FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Memo

Memo No. **1**

Issue Date **February 7, 2015**

Meeting Date(s) **BM: February 18, 2015**

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Project	**Revenue Recognition—Identifying Performance Obligations**
Project Stage	**Agenda Decision, Deliberations, and Permission to Ballot**
Issue(s)	**Identifying Promised Goods or Services, Distinct, and Shipping Services**

Purpose

1. The February 18, 2015 Board meeting is a decision-making meeting. The Board first will be asked to vote whether to add a project to its technical agenda to make changes to the guidance on identifying performance obligations (Step 2 of the model) included in ASU 2014-09, *Revenue from Contracts with Customer* (the new revenue standard). If the Board decides to add this project to its agenda, the Board then will be asked to make technical decisions about the issues raised in this memo. The staff's intention is that the Board would proceed to issuing an Exposure Draft of a proposed Accounting Standards Update for vote by written ballot.

2. The staff's objective during this research phase was to determine if an improvement could be made to the standard to better articulate the guidance for identifying performance obligations. The improvements are not intended to change the underlying principle that was previously established by the Board.

3. This paper is structured as follows:

   (a) Background

   (b) Accounting Guidance

(c) Issues Description

   (i) *Issue 1*: Promised Goods or Services

   (ii) *Issue 2*: Distinct in the Context of the Contract

   (iii) *Issue 3*: Shipping and Handling Services

   (iv) *Issue 4*: Technical Corrections

(d) Transition, Transition Disclosure & Effective Date

(e) Appendices

   (i) Appendix A – Accounting Guidance (Topic 606)

   (ii) Appendix B – Excerpt from 2010 Proposed Accounting Standards Update: Revenue Recognition (Topic 605)

   (iii) Appendix C – Excerpt from 2011 Proposed Accounting Standards Update: Revenue Recognition (Topic 605)

Questions for the FASB
1. Does the Board want to add a project to its agenda to improve the guidance on identifying performance obligations? 2. If the Board would like to add a project, which issues would the Board like to include in the scope of the project (Issue 1- Promised goods or services, Issue 2-Distinct in the context of the contract, Issue 3- Shipping, Issue 4-Technical corrections)? 3. If the Board decides to include Issue 1 in the project scope, which alternative would the Board like to pursue (A-Inconsequential or Perfunctory; B-Materiality at Contract Level)? 4. If the Board decides to include Issue 2 in the project scope, does the Board agree that the intent is to clarify the issued guidance (potential clarifications are discussed in this paper), and not to revisit the Board's previous decisions underlying the issued guidance? Which improvement(s) would the Board like to address for Issue 2 (1- Principle, 2-Factors, 3-Examples)? 5. If the Board decides to include Issue 3 in the project scope, which option would the Board like to pursue (A-Practical Expedient, B- Implementation Guidance, C-Apply solution to Issue 1)?

6. Does the Board agree with the technical corrections proposed by the staff?

7. Does the Board grant the staff permission to begin drafting an Exposure Draft of a proposed Accounting Standards Update for vote by written ballot? If yes, what is the comment period?

Background

4. At the October 31, 2014 meeting of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG), TRG members discussed the guidance related to identifying performance obligations (TRG Agenda Ref No. 9). The discussion primarily was about the criterion that a good or service that is promised to a customer is distinct if the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct in the context of the contract) in paragraphs 606-10-25-19 and 25-21.

5. TRG members generally agreed that multiple factors in a transaction will often influence the analysis such that one factor will often not be determinative. That is, an entity should consider all of the facts and circumstances in assessing whether promised goods or services are distinct in the context of the contract. For example, a learning curve, the customer's motivation, or contractual restrictions may have differing effects on the distinct analysis for different contracts or types of transactions. Some group members expressed the view that it was unclear to what extent all of the factors in paragraph 606-10-25-21 must be evaluated for each promise in the contract (that is, whether an entity needs to evaluate all three factors in the guidance or if they could solely look to those that are most applicable based on the nature of their transaction).

6. Two areas in which TRG members had some inconsistent views was whether the analysis should be made from the entity's perspective, the customer's perspective, or solely based on the contract and how to apply the factor in paragraph 606-10-25-21(c) about when goods or services are highly dependent on or highly interrelated with other goods and services promised in the contract. The factors in 606-10-25-21 are applicable only in the context of the criterion in paragraph 606-10-25-19(b). However, the discussion indicated

that some of the inconsistent views arise because some entities are analyzing those factors outside of that criterion.

7. The discussion helped to inform the staff and the Board about the challenges that are expected to arise in determining whether a promised good or service is distinct in the context of the contract. Board members instructed the staff to perform additional research and outreach on the topic. The focus of the additional research and outreach was to understand whether there are specific improvements the Board could make that would reduce the potential diversity in how entities identify performance obligations. At the January 26, 2015 TRG meeting, the staff provided the TRG members with an update on this research project (TRG Agenda Ref No. 22).

8. At the January 26, 2015 TRG meeting, the staff also discussed implementation questions raised by stakeholders about identifying promised goods or services (TRG Agenda Ref No. 12). Those implementation questions and feedback from TRG members are included in Issue 1 in this paper.

Accounting Guidance

9. The guidance on identifying performance obligations is included in paragraphs 606-10-25-14 through 25-22. The core premise of the guidance is that an entity identifies performance obligations for a good or a service (or a bundle of goods or services) that are distinct, or a series of distinct goods or services that are substantially the same and have the same pattern of transfer. The guidance is included in Appendix A.

Issues Description

10. Although the discussion at the October 31, 2014 TRG meeting was structured around the notion of 'distinct in the context of the contract', the discussion indicated that there might be implementation issues beyond that concept. Accordingly, in performing additional research and outreach, the staff analyzed the entire section of guidance on identifying performance obligations. The staff identified the following potential issues:

    (a) The level at which promised goods or services are identified in a contract with a customer (that is, whether 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)

(b) Determining whether promised goods and services are distinct

(c) Determining whether providing a shipping and handling is a promised service in the contract or a fulfillment cost.

11. As described earlier in this memo, some of the issues related to identifying performance obligations were discussed at the October 31, 2014 TRG meeting. Subsequent to that TRG meeting, the staff conducted research as follows:

(a) Performed a review of files from the revenue project to gain a better understanding of the principles that were included in the final standard

(b) Performed outreach with revenue recognition experts to better understand the issues and determine if the staff could improve the articulation of the principles for identifying performance obligations

(c) Held discussions about identifying promised goods or services at the January 26, 2015 TRG meeting (TRG Agenda Ref No. 12).

Issue 1: Promised Goods or Services

Issue Summary

12. Under existing revenue guidance, an entity identifies deliverables and determines whether those deliverables are separable. Under the new revenue guidance, an entity identifies the goods or services it has promised to the customer in the contract and then determines if those promised goods or services are performance obligations (that is, because they are distinct from each other). Both former GAAP and the new revenue standard require judgment in this area.

13. Some stakeholders have questioned whether an entity should be identifying items or activities as promised goods or services that are not identified as deliverables under 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. Those stakeholders reference paragraph BC84 in the Basis for Conclusions to support this view. The following is an excerpt from that paragraph:

> The notion of a performance obligation[1] is similar to the notions of deliverables, components, or elements of a contract in previous revenue guidance.

14. However, other stakeholders have indicated that the guidance in the new revenue standard (exclusive of the Basis for Conclusions) does not make it clear whether the Boards thought "promised good or service" and "deliverable" are similar notions.

15. Stakeholders also have suggested that the Boards' decision not to carry forward the existing SEC guidance on inconsequential or perfunctory performance obligations to the new revenue standard (and, in fact, to explicitly state their intention in BC90 was to not include an inconsequential or perfunctory notion) has contributed to the view that the new revenue standard might require an entity to identify significantly more promised goods or services than the entity identified as deliverables under existing guidance. Some stakeholders have asserted that some entities apply the SEC guidance on inconsequential or perfunctory to effectively "bypass" any consideration as to whether an item or activity is a deliverable if they would be able to conclude that the item would be inconsequential or perfunctory.

16. Although the notion of a deliverable is implicit in much of the existing literature on revenue recognition, there is no explicit definition in GAAP. The closest to a "definition" of a deliverable that exists is guidance that the SEC staff provided in a December 10, 2007 SEC staff speech by Mark Barrysmith before the AICPA National Conference on Current SEC and PCAOB Developments. That speech included the following:

[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 between the 2011 ED and the final standard despite the change in terminology elsewhere. Therefore, "performance obligation" in this paragraph should be read as "promised good or service."

> 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.

17. Early on in the revenue project, the staff had proposed a definition of performance obligation as "an enforceable promise by an entity within a contract with a customer to transfer an economic resource to a customer." This notion changed throughout the project because ultimately the Boards decided that a performance obligation did not have to relate to an enforceable right and the Boards provided guidance that entities should consider implicit promises that create valid expectations of the customer when identifying performance obligations.

18. Without a precise definition of what constitutes a promised good or service, judgment will need to be applied in practice when identifying the promises that exist in the contract with the customer. As noted earlier in this memo, the promises an entity makes to its customer may be explicit or implicit. Although it seems that it would be straight forward for entities to identify the explicit promises, there can be complexity in doing this. This is because a contract might list many goods or services and sometimes it may be difficult for an entity to identify which items in the contract are promises to the customer for purposes of applying the new revenue standard. Paragraph 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 goods or services are distinct. The staff believes that 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.

19. It can be difficult to identify implicit promises and to determine if they are general promises that an entity might make to any third party (that is, it does not matter if they are a customer or not) or if they promises *in the contract*. Judgment is required to identify those promises that are implicitly made outside of the written contract but are still considered to be part of the overall contract with the customer.

20. During outreach discussions on this topic, several preparers cautioned the staff and the Board about attempting to define a promised good or service. Those preparers highlighted that they know enough about their businesses and the nature of their arrangements to identify the promised goods or services in the contract, they are comfortable with applying judgment, and they do not think that more prescriptive guidance is required.

21. At the January 26, 2015 TRG meeting, TRG members provided their views on this issue. Most TRG members did not think that the standard would have required a significantly greater amount of promised goods or services to be identified compared to deliverables identified under the existing revenue guidance. The exception that many noted was marketing incentives (for example, loyalty points). Several members noted that under existing guidance most entities account for marketing incentives as an expense (that is, the entity accrues the costs it expects to incur to fulfill the incentive). Under the new revenue standard, marking incentives are evaluated under the guidance on identifying performance obligations.

22. In discussing this issue, many TRG members thought the source of some of the implementation questions is paragraphs BC89-90 in the Basis for Conclusions. Several members suggested that the Boards consider whether the Basis could be amended and shared concerns about potential unintended consequences of introducing an inconsequential or perfunctory notion into the standard. Other TRG members suggested guidance would be necessary if the Board intended for entities to be able to apply an inconsequential or perfunctory notion (or something similar).

23. During outreach, many stakeholders have requested the reintroduction of an inconsequential or perfunctory concept (which exists in current SEC guidance). Those stakeholders assert that including the concept in the new revenue standard would ease the implementation process. In practice, some entities are identifying any and every activity or product promised to its customers as a promised good or service under the new revenue standard and the staff does not think that was the Board's intent, principally because to do so would likely involve a significant effort with little incremental benefit. Some examples of items or activities that stakeholders have raised to the staff as potential promised goods or services under the new revenue standard 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, in the context of an entity that performs account management services

(c) A promise by a homebuilder to provide certain amenities after construction of a home, such as street lights

(d) 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)

(e) Shipping and handling services (which are discussed further in Issue 3 of this paper).

24. In considering the introduction of an inconsequential or perfunctory notion to the new revenue standard, the staff reviewed prior Board decisions to determine whether such course of action would be appropriate. At a Joint Board Meeting in January 2011, the Boards discussed perfunctory obligations, incidental obligations, and marketing incentives. At that meeting, Board members voted on the following:

(a) Not to include an exemption for inconsequential or perfunctory obligations

(b) Not to provide any guidance on marketing incentives (other than the proposals on accounting for options)

(c) Not to allow for a general exemption for incidental obligations based on the entity's own business model.

25. Memo No. 135D from that meeting describes the background for the staff recommendations, which aligned with how the Boards voted on this topic. At the time, the staff had thought that the notion of essential to functionality, which is a factor within the inconsequential or perfunctory guidance, was similar to the notion of capable of being distinct in the new standard. Therefore, the staff did not think it would be necessary to carry forward the inconsequential or perfunctory guidance. Additionally, many stakeholders considered inconsequential or perfunctory to be the equivalent of "immaterial" and, therefore, the staff had concerns that introducing an inconsequential or perfunctory concept would be akin to providing specific materiality guidance in the standard.

26. The following paragraphs in the Basis for Conclusions to the new revenue standard provide the Boards' reasoning for not excluding marketing incentives and incidental obligations and for not carrying forward the guidance on inconsequential or perfunctory:

> **BC89**…Consequently, the Boards decided that all goods or services promised to a customer as a result of a contract give rise to performance obligations because those promises were made as part of the negotiated exchange between the entity and its customer. Although the entity 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.
>
> **BC90**. For similar reasons, the Boards decided not to exempt an entity from accounting for performance obligations 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.

27. Although the concept of inconsequential or perfunctory might be similar to the notion of immaterial, there are some significant operational differences between the two concepts in the United States. The materiality assessment is subject to a rigorous process for preparers and auditors in the United States. Under the auditing guidance, "ignoring" a promised good or service (that is not specifically exempt from identification under GAAP) is a non-GAAP accounting policy. An entity would need to quantify the impact of the non-GAAP policy to prove that it is immaterial. This assessment would occur each interim and annual reporting period. The materiality assessment is not limited to whether an item is material to an individual transaction. The entity must evaluate whether (a) the non-GAAP policy is material to the applicable transactions in the aggregate and (b) the non-GAAP policy, when combined with other non-GAAP policies and misstatements, is material to the financial statements. An entity's auditor would be required to evaluate this assessment each reporting period. To the extent the aggregate error for a non-GAAP policy is above the auditor's threshold for reporting uncorrected misstatements, then the auditor would be required to formally communicate the misstatement to the entity's audit committee each reporting period. The threshold for reporting misstatements is very low. TRG members and observers based in the United States stated that this concept would apply if an entity decides not to identify immaterial promised goods or services in a contract with a customer under the new revenue standard. TRG members outside the United States did not report this matter as an issue.

28. If guidance existed in the revenue standard to allow entities to exempt inconsequential or perfunctory goods and services from the identifying performance obligations assessment, some stakeholders assert that an entity could perform the assessment described in the above paragraph during their implementation of the standard. The assessment generally would be a one-time effort (unless business circumstances and/or product/service offerings change). In addition, the entity and auditor would not be required to assess whether the policy in the aggregate is material to the financial statements because GAAP would permit an entity to not identify those promised goods or services.

29. Although the staff has heard support for the inconsequential or perfunctory notion from auditors, it is important to highlight that some preparers and practitioners do not have the same enthusiasm for this concept. In discussing this alternative with several preparers, most thought that they were able to identify the promised goods or services in a contract based on the nature of their business/arrangements and think that they are able to apply the notion of materiality where needed. They have concerns that some practitioners are interpreting the standard as requiring many more goods and services to be accounted for in comparison to existing practice and that the inconsequential or perfunctory concept could lead to a burdensome documentation exercise. For example, assume an entity contracts to build a power plant for a customer. The power plant might be comprised of hundreds of components. An entity might conclude, depending on the facts and circumstances, that there is a single "promise" in the contract (to provide the customer with a power plant) or might conclude that there are several promises (turbines, generators, buildings, etc.), but is unlikely to conclude that every component of the contract is a promise to be evaluated in the separation analysis. However, in interpreting the new revenue standard, some might take the view that an entity would be required to identify many (perhaps hundreds, in this case) individual promises, then evaluate which promises are inconsequential or perfunctory, and then assess the other promises (that is, those that were deemed to not be inconsequential or perfunctory) as to whether or not they are distinct performance obligations. In the staff's view, all of this cost and complexity likely would not change the conclusion that there is a single (or a limited number of) unit(s) of account (that is, the performance obligation(s)).

30. The staff has highlighted this example to illustrate that the introduction of the inconsequential or perfunctory notion might not entirely solve the issue relating to the granular level at which some entities are identifying promised goods or services. The Board might want to consider if improvements could be made to this area principally, or entirely, through education rather than through standard setting. A TRG member encouraged the FASB not to change the accounting requirements in an attempt to resolve what he characterized as an audit issue.

31. As noted in the introduction to this paper, the staff's goal with this potential project would be to better articulate the principles intended by the Boards and not to fundamentally reconsider core principles of the standard. Although the topic of an inconsequential or perfunctory concept was previously deliberated by the Boards, the resulting accounting during implementation is not what the staff thinks the Boards had intended. Therefore, by changing the words in the standard (and/or the language in the Basis for Conclusions), the end result might be closer to what the Boards had intended in their prior decisions.

Alternatives

32. As described earlier, the staff does not think it would be feasible to define promised goods or services or amend the definition of performance obligations.

33. The staff thinks reconsidering whether to include an inconsequential or perfunctory notion (or something similar) in the revenue standard might be an important tool for the Board to consider in order to ensure the guidance is applied as the Board intended in the United States. The different alternatives below are different paths the Board could take to either introduce an inconsequential or perfunctory concept (or something similar) or, at least, eliminate the perception of some stakeholders that the Boards intended entities to identify significant numbers of additional promised goods or services that are not identified as deliverables under existing revenue guidance.

34. Regardless of which alternative, if any, the Board selects, the staff thinks education should be a significant aspect of the Board's approach to addressing this issue.

Alternative A - Existing SEC Inconsequential or Perfunctory Guidance

35. Under this alternative, the Board would take the existing SEC guidance and incorporate it in the new revenue standard. Some modifications would likely need to be made to the guidance to ensure it flows with the other revenue guidance. For example, the use of consistent terminology, such as "promised goods or services" rather than "obligations". Additionally, the SEC guidance is written from the perspective of when obligations are not inconsequential or perfunctory. It may be more helpful to have this written in the positive, that is, when promised goods or service *are* considered to be inconsequential or perfunctory.

36. The following excerpt is from existing SEC guidance in Staff Accounting Bulletin Topic 13A: 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?
>
> *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:

- 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.

37. An advantage of this approach is that stakeholders are familiar with this guidance (this guidance was issued in 1999). The fact that many stakeholders are citing issues with the elimination of this guidance and a request for inconsequential or perfunctory guidance might indicate that this alternative would address the problem we are trying to solve. Based

on the FASB staff's discussion with stakeholders about the guidance, there does not appear to be practice issues related to the guidance.

38. The staff is aware of some examples in which practice has concluded that an item is *not* inconsequential or perfunctory:

(a) *Bill and Hold Arrangements* – Instances in which goods have not been completed. For example, a remaining task to complete a good would not be deemed to be inconsequential or perfunctory for purposes of recognizing revenue in accordance with guidance on bill and hold arrangements.

(b) *Loyalty Points* – Certain instances in which loyalty points, such as frequent flier miles for an airline, were not deemed to be inconsequential or perfunctory. That is, the amounts could not be recognized as a cost accrual rather than a deferral of revenue

(c) *When and if Available Upgrades* – Instances in which an entity is promising a license and when and if available upgrades in the pharmaceutical industry, upgrades are not deemed inconsequential and perfunctory

(d) *Circumventing Separation Guidance* – Instances in which deliverables were not separated under superseded guidance (for example, due to lack of objective evidence of fair value under EITF 00-21) and entities might have asserted that a deliverable was inconsequential or perfunctory during implementation of EITF 08-1 (which was then codified in Subtopic 605-25) so that they would not have to account for separate units.

39. It is important to understand the principal reason for the original issuance of the inconsequential or perfunctory guidance. Under the separation guidance that was included in EITF Issue 00-21 (which was superseded by the guidance presently in Subtopic 605-25 a few years ago), entities were required to have objective evidence of fair value in order to separate deliverables and allocate revenue to those deliverables. If an entity was unable to determine fair value, the deliverable could not be separated. In some cases, this would result in revenue recognition for a contract at the end, once all deliverables have been completed. This could have been the case even when the undelivered item for which fair

value was not determinable was minor in the context of the overall arrangement. The inconsequential or perfunctory guidance provided some relief in instances in which fair value was not available for undelivered goods or services. That is, if the undelivered goods or services were deemed to be inconsequential or perfunctory, then the entity could recognize all the revenue for the arrangement when the other goods or services (that are not inconsequential or perfunctory) are delivered. In contrast, the new revenue standard (and the existing, general, multiple-element revenue guidance in Subtopic 605-25) allows for separation and allocation based on the standalone selling price. If the standalone selling price is not directly observable, an entity estimates the standalone selling price. Accordingly, under the new revenue standard there should not be a scenario in which the entity would not be able to allocate revenue to the undelivered item.

40. Under Subtopic 605-25 and the new revenue standard, the presence of additional, minor, deliverables might not significantly affect the timing of revenue recognition. However, the financial reporting effort necessary to apply a relative selling price model to the arrangement, as compared to being able to conclude that one or more of the deliverables is inconsequential or perfunctory and, therefore, not undertake a process of determining standalone selling prices and performing a relative selling price allocation, might be significant relative to the benefit.

41. Although stakeholders are referring to the SEC guidance, the staff thinks that some stakeholders are not necessarily asking for the exact guidance to be incorporated into the new revenue standard, but are more so looking for a concept to provide relief in identifying promised goods or services. This is because there are several disadvantages of carrying forward the guidance "as is." The following is a summary of those potential disadvantages:

   (a) The guidance includes factors to be met in proving that an item is inconsequential or perfunctory. In practice, this could be a laborious exercise to assess every potential good or service against those factors (even though this might only have to occur once for a particular good or service). The staff is concerned about this risk because the FASB would have to issue an ASU about inconsequential or perfunctory guidance, including the factors, to make the change to Topic 606. In other words, there is a risk the guidance might take on a life of its own in practice and, therefore, not address the very cost and complexity problem we are trying to address. It is not clear to the staff whether that exercise is taking place today because, for example, some stakeholders have indicated that they are aware of, and apply, the inconsequential or perfunctory notion, but were not aware of the factors.

(b) The guidance is not applied outside the United States and, therefore, not well understood by stakeholders outside the United States. The FASB staff thinks it is unlikely the IASB would consider the guidance to be a cost-effective alternative, if the IASB decides to make an improvement in this area. That said, the staff observes that the inclusion of the guidance in U.S. GAAP, but not in IFRS, might lead to converged financial reporting outcomes despite the different language in the respective standards.

42. Although the staff has identified several disadvantages of this approach, a *significant* advantage of this approach is that entities have to deal with this guidance today so it would be difficult for U.S. stakeholders to argue that this approach would be too difficult to apply or cannot be understood. That said, the staff have observed that some stakeholders might be thinking about the guidance in the new revenue standard with a higher degree of precision, or at least reading the words more narrowly/literally, than existing revenue guidance.

Alternative B – Do Not Evaluate Materiality in the Aggregate

43. This alternative would not require the Board to add the inconsequential or perfunctory guidance to the new revenue standard. Instead, the new revenue standard would continue to rely on materiality in determining whether an item or an activity explicitly or implicitly promised in the contract must be identified as a promised good or service and carried into the separation analysis. However, the guidance would be revised so as to explicitly refer to materiality in a similar context as that which applies to determining whether a customer option constitutes a material right or whether a significant financing component exists. When an entity determines that a customer option does not represent a material right, the entity does not accumulate those immaterial rights and assess their significance in the

aggregate. The *immaterial* right is disposed of at the contract level. Excluding an immaterial right from consideration in the revenue accounting for a contract would not be considered a non-GAAP policy because Topic 606 would specifically permit not accounting for such items. Similarly, the significant financing component guidance (Basis discussion included below), does not require an assessment of whether insignificant financing components are material in the aggregate.

> **BC234**. The Boards also observed that for many contracts, an entity will not need to adjust the promised amount of customer consideration because the effects of the financing component will not materially change the amount of revenue that should be recognized in relation to a contract with a customer. In other words, for those contracts, the financing component will not be significant. During their redeliberations, ***the Boards clarified that an entity should only consider the significance of a financing component at a contract level rather than consider whether the financing is material at a portfolio level. The Boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole.*** (Emphasis added.)

44. The staff would intend for the materiality analysis under Alternative B to be consistent with, and work in concert with (that is, not create contradictions with), other guidance in the standard (for example, the guidance on what constitutes a material right).

45. The staff previously prepared the following summary of the discussion at the October 2014 TRG meeting (TRG Agenda Ref No. 11) about the issue of determining when a customer option provides the customer with a material right:

> Most TRG members agreed that the evaluation of whether an option provides a material right should consider relevant

> transactions with the customer (that is, current, past, and future transactions) and should consider **both quantitative and qualitative factors**, including whether the right accumulates (for example, loyalty points).
>
> The staff agrees with the view of most TRG members, which is consistent with the standard, that facts and circumstances, including those that exist outside of the current transaction with the customer, should be considered when evaluating whether a customer option gives rise to a material right, including how a right accumulates over time.
>
> The staff also agrees with the view of most TRG members, which is consistent with the standard, that **the assessment of whether an option gives rise to a material right includes both quantitative and qualitative factors**. This is consistent with the notion that identifying promised goods or services should consider valid expectations of the customer (BC87) and that a customer's perspective on what constitutes a "material right" might consider qualitative factors (for example, whether the right accumulates). (Emphasis added.)

46. Consistent with the how materiality is assessed in the specific context of the material right evaluation and the notion of materiality throughout GAAP, the staff thinks determining whether a promised item or activity is immaterial should consider quantitative *and* qualitative factors.

47. The staff thinks Alternative B could be drafted (including discussion in the Basis for Conclusions to any new ASU) in a manner such as the following:

> **606-10-25-16A** An entity is not required to identify goods or services promised to the customer that are immaterial in the context of the contract. Optional goods or services should be accounted for in accordance with paragraphs 606-10-55-41 through 55-45.

BCX1. The Board decided that an entity should consider whether a promised good or service is material only at the contract level. The Board decided that it would be unduly burdensome to require an entity to aggregate and determine the effect on the entity's financial statements of those items or activities determined to be immaterial at the contract level. Therefore, the Board thinks the guidance in paragraph 606-10-25-16A permits an entity to conclude that not identifying promised goods or services that are immaterial in the context of the contract is consistent with GAAP.

BCX2. Identifying only those goods or services promised to the customer that are not immaterial is also consistent with the objective of identifying the nature of the entity's performance obligation(s). Identifying immaterial goods or services might obscure, rather than clarify, the nature of the entity's performance obligation(s) in the contract.

BCX3. The assessment of whether promised goods or services are immaterial will require the use of judgment. Many entities routinely make similar judgments about materiality in applying other GAAP and also made similar judgments under former GAAP about whether an obligation to a customer is inconsequential or perfunctory.

BCX4. Assessing the materiality of promised goods or services in a contract with a customer should include an assessment of quantitative and qualitative factors. For example, an entity ordinarily will find it useful to consider the nature of its arrangement with the customer.

BCX5. The Board considered whether to explicitly write in Topic 606 that entities should accrue the incremental costs, if any, to transfer the immaterial goods or services to the customer in instances in which the costs will be incurred after satisfaction of the performance obligation. The Board decided not to include an explicit requirement in this Topic about revenue. Entities should apply the guidance in other GAAP (for example, Topic 405- Liabilities) in determining whether or not a liability exists. The Board also observed that if the good or services in the contract with a customer is deemed by an entity as immaterial, then the related costs also are immaterial in many cases.

48. The staff thinks that this alternative might resolve the principal concern expressed about relying upon materiality (that is, the notion in BC90) in the United States, which is that entities will have to undertake a substantial exercise each reporting period to quantify and evaluate, at the entity level, the immateriality of the promised goods and services it has not identified and accounted for. Specifying that the exclusion of a promised good or service from analysis under the model that is immaterial is not a "non-GAAP" accounting policy, would prevent entities from having to undertake this exercise.

49. Conceptually, as outlined in the example drafting above, the staff thinks excluding immaterial items or activities from identification as promised goods or services is consistent with the intent of Step 2 of the revenue model, which is to identify the nature of the entity's promise(s) to the customer. The staff thinks that *excluding* immaterial items and activities from that analysis makes it *more* likely, rather than less likely, that the entity will appropriately evaluate the nature of its promise to the customer and, therefore, properly identify its performance obligation(s) in the contract.

50. The staff thinks this revision to the issued guidance might not result in significantly different financial reporting outcomes than an inconsequential or perfunctory concept because the staff thinks that, practically, many entities think of inconsequential or perfunctory through the lens of materiality. The principal difference between the existing inconsequential or perfunctory guidance and what the Boards issued in the new revenue standard (as explained in BC90) is that because of the inconsequential or perfunctory guidance an entity is *in accordance with* GAAP when not accounting for inconsequential or perfunctory obligations, while under the new revenue guidance, not identifying those same items would be considered "non-GAAP" accounting.

51. The staff thinks that this alternative might be preferable to introducing the existing SEC guidance into the new revenue standard because, while inconsequential or perfunctory are terms applied today, additional stress will be placed on those terms if they are introduced into Topic 606 through a new ASU, such that entities might apply them in a manner other than as intended. In contrast, the concept of materiality is applied pervasively throughout GAAP.

52. To better understand the terms inconsequential and perfunctory, the staff reviewed the definitions in the Merriam-Webster dictionary as follows:

> **Inconsequential**: Of no significance, not important
>
> **Perfunctory**: Used to describe something that is done without energy or enthusiasm because of habit or because it is expected

53. The staff thinks that each of those terms is different, or can be interpreted differently, from materiality and, therefore, the terms *might* capture different items than Alternative B. The staff thinks the Board might be more comfortable with the notion of excluding items or activities from analysis that are immaterial (consistent with the discussion in BC90), but wants to alleviate the burden on preparers and practitioners that results from the conclusion that excluding the immaterial items or activities is not in accordance with GAAP.

54. Alternative B may be the simplest solution to the core concern the staff thinks the Board would be trying to address if they include this issue in the scope of a new project (that is, the cost of assessing the exclusion of immaterial items or activities in the aggregate and reporting the effects on the financial statements of those exclusions).

Staff Analysis of Alternative A versus Alternative B

55. In contrasting Alternative B with Alternative A, the staff notes that some stakeholders are concerned that including specific guidance on inconsequential or perfunctory could actually have the effect of increasing the number of promised goods or services evaluated by entities as compared to current practice and/or how many entities are interpreting the new revenue standard. This is possible because some of the factors in the SEC guidance are

somewhat broad and if all entities take a fresh look at their contracts using those factors, it is possible that they would decide they need to break their contracts down further than they do today.

56. The staff also notes that the inconsequential or perfunctory notion might result in other implementation issues if entities applying IFRS would have to apply the guidance in Alternative A. Although U.S. stakeholders are familiar with the existing SEC guidance, this might be a new concept for international entities, as well as for U.S. private companies. During the January 2015 TRG meeting, some members cautioned the Boards about unintended consequences of bringing that guidance into the standard. Although inconsequential or perfunctory has a particular meaning in U.S. GAAP, it may not be applied consistently internationally. For example, the dictionary definition of perfunctory has a broad meaning and may capture more promised goods and services than would be intended by the Boards.

57. The staff's understanding is that many of the issues on this topic are not entirely caused by the guidance in the core standard, but may be arising as a result of paragraphs BC89 and BC90 in the Basis for Conclusions. Many stakeholders have cited that the inclusion of those paragraphs has led them to believe that each and every possible good or service (no matter how insignificant) in the contract needs to be assessed under the Step 2 of identifying performance obligations guidance. Some stakeholders are concerned that, due to the language in the Basis for Conclusions, they cannot apply discretion or judgment in identifying performance obligations. Some stakeholders have asserted that, absent those Basis paragraphs, they do not think this would have been *as significant* an issue.

58. Based on the concerns expressed about potentially introducing the inconsequential or perfunctory guidance into the new revenue standard, Alternative B may be the simplest path to remedying the issues that have been identified, including with respect to the language in the Basis for Conclusions, since any revisions to the issued guidance would afford the Board the opportunity to explain its revision in a manner that, in effect, negates the prior Basis discussion about this topic.

59. The staff notes that some have suggested *solely* revising the Basis for Conclusions to the new revenue standard, but the staff does not think that would be as effective as the

alternatives presented above. There is at least some question, in terms of process, of how to revise only the Basis for Conclusions of an issued standard. The staff's understanding is that if we wanted to take this path, we would need to reissue the new revenue standard with the updated Basis for Conclusions. A risk is that the standard has been printed and distributed and that stakeholders could have version control issues. The staff also are concerned that reissuing the Basis for Conclusions might (a) give more authoritative standing to the Basis than the Board desires, especially considering the Basis currently is not part of the Codification, and (b) it might start a precedent whereby practitioners and preparers regularly ask for items to be added to, or deleted from, the Basis.

60. Another option might be to include additional discussion in the Basis for Conclusions of any ASU issued solely to address Issues 2 and/or 3 in this memo. That is, the Basis in that ASU might include some explanation of why the Board decided not to undertake standard setting on this issue. However, the Basis for Conclusion is not authoritative so may not fully solve the issue raised herein. Therefore, the staff thinks the most helpful and clear way to communicate GAAP about this particular issue, which impacts a significant number of stakeholders, is to amend the Codification.

Staff Recommendation

61. The staff thinks Alternative B is the most effective way to address the concerns that have been raised by U.S. stakeholders, and it would be fairly simple to make the change because it would involve adding very little to the Codification. The staff also thinks this approach carries the least potential for unintended consequences, such as application of the SEC guidance in new or unintended ways. The FASB staff thinks that if the FASB amends Topic 606 to include Alternative B and the IASB decides not to make a change to IFRS 15 for this issue, the financial reporting outcomes under GAAP and IFRS would generally be the same. In other words, the staff thinks Alternative B would not result in de-convergence; it would merely address a U.S.-specific application issue.

Issue 2: Distinct in the Context of the Contract

62. The new revenue standard requires that distinct goods or services be identified as performance obligations. Refer to Appendix A for the guidance in the new revenue standard. There are two criteria that must be met for a good or service to be distinct:

    (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).

63. The first criterion is similar to the notion of standalone value in existing GAAP. Therefore, entities are not asking a significant number of questions about how to apply this criterion. The staff notes that in order for a promised good or service to be distinct, it first must be capable of providing benefit to the customer on its own or together with other readily available resources. The capable of being distinct criterion effectively establishes a "floor" to determining the performance obligations in a contract. Unless the customer can benefit from a promised good or service either on its own or together with other readily available resources, it cannot be distinct. However, the staff notes that this "floor" is a relatively low hurdle to clear. For example, a promised good is capable of being distinct merely if it can be resold by the customer "for more than scrap value."

64. The second criterion is less familiar to stakeholders and is the subject of a number of implementation questions. The staff notes that the second distinct criterion was developed with the *intention* of being judgmental in application, specifically in response to feedback received from stakeholders during the revenue project. Stakeholders expressed concern that the proposed separation guidance in the 2010 and 2011 EDs did not provide adequate flexibility to address the wide variety of revenue arrangements that exist in practice across all industries. Stakeholders asserted that the separation guidance in the two EDs might result in separation results that do not reflect the true nature of the arrangement with the customer. The Boards responded to this feedback by developing the second distinct

criterion (whether a promise to transfer a good or service is separately identifiable in (that is, distinct in the context of) the contract as an evaluation of a relatively broad principle that provides a set of *not all-inclusive* factors to help entities consider whether or not that criterion was met.

65. The separation guidance with respect to the distinct in the context of the contract analysis underwent numerous iterations in drafting of the final revenue standard. At various points, the principle underlying this analysis was articulated in more detail than in the final standard. Some of the factors included as examples in paragraph 606-10-25-21 were alternatively proposed as the principle itself in prior versions of the guidance. For example, various forms of the factors in paragraphs 606-10-25-21(a) and 25-21(c) were, at different points in the drafting process, articulated as the principle for the distinct in the context of the contract analysis.

66. After considering all of the drafting variations, having discussions with former FASB and IASB project team members about those variations, and reviewing the feedback received from stakeholders since the issuance of the final revenue standard, the staff does not think significant changes to the guidance in the new revenue standard will significantly reduce the judgment entities will need to make in determining whether promised goods or services are, or are not, distinct. The staff thinks this level of judgment is the natural consequence of stakeholders' requests, and the Boards' decision, to permit judgment in this area. The staff notes that identifying separate deliverables or separate elements under existing revenue guidance also is challenging and judgmental, especially in particular industries (for example, software and bio-technology).

67. That being said, specific feedback from stakeholders has convinced the staff that there are some *measured* actions the Board could take to ensure a more consistent and reasonable application of the separation model in the new revenue standard. The potential actions include the following:

(a) First, the staff thinks the Board could further articulate the principle about what it means for a promise to be "separately identifiable" within the Codification.

(b) Second, the staff thinks the Board could reframe the existing factors to more clearly align with the principle. The staff thinks that this would, principally, involve evaluating the separately identifiable principle in the context of the *bundle* of promised goods or services in the contract, rather than in the context of each individual promised good or service.

(c) Third, and most importantly, the staff thinks additional examples should be added to the implementation guidance. Examples might be the Board's most effective way to provide additional clarity about how the Board intends the separation guidance to be applied.

Improvement 1 - Articulating the Principle of Separately Identifiable

68. The factors in paragraph 606-10-25-21 were intended to be examples of when a promised good or service is not separately identifiable in a contract. These factors were *not* intended to be applied as *criteria*. However, feedback received since the issuance of the final revenue standard has suggested that many stakeholders are viewing the factors as criteria (that is, if a promised good or service meets any *one* of the three factors, it is not separately identifiable). The staff thinks this might be at least partially a consequence of some stakeholders not understanding the "separately identifiable" principle. Some stakeholders have communicated that they do not know what "separately identifiable" means and that the reference to "separable risks" in the Basis of Conclusions that attempts to explain the principle is not helpful because stakeholders do not understand that notion well (the Boards acknowledged this in the Basis for Conclusions to both the 2011 ED and the final revenue standard).

69. Without an understandable articulation of the principle underlying "separately identifiable," entities can only look to the factors provided in paragraph 606-10-25-21, which were supposed to be examples, rather than criteria, for the distinct in the context of the contract analysis. The staff thinks that additional articulation of the premise underlying the "separately identifiable" principle would take some "stress" off of the factors, allowing them to serve in the manner that was intended.

70. Looking at previous staff papers on this topic, as well as previous drafts of the revenue standard, the staff thinks there has been a consistent concept underpinning the distinct in the context of the contract criterion. The staff thinks that concept has been, and continues to be, evaluating whether the entity, in fulfilling the contract with the customer, is

delivering multiple goods or services, or is, instead, delivering a combined item (or items) that is (are) *comprised of* the individual goods or services promised in the contract. Put another way, the distinct in the context of the contract analysis should evaluate whether the multiple promised goods or services in the contract are, themselves, a series of outputs, or instead, are a series of *inputs* to a combined item (or items). The inputs to a combined item (or items) concept might be further explained, in many cases, as those in which the entity's promise to transfer the promised goods or services results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised (component) goods and services.

71. The staff thinks that previous iterations of the inputs to a combined item (or items) concept were interpreted by some too narrowly. For example, some interpreted the notion as applying only in the context of where the entity provides what the standard refers to as a "significant integration service," such as that provided when an entity constructs something significant like a building or a ship. The staff thinks the presence of a significant integration service is certainly indicative of a contract in which multiple promised goods and/or services are solely inputs to a combined item (or items), but that the absence of a significant integration service does not necessarily mean a bundle of promised goods or services are not still inputs to a combined item (or items).

72. The staff thinks the notion of *significant* interdependence or interrelation that was also, for a period of time, considered as a possible underlying principle for the distinct in the context of the contract analysis, also might suggest a bundle of goods or services are principally inputs to a combined item (or items). That is, the concept of significant interdependence or interrelation might not be a *separate* underlying principle to the distinct in the context of the contract notion, but rather another example of a situation, other than a significant integration service, when a bundle of goods or services are fundamentally inputs to a combined item (or items). When the substance of the contract is such that the promised goods or services are *each* integral to one or more of the other goods or services in the contract (for example, a delivered item *and* an undelivered item significantly affect *each other* in the contract), the most accurate reflection of the entity's performance in fulfilling the contract might be in the context of the combined item (or items).

73. The staff thinks the notion in the paragraph above has potentially been confused with the first distinct criterion (that is, the capable of being distinct criterion). The capable of being distinct criterion is intended to establish the "baseline" level of economic substance a promised good or service must have to be *capable* of being distinct. That "baseline" or "floor" is a relatively low level. The notion of significant interrelation or interdependence might, in many cases, rely upon similar considerations as the capable of being distinct analysis. *However,* in the context of attempting to determine whether a bundle of goods or services are, principally, inputs to a combined item (or items) rather than outputs in their own right, the entity is attempting to establish more than a "baseline" level of economic substance. The staff thinks that a customer might be able to generate economic benefits from each of the promised goods or services on their own (or with other readily available resources), but in the context of the contract, each of the goods or services *significantly* affects the other and the benefits that can be derived therefrom. In that case, the two (or more) goods or services are merely inputs to the combined output that was the nature of the promise to the customer in the contract.

74. Therefore, the staff suggests that the Board clarify the separately identifiable principle around the notion of attempting to identify when two or more promised goods or services are themselves outputs in the contract with the customer or, instead, are principally inputs to a combined output(s). This might be an addition to the guidance akin to the following:

> The objective when considering whether promised goods and/or services are separately identifiable from each other is to determine whether the nature of the entity's promise to the customer primarily is to transfer (a) each of those separate goods and/or services or (b) a combined item (or items) to which each of those goods and/or services are an input.

75. The staff envisions that this proposed improvement would include additional guidance, of the nature in the paragraph above, and additional discussion in the Basis for Conclusions for any proposed ASU, which might include some of the discussion in the paragraphs above. *Inseparable* from this recommendation is the staff recommendation discussed below to include additional examples in the implementation guidance about the application of the

separation model. The staff thinks some entities will continue to misapply the guidance by over-reading or misinterpreting specific words or phrases *however* drafted, without additional examples illustrating the Board's intent with respect to application of the separation guidance.

Improvement 2 – Aligning the Factors to the Re-Articulated Principle

76. The staff thinks improving the articulation of the "separately identifiable" principle will take some of the "stress" off of the factors. However, the factors will continue to provide important insight into application of the principle. Therefore, the staff would not recommend eliminating any of the three factors.

77. If the Board agrees with the staff's proposal to provide additional clarity around the separately identifiable principle, the staff thinks some minor changes to the factors should be made in drafting to ensure the potential benefits from the clarified principle (and additional examples) are fully realized.

78. The principal change the staff would propose is to "pluralize" the factors. However, in addition, while considering how to draft revisions to the factors, the staff concluded that it may be clearer to structure those factors to help identify when a bundle of promised goods or services *are* inputs to a combined item (or items) rather than to help identify when an individual promised good is not separately identifiable. For example, the following might be how factor (c) in paragraph 606-10-25-21 would be revised:

> **Existing**: 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 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 services**.**
>
> **Example Revision**: The goods or services are highly interdependent or highly interrelated. *Each* of the goods or services is significantly affected by one or more of the other goods or services in the contract.

79. The new revenue standard is written in such a way so as to evaluate the distinct in the context of the contract criterion for each promised good or service individually. Based on the staff's evaluation of the feedback from stakeholders since issuance of the final revenue standard, the effect of the "singular" structuring of the factors appears to have been to lose the notion that, for a bundle of goods and services to, in effect, be a combined output, those goods or services should significantly affect *each other*. It is, therefore, resulting in some conclusions that the staff does not think are in accordance with the intent of the principle because it is capturing contract scenarios where only one good or service is significantly affecting the other (but not vice versa). The staff thinks that the separately identifiable principle is intended to look at the level of integration and/or interrelation/interdependence *among* promised goods or services. That is, the separately identifiable principle, as articulated above, is intended to evaluate when the entity's performance in transferring a bundle of goods or services in a contract is, in substance, fulfilling a single promise to the customer. Therefore, an entity should be evaluating whether two promised goods or services (for example, a delivered item and an undelivered item) *each* significantly affect the other (and therefore are highly interrelated or interdependent) in the contract, not merely whether one is, by its nature, dependent upon the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract – such as, maintenance services on off-the-shelf equipment).

80. Therefore, the staff thinks the factors should be restructured, in concert with the other two improvements to the distinct in the context of the contract guidance proposed herein, so as to more closely relate to those other improvements.

81. The Basis for Conclusions that would accompany the improvements to the factors would further clarify and educate stakeholders that, like current GAAP, this is an area that requires judgment. In addition, the Board could educate stakeholders that the three items included in the standard are factors (not criteria) and that an entity might need to consider other factors to appropriately account for its promise(s) to the customer.

82. In drafting the alternatives about how to address the issues with distinct in the context of the contract, the staff considered improvements that were recommended by (and sent to the Board from) a group of preparers, principally from a few industries that currently apply

specialized GAAP, that participated in one of the staff's outreach meetings in December 2014. To be helpful to the Board and the staff, this group provided the staff with proposed revisions to the guidance on identifying performance obligations, principally related to paragraph 606-10-25-21. The staff notes that the proposed changes to paragraph 606-10-25-21 related to revisions of the factors and did not amend the principle. The staff agrees with those preparers that revisions to the guidance would be helpful to stakeholders. However, when the staff considers input from stakeholders more broadly across many different industries, the staff thinks that the most effective approach would be to amend the factors in a way that clearly links back to the principle (as it would be clarified through Improvement 1). In addition, the staff thinks that adding examples to the standard (addressed below) might be the most effective way to address the implementation questions.

83. In drafting the alternatives about how to address the issues with distinct in the context of the contract, the staff also considered two recent unsolicited comment letters from stakeholders – one from a defense contractor that requested the Board make no changes to this area and one from a group of software companies that requested the Board make significant changes to this area. Those two comment letters previously were distributed to the Board.

Improvement #3 – Additional Examples

84. The separation guidance was intended to be judgmental. However, it is clear to the staff that some stakeholders are applying that guidance in a manner other than what was intended. Some of that misapplication can validly be attributed to the written guidance or absence of written guidance. Improvements 1 and 2 above are intended to *help* rectify those issues. Other instances of misapplication appear to be resulting from over-focusing on a single factor, phrase, or even word (including whether that word is articulated in the singular or plural) in the guidance. The staff does not think it will be possible to amend the separation guidance itself sufficiently to prevent all forms of misapplication. Therefore, the staff thinks *additional* examples should be provided as implementation guidance to any proposed (and final) ASU to demonstrate how the Board intends the separation guidance to be applied. Specifically, the staff would suggest examples tailored to scenarios that have

consistently arisen in feedback received since the issuance of the final standard. The staff thinks the additional examples can help to educate stakeholders about the separately identifiable principle and how to apply the three factors.

85. The staff understands that there are numerous examples of the separation model included in the new revenue standard, and it is reasonable to ask whether more examples will be helpful to stakeholders. The staff thinks additional examples can only *help*, and note that more examples around this vital aspect of the new revenue model would, in effect, only replace a fraction of the implementation guidance that exists around the separation guidance in current GAAP. The staff notes that, over time, the numerous industry-specific standards in GAAP and the countless interpretative publications of accounting firms, the AICPA, and other practitioners have produced hundreds of separation examples (for example, with respect to the general multiple-element guidance in Subtopic 605-25 or the software industry-specific revenue guidance in Subtopic 985-605) that have no present replacement other than what is included in the new revenue standard and *preliminary* interpretations from some practitioners/accounting firms. Over time, there will undoubtedly be more interpretive guidance, just as there is for existing guidance, but in the near-term, additional implementation examples from the FASB might ensure a more consistent and reasonable application of the new standard.

86. A number of examples follow that the Board could add to the new revenue standard. The staff is not planning to ask the Board to vote whether to add each example to Topic 606. Instead, the staff has included the examples to demonstrate what the staff has in mind with Improvement 3 so that the Board can instruct the staff to (or not to) develop additional examples about the separation guidance in the new revenue standard.

Example 1 – Off-the-Shelf Equipment and Installation

An entity enters into a contract with a customer to provide a piece of "off-the-shelf" equipment (that is, the equipment is functional without any significant customization or modification) and to install that equipment at the customer's premises. Similar equipment is sold by the entity's competitors and there are a number of third parties that could provide the relatively standard and non-complex installation services for the customer.

The entity determines that the customer can benefit from the equipment together with other readily available installation services (those available from numerous alternate providers) and can benefit from the installation services together with the equipment delivered upfront. Therefore, the equipment and the installation services are each capable of being distinct.

The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (that is, the promises are distinct in the context of the contract). The entity considers the factors in paragraph 606-10-25-21 in determining that the equipment and the installation services are not inputs to a combined item in this contract.

- Because the entity's installation services will not significantly customize or otherwise significantly modify the equipment, the entity is not providing a significant integration service of creating a combined item derived from the equipment and the installation services.
- While the installation services, by default, are dependent upon the successful transfer of the equipment to the customer, those services do not significantly affect the customer's ability to derive benefit from the equipment. This is because the installation services to be provided are non-complex in nature and could be provided by numerous alternate vendors. Therefore, because the equipment and the installation services do not *each* significantly affect the other, they are not highly interrelated or highly interdependent.

As a result, the entity determines that the equipment and installation services are distinct and will account for them as separate performance obligations.

Example 2 – Contractual Restrictions on Separately Identifiable

Assume the same scenario as in Example 1, except that, as a condition of the contract, the customer is required to use the entity's installation services.

The contractual requirement to use the entity's installation services does not change the distinct evaluation in this example.

The entity still determines that the customer can benefit from the equipment together with other readily available installation services (that is, installation services that are sold separately by other entities) and will benefit from the installation services together with the equipment delivered upfront. Therefore, the equipment and the installation services are each capable of being distinct.

The entity further determines that its promises to transfer the equipment and to provide the installation services are each separately identifiable (that is, the promises are distinct in the context of the contract) for the same reasons as in Example 1. The contractual requirement to obtain the installation services from the entity does not change the fact that the entity is *not* providing a significant integration service in the contract, and the contractual requirement does not affect the level of interrelation or interdependence between the equipment and the installation services as compared to the level of interrelation or interdependence between the equipment and the installation services in Example 1.

Example 3 – Equipment and Consumables

A manufacturer enters into a contract with a customer to provide a piece of "off-the-shelf" equipment (that is, it is functional without any significant customization or modification) and to provide specialized consumables for use in the equipment at pre-determined intervals over the next three years. The consumables are only produced by the manufacturer, but are readily available from other entities (for example, distributors of the manufacturer's products and some retailers).

The manufacturer determines that the customer can benefit from the equipment together with other readily available resources (that is, consumables it could obtain from an entity other than the manufacturer and that are also sold separately – through refills – by the manufacturer), and the customer will benefit from the consumables that will be delivered under the contract together with the equipment delivered upfront. Therefore, the equipment and the consumables are each capable of being distinct.

The manufacturer further determines that its promises to transfer the equipment and to provide consumables over a three-year term are each separately identifiable (that is, are each distinct in the context of the contract). In determining that the equipment and the consumables are not merely inputs to a combined item in this contract, the manufacturer considers that it is not providing a significant integration service of producing a combined item using the equipment and consumables as components, nor does either promised item significantly customize or modify the other from the form in which it is sold separately.

The manufacturer further concludes that, because the customer can readily obtain the consumables in the contract from entities other than the manufacturer, its promise to provide those consumables does not significantly affect the customer's ability to derive benefit from the equipment. Therefore, while the consumables are necessarily dependent upon the successful transfer of the equipment (that is, the consumables would be useless separate from the equipment), the equipment and the consumables are not highly interrelated or interdependent and are not, in effect, inputs to a combined item because they do not *each* significantly affect the other.

As a result, the entity determines that the equipment and the consumables are distinct from each other and will account for them as separate performance obligations.

Example 4 – 100 Highly-Specialized Devices

A contractor enters into a contract to deliver 100 highly-specialized devices to a customer. In addition to the 100 devices, the contractor is managing the overall fulfillment of the customer-specific contract and is responsible for developing and implementing a production process to ensure timely fulfillment of this specialized order.

Each of the 100 devices is capable of being distinct because it will function as designed independent of the other 99 units.

However, the contractor concludes that its promises to deliver each device are not separately identifiable (that is, they are *not* distinct in the context of the contract) because it is providing a significant service of integrating its manufacturing, assembly, and contract management know-how specifically to deliver the combined output (that is, the 100 units) in this contract. In addition, in the context of this contract, the customer's ability to derive its intended benefit from each of the devices is highly dependent on each of the other devices in the contract. This is because the customer's ability to derive its intended benefit from the contract is significantly affected by contractor providing the agreed upon number of units. Therefore, in substance, each of the 100 devices is an input in the contractor's fulfillment of its promise to deliver a combined output that has benefit to the customer that is greater than the sum of the component parts.

Therefore, the customer accounts for its promise to deliver the 100 highly-specialized devices as a single performance obligation.

Example 5 – Software with Critical Updates

An entity grants a customer a three-year term software license and promises to provide the customer with when-and-if available updates to that software during the license period. The customer is aware in entering into the license that the entity regularly provides updates that are critical to the effectiveness of the software. Without the updates, the customer's ability to benefit from the software will decline significantly in the first few months of the three-year arrangement. In fact, the customer likely would not enter into a three-year arrangement with the entity without the updates because the software delivered at the beginning of the arrangement will have limited benefit over the entire three-year term without the updates.

The entity concludes that the software and the updates are each promised services in the contract and are each capable of being distinct. This is because the customer will be able to derive *some* benefit from the software on its own throughout the license period (that is, without the updates the software will still provide its Day 1 functionality to the customer), while the customer will benefit from the updates together with the software license transferred at the outset of the contract.

However, the entity concludes that its promises to (i) transfer the software license and (ii) to provide the critical updates, when-and-if available, are not separately identifiable (that is, they are *not* distinct in the context of the contract) because the license and the critical updates are, in effect, inputs to a combined item in the contract. Because the software license would provide little of its intended benefit to the customer absent the updates, and the updates are useless without the base software, the license and the update rights *significantly* affect *each other* and are highly interrelated and interdependent such that they, in effect, fulfill a single promise to the customer.

Therefore, the customer accounts for its promise to transfer the software license and its promise to deliver when-and-if available updates as a single performance obligation.

Staff Recommendation

87. The staff recommends that the Board include Issue 2 as part of a project to clarify the guidance on identifying performance obligations in the new revenue standard. Specifically, the staff recommends the following:

(a) First, that the Board further articulate what it means for a promise to be "separately identifiable" in the revenue standard, and provide additional explanation as to its thinking in the Basis for Conclusions.

(b) Second, the Board should reframe the factors in paragraph 606-10-25-21 to more clearly align to the intent of the guidance. The staff thinks that this primarily would involve evaluating the separately identifiable principle in the context of the *bundle* of promised goods or services in the contract, rather than evaluating the promised goods or services, in effect, individually.

(c) Third, and most importantly, additional examples should be added to the implementation guidance in order to provide additional clarity as to how the Board intends the separation guidance to be applied.

Issue 3: Shipping and Handling Services

88. In identifying the promised goods or services in a contract with a customer, the staff has been informed that there are varying views about whether shipping and handling services (collectively referred to as shipping below) should be accounted for as a promised service or as a fulfillment cost. It is the staff's understanding that, under existing revenue guidance, entities generally do not account for shipping services provided in conjunction with the sale of its products as an additional deliverable. It is not entirely clear what the new revenue standard changed in this respect.

89. If an entity identifies shipping as a promised service in a contract, then the entity would need to determine whether or not the shipping is distinct from other promised goods or services.

    (a) If shipping is distinct, then the entity would need to determine the standalone selling price for the shipping services and allocate a portion of the transaction price to the shipping performance obligation. The entity also would then need to determine when to recognize revenue based on its assessment of when the performance obligation is satisfied.

    (b) If shipping is not distinct (which the staff thinks would be infrequent if shipping is identified as a promised service), then the inclusion of the shipping services in a combined performance obligation (that is, the product and the shipping together) *might* affect the timing of the entity's revenue recognition as compared to what would result from a conclusion that the product is the only promised good in the contract and shipping is a fulfillment cost.

90. In circumstances in which the entity does not transfer control of the good being shipped prior to shipment, the staff's view is that shipping ordinarily would *not* be an additional service to the customer. If the customer obtains control of the good after shipment, the staff thinks the entity is merely shipping its own asset (that is, the asset the entity has

concluded it still controls) to facilitate the sale to the customer. In those circumstances, shipping is a fulfillment cost. Conversely, the staff thinks there is a reasonable argument that shipping would be an additional service in a contract in which control of the good transfers at shipping point (that is, the shipping service is performed subsequent to transfer of control of a product).

91. Similar to Issue 1, there are mixed views as to whether standard setting is needed in this area. The feedback provided by preparers was that they have the best understanding of their business, contracts, and customers and are able to identify circumstances where shipping is a promised good or service and when it is solely a fulfillment effort. Preparers have some concerns about introducing additional prescriptive guidance and would prefer to be able to apply judgment in dealing with this issue. In contrast, the staff has heard from some auditors that leaving this to preparer judgment could result in diversity in practice and/or a requirement to quantify what some might consider an error. Therefore, auditors generally would prefer clearer guidance about how to make the distinction.

92. In the staff's view, if an entity were required to consider this matter an error (that is, not allocating a portion of the transaction price to shipping as a separate performance obligation), then there would be unnecessary cost and complexity in the U.S. financial reporting system.

93. The staff obtained some preliminary views from a FASB investor liaison about what financial statement user views might be on this issue. First and foremost, users are generally concerned with comparability and consistency. At a high level, users would be concerned with results related to shipping services if a large portion of the entity's business relates to providing shipping services. Also, users might be interested in shipping services if the entity has had frequent or significant reversals of revenue for nonperformance of shipping (for example, the product revenue is reversed because of an inadequate or not completed shipping service). Other than those scenarios, a requirement to break apart shipping as a performance obligation separate from the transfer of the product might diminish the usefulness of the information because financial statement users might need to put back the pieces of revenue for their analysis. For example, users might add together shipping revenue and product revenue for analysis purposes, which might be presented in

separate line items in the income statement (sale of services versus sale of goods). Further, since shipping is not accounted for as a separate deliverable today, the separation of shipping under the new standard may impair comparability and distort margins.

94. For purposes of contemplating this issue, consider the following example:

> An entity manufactures a widget. The entity will arrange for the widget be delivered to the customer using a third-party carrier. The shipping terms are FOB shipping point. The entity concludes under the new revenue standard that control of the widget would transfer at its loading dock.

95. A key question for this scenario is: did the Board intend for the entity to identify (a) a single promised good (that is, the widget) or (b) two promised goods and services (that is, the widget *and* the shipping service), which might be one or two performance obligations?

96. Some stakeholders hold the view that shipping of goods is a fulfillment activity that supports the transfer of control of the goods to the customer even in this example where the customer obtains control under the model prior to shipment. That is, shipping is similar to other fulfillment activities such as purchasing the underlying inventory and manufacturing the good. Other stakeholders assert that the shipping is a promised service in the contract and not a fulfillment activity because the entity is providing a service of transporting the *customer's* asset to a location designated by the customer. Some assert that shipping is more clearly an additional promised service in circumstances in which the customer has a choice of delivery vendors (for example, the entity or a third party) and the choice of different delivery alternatives (for example, expedited shipping or rail versus air).

97. If Board members do not think that shipping is, or should be accounted for as, a promised service in a contract with a customer, then the staff thinks this issue should be clarified in the guidance. Even if Board members think that shipping generally is a promised service in scenarios in which the entity is shipping the customer's asset, the Board might want to provide some relief to practice due to the operational difficulties with implementing this accounting answer, as described in more detail below.

98. Shipping is generally not considered a deliverable under existing revenue guidance. Since shipping is not a deliverable under existing guidance in many circumstances, a requirement that shipping be considered a promised service would be a significant change in practice for many entities. There are many manufacturers, retailers, and others that do not consider their arrangements to include multiple deliverables (that is, a product and a shipping service) today. Consequently, they do not have the systems, processes, and internal controls to account for multiple-element arrangements. Further, the staff thinks that if shipping is a separate performance obligation, that the new revenue standard technically would require shipping revenue to be recognized over time, because it meets the first criterion in paragraph 606-10-25-27 (which is, the entity simultaneously consumes and receives the benefits from the entity's performance as the entity performs), which would be operationally difficult for many companies. One could argue whether over time recognition is necessary in circumstances in which the shipping time is a couple of days (although it is possible an auditor in the United States would consider point in time recognition for shipping to be a non-GAAP policy, which has its own challenges, as described above in Issue 1).

Alternatives – Shipping and Handling

99. The staff has identified three potential alternatives if the Board thinks the issue warrants standard setting.

(a) Alternative A would introduce a practical expedient that provides entities with an option to account for shipping as a fulfillment cost rather than as a promised good or service in the contract.

(b) Alternative B provides new implementation guidance on shipping that would apply to all entities (that is, it would not be an election).

(c) Alternative C would rely upon the Board's decision in Issue 1; that is, applying the same threshold (whether that is inconsequential or perfunctory or materiality at the contract level) to an entity's shipping activities as it would to any other promised item or activity in the contract.

100. Under any of those approaches, the staff is not proposing any changes to the guidance on satisfaction of a performance obligation. Therefore, although the entity would not have to account for shipping as a promised good or service, when the entity relinquishes (and/or the customer obtains) physical possession of the good being shipped and which party has the significant risks and rewards of ownership in-transit remains something that should be *considered* as part of an entity's assessment as to when the performance obligation to transfer the good is satisfied.

101. Under any of the alternatives outlined below, the staff would plan to include a clarification that shipping and handling that occurs prior to the customer obtaining control of the good is a fulfillment cost. As described above, this is because the staff thinks the entity is shipping its own asset in order to facilitate a sale. The guidance that would result from any of the three alternatives would apply only when shipping and handling is performed after the customer obtains control. This notion will work well for instances in which the performance obligation is satisfied at a point in time. During outreach on the alternatives, the staff received some feedback that the scoping might be more difficult in situations in which the performance obligation is satisfied over time. For example, stakeholders question how they would apply the guidance in a situation with continuous transfer of control when a customer owns work in process inventory. However, in order of magnitude, the staff thinks the companies that would be in the over time scenario are a small minority of those that may be affected by as change in guidance that views shipping as a separate performance obligation.

Alternative A – Practical Expedient

102. A way to improve the operability of the standard might be to provide a practical expedient that allows entities to simplify their accounting for shipping. The core principles in the standard would still require an entity to identify promised goods or services in the contract and identify the performance obligations. However, entities could elect not to apply the model to a promised shipping and/or handling service. The Board could decide that the practical expedient would be either (a) to treat shipping as a fulfillment cost (Alternative A-1) or (b) to delay revenue recognition for the good until the shipping is

complete (Alternative A-2). The Board could decide that the practical expedient should be applied at the entity level or applied consistently to similar arrangements.

103. The Board will need to decide on the scope of the practical expedient. This topic is discussed below. The question is whether the expedient should only be applied to shipping or if it could also be applied to other obligations in the contract. Much of the discussion on the issues on shipping arises in circumstances where the shipping takes place after control of the related product has transferred. Accordingly, the staff thinks that the shipping issue may be symptomatic of a broader question regarding how an entity should account for any services/obligations performed subsequent to the transfer of control of a product. Some examples include warehousing or custodial services and coverage for risk of loss in transit (for example, insurance). While the new revenue standard does not specifically discuss shipping as a separate performance obligation, there are multiple references to remaining performance obligations after transfer of control, including the bill-and-hold guidance (paragraph 606-10-55-84), customer acceptance guidance (paragraph 606-10-55-86), and the discussion in BC 118(c), which states that an assessment based on control (as opposed to a "risk-and-rewards approach") could result in performance obligations remaining after control transfer.

104. The staff questions whether Alternative A-2 (defer all revenue for the good until the shipping is complete) is a cost-effective solution. However, at least some stakeholders have raised the idea so we decided the Board should be aware of it. The staff notes that Alternative A-2 would be a significant change in practice for some entities. The staff would expect that many entities that recognize revenue at shipping point under existing revenue guidance might come to a similar conclusion in evaluating the timing that a performance obligation is satisfied under the new revenue standard. However, if the Board would like to pursue alternative A-2, an entity would default to recognizing revenue only after it has fulfilled its shipping obligation (assuming the customer obtains control by the time that shipping obligation is fulfilled in accordance with the new revenue guidance). Adopting this approach would delay revenue recognition for those entities, which might mean that many entities that could benefit from the practical expedient would not apply the expedient because it could have a material impact on the entity's revenue recognition. Also, Alterative A-2 might be viewed by some stakeholders as being inconsistent with the

transfer of control model in the new standard since it would appear to suggest primacy of one or more of the point in time transfer of control indicators (for example, physical possession) over others.

Alternative B – Implementation Guidance

105. Under Alternative B, the Board could provide new implementation guidance to assist entities in determining when shipping is, or is not, a promised good or service. This approach would be similar in concept to the implementation guidance that the Boards provided for warranties in paragraphs 605-10-55-30 through 55-35 [B28 through B33].

106. The Board would need to decide if the implementation guidance would require that shipping is never a promised good or service or whether there are certain instances where it is a promised good or service. The staff's view is that the Board will have to draw a line to distinguish when shipping is a fulfillment activity versus when is it an additional promised service. The questions are where, and how, to draw that line. This is because, at a minimum, the standard would need to allow entities whose primary business is shipping to account for shipping as a promised service. The staff considered the following alternatives about how to draw the line:

    (a) *Nature of Business* - Entities that are in the business of performing shipping services would account for the shipping as a promised service in the contract; whereas, all other entities would account for shipping as a fulfillment cost.

    (b) *Predominant Component* - Entities would look to the nature of the shipping service in relation to the overall promised goods or services in the contract. In instances in which the shipping service is the predominant promise in the contract, an entity should account for the shipping as a promised service in the contract.

    (c) *Significant Component* - Entities would look to the significance of the shipping service in relation to the overall promised goods or services in the contract. This alternative could also be drafted in the inverse by saying that in instances in which the shipping service is incidental to the transfer of control of the product, an entity should account for the shipping as a fulfillment cost of providing the good.

(d) *Criteria* - The most detailed scoping approach would be to provide a list of criteria for when shipping is merely a fulfillment cost and would not be a promised service in the contract. The staff considered the following criteria:

   (i) The time period over which the shipping service is performed is short

   (ii) The shipping is not separately negotiated or separately billed

   (iii) The cost that the entity incurs in providing the shipping service is insignificant in relation to the total contract

   (iv) The shipping is performed by a third party.

107. The following is example drafting of possible implementation guidance to give the Board a sense for what the staff has in mind:

> It is common for entities that transfer a promised good to a customer to also provide shipping and/or handling services to facilitate the sale of the good. Those services might be provided by a third party or the entity. The arrangements might take various forms including free shipping, expedited shipping, and separately-priced shipping.
>
> In instances in which the shipping and/or handling service is performed prior to the transfer of control of a product (see 606-10-25-25 through 25-30 for guidance on satisfying performance obligations), the shipping and/or handling is not a promised service to the customer in the contract; it is instead a fulfillment activity, the costs of which are incurred to facilitate the sale to the customer. Because control of the good has not transferred, the shipping and handling relates to an asset owned by the entity and not an asset owned by the customer. The entity's effort to deliver the good to the customer is no different in this case from its effort to procure raw materials, manufacture the good, or ship the finished

product from the entity's manufacturing facility to its warehouse.

The following guidance applies when shipping and/or handling is performed after the customer obtains control of the product:

a. In instances in which the shipping service is [scoping open], an entity should account for the shipping as a promised service in the contract.

b. In instances in which the shipping service is [scoping open], an entity should account for the shipping as a cost that the entity will incur in order to fulfill its promise to provide the customer with a promised good. This is because in those circumstances, it might not be cost beneficial to allocate revenue to the shipping and handling service as a separate performance obligation. [The Board might also want to caution that the implementation guidance should not be applied by analogy.]

108. As noted above, the most difficult aspect of this approach would be the scoping and determining where to draw the line of when shipping is a fulfillment cost and when it is a promised good or service in the contract. The staff thinks that this approach could be complex in practice.

Alternative C – Apply Solution to Issue 1

109. Alternative C would be for the Board to simply rely on what it does with respect to Issue 1 to address Issue 3, with one caveat. The staff would want to ensure the Board stipulates that shipping and/or handling that occurs *prior to* the customer obtaining control of the good being shipped is a fulfillment cost. The staff's rationale for this view is expressed above.

110. Alternative A to Issue 1 would introduce an inconsequential or perfunctory concept into the revenue standard. The staff thinks that although that alternative would likely alleviate some of the concerns that stakeholders have with the application of the guidance on identifying promised goods or services (that is, Issue 1), it might not address this shipping and handling issue. The staff thinks that it might be difficult for an entity to support an assertion that shipping is inconsequential or perfunctory under the existing SEC guidance. The staff thinks that, in particular, the requirement that an obligation is not inconsequential or perfunctory if the customer would receive a full or partial refund (or have a right to reject the "main" good) if the obligation is not fulfilled might be troublesome. The staff thinks customers often would demand a refund for a good that is not delivered as promised. In discussions with stakeholders, some thought that shipping might be considered perfunctory. However, other stakeholders thought that it would not. Therefore, the staff does not think Alternative C will provide significant practical relief if the Board adopts Alternative A for Issue 1 (that is, the Board decides to introduce the inconsequential or perfunctory guidance into the new revenue standard).

111. Alternative B to Issue 1 (that is, the Board decides to introduce the notion of materiality only at the contract level for the purposes of identifying promised goods or services) *might* provide more practical relief than Alternative A to Issue 1 because the guidance would be less prescriptive (for example, there is no specific discussion about the effect of a customer being entitled to a refund or a right to reject the good). However, given the qualitative aspect to materiality, the staff is not sure how much relief this alternative would provide. If the Board wanted to pursue this alternative, the staff thinks that implementation guidance specific to shipping might be necessary to outline in what scenarios the Board would agree that shipping is, in fact, immaterial after the customer has obtained control of the good. The staff thinks that from a qualitative standpoint, it might be difficult to argue that a customer's points earned in a loyalty program *are* material, but that the service of delivering the good to the customer is immaterial.

112. The next section of this memo addresses how to scope a shipping and handling specific alternative. One benefit of Alternative C is that, because it relies on the guidance that would apply to any identified items or activities promised in a contract with a customer, no additional scoping guidance would need to be considered.

Staff Recommendation

113. If the Board wants to address the issue of shipping and handling, the staff recommends the following:

(a) The Board clarify that shipping and/or handling that occurs before the customer obtains control of the good are fulfillment activities

(b) The Board adopt Alternative A-1 outlined above, which would allow an entity to elect to account for shipping and handling that occurs after the customer has obtained control of a good as a fulfillment cost.

114. The staff's rationale for recommendation (a) is that the staff thinks that shipping or handling activities performed prior to the customer obtaining control of the good are fulfillment activities to facilitate the sale. The staff thinks this is not clear to some stakeholders and the Board should clarify that fact in the guidance (preferably) or the Basis for Conclusions to any new ASU.

115. With respect to recommendation (b), the staff thinks that the revenue model would suggest the activity of shipping a customer's asset would be a promised service in the contract. The staff does not think Alternative C would provide substantial relief with respect to shipping and/or handling, particularly in the current environment where stakeholders appear to be reading the words in Topic 606 narrowly. Therefore, if the Board wants to provide practical relief in the form of what the staff thinks would be an *exception* to the model, it should do so in the clearest way possible and in acknowledgement that its action *is* an exception to the model due to cost-benefit considerations raised by stakeholders after the new revenue standard was issued by the Boards. The staff thinks Alternative A-1 is the simplest way to develop an expedient in this area. Alternative A-2 might create issues in applying the transfer of control guidance to other transactions and might not provide much relief because many entities affected by this issue might not use the expedient. The staff thinks the Board should provide this expedient despite the fact that it would be, in the staff's view, an exception to the model. This is because the staff simply does not think requiring entities to recognize separate shipping performance obligations typically would provide useful information to financial statement users. The staff also thinks it will increase costs for entities with a straightforward revenue recognition model to (i) apply multiple-

element revenue accounting where they mostly previously applied a simple single-element model and (ii) establish a further ability to recognize revenue on the shipping performance obligation over time.

116. The staff thinks this expedient should be an accounting policy election, not applied on a contract-by-contract basis. This is because, at least in theory, a contract-by-contract election would invite structuring. For example, an entity that wants to shift revenue between reporting periods might be able to (a) move revenue forward by applying the expedient to contracts fulfilled near the end of the reporting period, or (b) push revenue to a future period by accounting for the shipping separate from the good.

Scoping

117. The staff has previously highlighted that the issue that has arisen with respect to shipping and/or handling occurring subsequent to the customer obtaining control of the good might not be unique and might be symptomatic of questions that could arise any time a service or obligation takes place subsequent to the transfer of control of a good or service. The staff discussed this with stakeholders and most thought the issue was limited to shipping and handling and that the scope would not need to be broadened. The staff has proposed scoping for shipping and handling only, but notes that there is a risk that stakeholders might request this to be broadened during the exposure process. Accordingly, if the Board decides to address this issue, the staff would propose using definitions of shipping and handling (as defined in Subtopic 605-45) as a way to define the high-level scope of the guidance as follows:

> “Shipping" is understood to be the activity of physically moving the product from the seller's place of business to the buyer's designated location. Shipping costs comprise payments to third-party shippers as well as costs incurred directly by the seller.
>
> "Handling" is understood to be those activities related to storing, moving, and preparing products for shipment. Generally, handling costs are incurred from the point the

product is removed from finished goods inventory to the point the product is provided to the shipper and often include an allocation of internal overhead.

Staff Recommendation – Scoping

118. The staff recommends that the Board limit the scoping of the practical expedient in Alternative A-1 to shipping and handling. The staff thinks that the Board can reconsider the scoping after exposure, if necessary, but have heard (as outlined above) that stakeholders think this is, principally (if not exclusively) a shipping and handling issue.

Issue 4: Technical Corrections

119. In addition to the issues described in this paper, the staff has identified a number of editorial improvements and technical corrections that would improve the standard. While none of these improvements are critical, the staff recommends that, if the Board is otherwise issuing an exposure draft to make improvements to Topic 606, then the Board should make these improvements to be helpful to stakeholders.

Reference	**Description**	**Rationale**
606-10-25-16[24]	Replace “valid customer expectation” with “reasonable customer expectation”	The staff has received feedback questioning what it means to have a valid expectation, especially because the standard is clear that promised goods and services do not need to be enforceable or explicit in the contract. Some Board members have suggested changing this to a reasonable expectation.
Various	Correct the use of terms “promised goods or services” and “performance obligations” throughout the document	In previous exposure drafts of the 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"). In various parts of the standard (including some of the examples) the language was not changed to reflect the change in terminology. Some stakeholders think this is confusing.

Transition, Transition Disclosure, & Effective Date

120. The issues described in this memo relate to updates of guidance that is not yet effective. Therefore, the staff would propose that the transition, transition disclosures, and effective date of the proposed updates in this project be identical to those in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers.*

Appendix A - Accounting Guidance (Topic 606)

> Identifying Performance Obligations

606-10-25-14 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).

606-10-25-15 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 to be a performance obligation satisfied over time.

b. In accordance with paragraphs 606-10-25-31 through 25-32, 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.

> > Promises in Contracts with Customers

606-10-25-16 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.

606-10-25-17 Performance obligations do not include activities that an entity must undertake to fulfill 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.

> > Distinct Goods or Services

606-10-25-18 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).

606-10-25-19 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 the 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).

606-10-25-20 A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

606-10-25-21 Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable (in accordance with paragraph 606-10-25-19(b)) include, but are not limited to, the following:

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 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 services.

606-10-25-22 If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

Appendix B - Excerpt from 2010 Proposed Accounting Standards Update: Revenue Recognition (Topic 605)

23. A good or service, or a bundle of goods or services, is distinct if either:

a. the entity, or another entity, sells an identical or similar good or service separately; or

b. the entity could sell the good or service separately because the good or service meets both of the following conditions:

   (i) it has a distinct function—a good or service has a distinct function if it has utility either on its own or together with other goods or services that the customer has acquired from the entity or are sold separately by the entity or by another entity; and

   (ii) it has a distinct profit margin—a good or service has a distinct profit margin if it is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service.

24. When an entity transfers promised goods or services to a customer at the same time, it is not necessary to apply the proposed recognition and measurement requirements to each performance obligation separately if accounting for those performance obligations together would result in the same amount and timing of revenue recognition as if they were accounted for separately. For example, if an entity transfers two distinct services to a customer over the same time period, it could account for the promises to transfer those services as a single performance obligation if applying the same revenue recognition method to both services would faithfully depict the transfer of services to the customer (as described in paragraph 32).

Appendix C - Excerpt from 2011 Proposed Accounting Standards Update: Revenue Recognition (Topic 605)

28. Except as specified in paragraph 29, a good or service is distinct if either of the following criteria is met:

(a) The entity regularly sells the good or service separately.

(b) 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. Readily available resources are goods or services that are sold separately (by the entity or by another entity) or resources that the customer already has obtained (from the entity or from other transactions or events).

29. Notwithstanding the requirements in paragraph 28, a good or service in a bundle of promised goods or services is not distinct and, therefore, the entity shall account for the bundle as a single performance obligation if both of the following criteria are met:

> (a) The goods or services in the bundle are highly interrelated and transferring them to the customer requires that the entity also provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted.
>
> (b) The bundle of goods or services is significantly modified or customized to fulfill the contract.

30. As a practical expedient, an entity may account for two or more distinct goods or services promised in a contract as a single performance obligation if those goods or services have the same pattern of transfer to the customer. For example, if an entity promises to transfer two or more distinct services to a customer over the same period of time, the entity could account for those promises as one performance obligation if applying one method of

measuring progress (as discussed in paragraphs 38–48) would faithfully depict the pattern of transfer of those services to the customer.