> **BC87.** Before an entity can identify its performance obligations in a contract with a customer, the entity would first need to identify all of the promised goods or services in that contract…
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> **BC89.** The Boards observed that 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 the 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 give rise to performance obligations[1] because those promises were made as part of the negotiated exchange between the entity and its customer. Although the entity

[1] In previous exposure drafts of this standard, the term "performance obligation" was synonymous with how "promised good or service" is used in the final revenue standard, while the unit of account was referred to as a "separate performance obligation" (rather than "performance obligation"). The language in these paragraphs was not changed to reflect the change in terminology. Therefore, "performance obligation" in *these paragraphs* should be read as "promised good or service."

might consider those goods or services to be marketing incentives or incidental goods or services, they are goods or services for which the customer pays and to which the entity should allocate consideration for purposes of revenue recognition. However, the Boards observed that in some cases, an entity might provide incentives to a customer that would not represent a performance obligation if those incentives are provided independently of the contract that they are designed to secure. (See paragraphs BC386–BC395 for additional discussion on marketing incentives and the accounting for customer options to acquire additional goods or services.)

BC90. For similar reasons, the Boards decided not to exempt an entity from accounting for performance obligations[1] that the entity might regard as being perfunctory or inconsequential. Instead, an entity should assess whether those performance obligations are immaterial to its financial statements as described in FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting, or IAS 8.

BC93. The Boards also clarified that an entity should not account for activities it may perform that do not transfer goods or services to the customer. This may occur in many contracts in which an entity undertakes separate activities that do not directly transfer goods or services to the customer (for example, service contracts that require significant setup costs), even though those activities are required to successfully transfer the goods or services for which the customer has contracted. The Boards decided that including those activities as performance obligations would have been inconsistent with the core revenue recognition principle because those activities do not result in a transfer of goods or services to the customer.

[Footnote added.]

Potential Implementation Question Reported by Some Stakeholders

Question 1: What are the promised goods or services in a contract with a customer?

Identifying the issue raised

9. According to paragraph 606-10-25-17 [25], activities that “do not transfer a good or service to the customer” would not be performance obligations (or promised goods or services) in the contract. The staff have received some questions from stakeholders about whether or not some items or activities should be accounted for as promised goods or services in a contract with a customer because they appear to provide something of benefit, even if only minor, to the customer. That is, these items that have been suggested to the staff are not *purely* “administrative” in nature and provide a good or service to the customer. Those stakeholders suggest that the guidance in paragraph 606-10-25-17 [25], particularly when combined with the discussion in the Basis for Conclusions of the Boards’ intent *not* to explicitly exclude perfunctory or inconsequential promised goods or services, does not allow an entity to ignore an item or activity that provides a good or service to the customer, no matter how minor or insignificant the benefit the customer will receive (subject to materiality). Stakeholders are raising those questions because many of them think that it was not the Boards’ intent (see BC84, included above) to identify a significant number of additional promised goods or services under the new revenue standard that are not identified as deliverables under existing revenue guidance.

10. A few examples of items or activities that stakeholders have raised to the staff as potential promised goods or services that are generally not accounted for as deliverables under existing revenue guidance include:

    (a) A requirement to stand-ready to answer questions about a consumer product because that product includes a helpline telephone number for customer questions or complaints about the product

    (b) A promise by the entity to deliver periodic account statements to the customer

(c) A promise to deliver *additional* copies of licensed intellectual property (for example, a promise to deliver 10 additional copies of software or media content to the customer beyond the initial copy that makes available the intellectual property for the customer's use).

11. In each of the examples, the benefit to the customer is minor and the cost to provide the item or perform the activity also is minor in the context of the overall arrangement. However, there is an identifiable benefit to the customer. Consequently, it is not clear to some stakeholders whether the items qualify as "administrative tasks" addressed in paragraph 606-10-25-17 [25].

12. In addition, even if an entity were to conclude that the example activities are not distinct, and hence would be combined with the main good or service, the effect of identifying these items or activities as promised goods or services could affect the timing and pattern of revenue recognition. Even if an entity concludes the effect is immaterial, it might need to spend resources to support its conclusion to that effect.

Stakeholder views

13. Many stakeholders that are evaluating this issue think the discussion in BC84 is instructive to that evaluation. The discussion in that paragraph, as well as the fact that the Boards' emphasis during the deliberations of this standard was on the *separability* of promised goods or services from one another (that is, the distinct analysis), suggests to many stakeholders that it was not the Boards' intent that entities should identify a significant number of additional promised goods or services under the new revenue standard that are not identified as deliverables under existing revenue guidance. Those stakeholders think that while an entity's identification of the units of account (that is, the performance obligations) under the new revenue standard might differ for some (but not all) entities from existing revenue guidance, they did not think it was the Boards' intent that the overall population of promised items to take *through* the separation model should change from existing guidance in a significant manner.

14. However, some stakeholders that view the Boards' intent as described in the paragraph above have questioned whether the guidance in the standard reconciles with that apparent intent. Those stakeholders suggest that one or both of the

following changes from existing revenue guidance have resulted in their question that the new revenue standard, as written, requires the identification of promised goods and services that are not identified as deliverables currently:

(a) While not authoritative, U.S. GAAP stakeholders often apply SEC staff guidance on what constitutes a deliverable. A 2007 SEC staff speech (refer to Appendix A to this paper) included a series of indicators as to what constitutes a "deliverable." Certain of those indicators, if they were included in the new revenue guidance about identifying promised goods or services, might suggest that some of the items or activities stakeholders are questioning are not additional promised goods or services.

(b) Existing SEC guidance includes the notion of an inconsequential or perfunctory performance obligation (refer to Appendix A to this paper) that is often applied by public and private entities. However, the Basis for Conclusions to the new revenue standard explicitly states that it was the Boards' intent to *not* "exempt an entity from accounting for performance obligations that the entity might regard as being perfunctory or inconsequential." Some think that this existing inconsequential or perfunctory revenue guidance is what allows an entity not to account for many of the minor activities that are being raised as possible promised goods or services under the new revenue standard as deliverables under existing revenue guidance. Some think that these activities provide incremental benefit to the customer, and therefore, transfer a good or service (so would not be "administrative tasks" in the new standard), but would be considered inconsequential or perfunctory under the existing SEC guidance.

15. Other stakeholders do not appear to be struggling with reconciling the guidance in the new revenue standard to what most view as the Boards' intent with respect to identifying the promised goods or services in the contract. Some of those stakeholders have observed that the standard acknowledges (paragraph 606-10-25-17 [25]) that an entity is often required to undertake numerous activities to ultimately fulfill its promise to a customer, and that not every activity will result in

the transfer of a promised good or service. For example, the profit-directed activities of an entity that includes the process by which revenue is generated, encompassing activities such as purchasing raw materials, manufacturing goods, transporting goods to market, and selling would generally not be additional promises to the customer to undertake those activities.

16. Some stakeholders observe that fulfillment costs that an entity incurs when performing some activities, although required to ultimately transfer the good or service to the customer, are not necessarily a promise to transfer an additional good or service. In BC93, the Boards reiterated their intent that an entity should not account for activities that do not transfer a good or service, including fulfillment activities, "even though those activities are required to successfully transfer the goods or services for which the customer has contracted." Some stakeholders think that the activities some are questioning as additional promised goods or services are activities to successfully complete the transfer of the goods or services for which the customer has contracted. For example, an entity might perform activities to set up a contract (which is the example included in paragraph 606-10-25-17 [25]); perform activities to provide account information; or maintain a customer service telephone line, e-mailbox, or a website for accepting warranty claims or customer complaints, facilitating sales returns, addressing billing inquiries or general product or service questions, or downloading product operating manuals. While many would assert that those activities provide some benefit to the customer (for example, the entity making its personnel available to respond to questions about the product or expressly providing individual account information); and therefore, represent an additional promise in the contract to undertake the activities, others think that those sorts of activities are more appropriately viewed as fulfillment activities with respect to the promise to sell a product or provide a service. Those stakeholders think that categorizing those types of activities as fulfillment activities, rather than additional promises in the contract, is consistent with the goal of identifying the goods and services that were promised to the customer in the contract and with the Boards' intent that the notion of a promised good or service is similar to the notion of a deliverable in existing revenue guidance.

17. Others have suggested that many of the activities some are questioning under the new guidance are actually promises *to the customer* in the contract. For example, while the toll-free number available to customers for product questions or advice might provide a benefit to the customer, that toll-free number might also be available to non-customers. The same might be said with respect to making product operating manuals available to customers on the entity's website. If the website and these materials on it are available to non-customers as well as customers, they would likely not be considered part of the negotiated exchange with the customer; and therefore, not an additional promised good or service in the contract. Some suggest that this concept is addressed in BC89, which states that the Boards observed that an entity might, in some cases, provide incentives to a customer that would not represent a performance obligation (or promised good or service) if those incentives are provided independently of the contract that they are designed to secure.

18. Lastly, some note that paragraph 606-10-25-16 [24] states that the assessment of whether a promise is created to transfer a good or service to the customer should be evaluated from the customer's perspective. That is, the promise must create a valid expectation of the customer that the entity will transfer a good or service to that customer. Although certain fulfillment or setup activities, or other non-earning events, may result in performance by the entity, it is not necessarily the case that there is a customer expectation of receiving a promised good or service from those activities. Some of the activities stakeholders have raised with respect to this issue (for example, the product helpline) might not represent something that the customer views as part of the negotiated exchange.

Questions for the TRG Members
1. Do the TRG members think the guidance in the new revenue standard requires the identification of promised goods or services that are generally not identified as deliverables under existing revenue guidance? 2. Do the TRG members think the Boards' intent to not identify significant numbers of new promised goods or services (that is, beyond those identified as deliverables under existing revenue guidance), is not sufficiently clear in the new revenue standard? If not, what might more clearly communicate the Boards' intent with respect to identifying the promised goods or services in a contract with a customer?

Appendix A: Excerpts from Existing SEC Guidance

A1. The following excerpt is from Staff Accounting Bulletin Topic 13.A "Selected Revenue Recognition Issues" (3C: inconsequential or perfunctory performance obligations):

> Question: What factors should be considered in the evaluation of whether a remaining obligation related to a unit of accounting is inconsequential or perfunctory?
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> Interpretive Response: A remaining performance obligation is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services. In addition, remaining activities are not inconsequential or perfunctory if failure to complete the activities would result in the customer receiving a full or partial refund or rejecting (or a right to a refund or to reject) the products delivered or services performed to date. The terms of the sales contract regarding both the right to a full or partial refund and the right of return or rejection should be considered when evaluating whether a portion of the purchase price would be refundable. If the company has a historical pattern of granting such rights, that historical pattern should also be considered even if the current contract expressly precludes such rights. Further, other factors should be considered in assessing whether remaining obligations are inconsequential or perfunctory. For example, the staff also considers the following factors, which are not all-inclusive, to be indicators that a remaining performance obligation is substantive rather than inconsequential or perfunctory:
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> - The seller does not have a demonstrated history of completing the remaining tasks in a timely manner and reliably estimating their costs.
> - The cost or time to perform the remaining obligations for similar contracts historically has varied significantly from one instance to another.

- The skills or equipment required to complete the remaining activity are specialized or are not readily available in the marketplace.
- The cost of completing the obligation, or the fair value of that obligation, is more than insignificant in relation to such items as the contract fee, gross profit, and operating income allocable to the unit of accounting.
- The period before the remaining obligation will be extinguished is lengthy. Registrants should consider whether reasonably possible variations in the period to complete performance affect the certainty that the remaining obligations will be completed successfully and on budget.
- The timing of payment of a portion of the sales price is coincident with completing performance of the remaining activity.

Registrants' determinations of whether remaining obligations are inconsequential or perfunctory should be consistently applied.

A2. The following is an excerpt from the December 10, 2007 SEC Staff Speech by Mark Barrysmith before the AICPA National Conference on Current SEC and PCAOB Developments:

> In recognizing that the term "deliverable" is not defined in accounting literature, we understand that some have considered a deliverable to be an item that 1) is explicitly referred to as an obligation of the vendor in a contractual arrangement, 2) requires a distinct action by the vendor, 3) if not completed by the vendor would result in a significant contractual penalty, or 4) if included or excluded from the arrangement would cause the arrangement fee to vary by more than an insignificant amount. We agree that these criteria are a helpful starting point and if you consider them in conjunction with my earlier presumptive statement and

the discussion of inconsequential or perfunctory deliverables in SAB 104, we believe you'll find a general principle to follow.