

STAFF PAPER

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Purpose

- Some stakeholders informed the staff that there are questions on the application of the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers*, and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the “new revenue standard”) about how an entity identifies and accounts for “stand-ready” performance obligations. This paper includes a summary of the implementation questions that stakeholders reported to the staff. The staff plan to solicit feedback from members of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) about the issues and analysis presented in this paper.

Background

- Paragraphs 606-10-25-16 [24] through 25-18 [26] of the new revenue standard provide guidance on identifying an entity’s promises in contracts with customers. Paragraph 606-10-25-18 [26] of the new revenue standard provides at list (not all-inclusive) of examples of promised goods or services that may be included in a contract with a customer. Example (e) in that paragraph is:
 - 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

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making goods or services available for a customer to use as and when the customer decides (hereafter referred to in this paper as stand-ready obligations)

3. Stakeholders have communicated that they think there are broadly four types of promises to customers that *could* be considered stand-ready obligations:
 - (a) *Type A* - Obligations in which the delivery of the good(s), service(s), or intellectual property underlying the obligation is within the control of the entity, but for which the entity must still further develop its good(s), service(s), or intellectual property. For example, a software vendor might promise to transfer unspecified software upgrades at the vendor's discretion or a pharmaceutical company might promise to provide when-and-if-available updates to previously licensed intellectual property based on advances in research and development;
 - (b) *Type B* - Obligations in which the delivery of the underlying good(s) or service(s) is outside the control of the entity and the customer. For example, an entity promises to remove snow from an airport's runways in exchange for a fixed fee for the year;
 - (c) *Type C* - Obligations in which the delivery of the underlying good(s) or service(s) is within the control of the customer. For example, an entity might agree to provide periodic maintenance, when-and-if needed, on a customer's equipment after a pre-established amount of usage by the customer; and
 - (d) *Type D* - Making a good or service available to the customer continuously, such as in the health club example set forth in Example 18 (paragraphs 606-10-55-184 [IE92] through 55-186 [IE94]) of the new revenue standard.
4. Example 18 is the only attribution example for a stand-ready performance obligation included in the new revenue standard and it only specifically addresses Type D. In Example 18, revenue is recognized on a straight-line basis over the performance period because the entity makes the health club facilities available continuously to the customer over the performance period and the customer controls

the extent to which it uses, or does not use, the health club facilities. Stakeholders have raised questions about the appropriate accounting for other types of arrangements, such as those described above, that they view as at least somewhat similar to the health club scenario. The principal issue raised by stakeholders with respect to the appropriate accounting for those arrangements they view as similar is about measuring progress towards complete satisfaction of the entity's performance obligation. The staff think properly distinguishing those arrangements that fundamentally provide a service of "standing ready" to perform from other types of promises made to customers is equally integral to properly applying the new revenue model and, also, directly affects the determination of the best measure of progress to apply to the performance obligation (see paragraph 606-10-25-33 [41] included below).

Additional Accounting Guidance

5. The following is a summary of guidance from the new revenue standard pertinent to the questions in this paper.
6. The new revenue standard includes the following guidance about identifying promises in contracts with customers:

606-10-25-16 [24] A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

606-10-25-18 [26] Depending on the contract, promised goods or services may include, but are not limited to, the following:

- a. Sale of goods produced by an entity (for example, inventory of a manufacturer)
- b. Resale of goods purchased by an entity (for example, merchandise of a retailer)
- c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
- d. Performing a contractually agreed-upon task (or tasks) for a customer
- e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
- f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)
- g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- h. Constructing, manufacturing, or developing an asset on behalf of a customer
- i. Granting licenses (see paragraphs 606-10-55-54 through 55-65)

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

BC87. ...The Boards noted that in many cases, all of the promised goods or services in a contract might be identified explicitly in that contract. However, in other cases, promises to provide goods or services might be implied by the entity's customary business practices. The Boards decided that such implied promises should be considered when determining the entity's performance obligations if those practices create a valid expectation of the customer that the entity will transfer a good or service (for example, some when-and-if-available software upgrades). The Boards also noted that the implied promises in the contract do not need to be enforceable by law. If the customer has a valid expectation, then the customer would view those promises as part of the negotiated exchange (that is, goods or services that the customer expects to receive and for which it has paid).

7. In addition to the guidance on identifying the promises in the contract, the new revenue standard includes guidance about measuring progress towards the complete satisfaction of a performance obligation. Guidance pertinent to the analysis in this paper follows:

606-10-25-31 [39] For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 [35] through 25-29 [37], an entity shall recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

606-10-25-33 [41] Appropriate methods of measuring progress include output methods and input methods.

Paragraphs 606-10-55-16 [B14] through 55-21 [B19] provide guidance for using output methods and input methods to measure an entity's progress toward complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

606-10-55-17 [B15] Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract. Output methods include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered. When an entity evaluates whether to apply an output method to measure its progress, the entity should consider whether the output selected would faithfully depict the entity's performance toward complete satisfaction of the performance obligation. An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

606-10-55-20 [B18] Input methods recognize revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time

elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation. If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis.

BC159. There are various methods that an entity might use to measure its progress toward complete satisfaction of a performance obligation. Because of the breadth of the scope of Topic 606 [IFRS 15], the Boards decided that it would not be feasible to consider all possible methods and prescribe when an entity should use each method. Accordingly, an entity should use judgment when selecting an appropriate method of measuring progress toward complete satisfaction of a performance obligation. That does not mean that an entity has a "free choice." The guidance states that an entity should select a method of measuring progress that is consistent with the clearly stated objective of depicting the entity's performance—that is, the satisfaction of an entity's performance obligation in transferring control of goods or services to the customer.

BC160. To meet that objective of depicting the entity's performance, an entity would need to consider the nature of the promised goods or services and the nature of the entity's performance. For example, in a typical health club contract, the entity's promise is to stand ready for a period of time (that is, by making the health club available), rather than providing a service only when the customer requires it. In this case, the customer benefits from the entity's service of making the health club available. This is evidenced by the fact that the extent to which the customer uses the health club does not, in itself, affect the amount of the remaining goods or services to which the customer is entitled. In addition, the customer is obliged to pay the consideration regardless of whether it uses the health club.

Consequently, in those cases, the entity would need to select a measure of progress based on its service of making goods or services available instead of when the customer uses the goods or services made available to them.

Implementation Questions Reported by Some Stakeholders

Question 1: What is the nature of the promise to the customer in arrangements described as Types A through D above?

8. Stakeholders have observed that determining the nature of the good or service an entity is promising to transfer to the customer is fundamental to properly accounting for a performance obligation. Paragraph 606-10-25-33 [41] states that doing so is necessary in order to determine the appropriate measure of progress for a performance obligation. However, some stakeholders are raising questions about determining the nature of the good or service that is being provided to the customer in arrangements such as those described at the beginning of this paper. Those stakeholders question whether the nature of the good or service underlying promises such as Types A through D is the act of “standing ready” or whether it is the actual delivery of the underlying goods or services that the entity stands ready to provide to the customer.
9. The staff think that whether the obligation is to provide a defined good or service (or goods or services), or instead, to provide an unknown type or quantity of goods or services might be a strong indicator as to the nature of the entity’s promise in the contract. The staff note, however, that in *either* case the entity might be required to “stand ready” to deliver the good(s) or service(s) whenever the customer calls for them or upon the occurrence of a contingent event (for example, snowfall).
10. In general, in a contract to provide, for example, 100 specified goods or services, the nature of the entity’s promise is to provide those goods or services, and that this would be the case regardless of whether or not the customer was able to specify the timing for the transfer of those goods or services.

11. In contrast, in arrangements such as Types B, C, or D (that is, where the entity will provide uncertain goods or services – for example, the entity knows it will provide maintenance services, but does not know how many service calls it will make or what it will be required to fix), the entity provides a service to the customer in “standing ready” to perform. BC160 (included above) supports the view that the Boards intended that, in some cases, the nature of the “entity’s promise is to stand ready for a period of time, rather than providing a service only when the customer requires it.” The customer obtains (that is, receives and consumes) a benefit from the assurance that a “scarce” resource is available to it (“standing ready”), when-and-if needed or desired. Some additional examples that might further illustrate the benefit a customer obtains from the entity “standing ready” include:
- (a) A customer paying an attorney a fixed fee (a retainer) for a period of time so that he/she is available to the customer when needed (for example, if the customer is served with litigation) or desired (the customer wishes to file a legal complaint against another entity).
 - (b) A customer that purchases an extended product warranty for a piece of equipment that requires the entity to remediate any issues with the product when-and-if problems arise.
12. Some stakeholders have suggested that promises of the nature described as Type A above (for example, to provide when-and-if available updates or upgrades in software or biotechnology licensing arrangements) require additional analysis to determine the nature of the promise because the entity, rather than the customer or external events, might unilaterally control when updates or upgrades become available for transfer to the customer. However, given that an entity often will not be able to predetermine when a major intellectual property improvement will be completed and available for transfer to a customer, how many will be completed and available for transfer during the contract period, or what features or functionality will be included as part of those upgrades, the nature of the entity’s promise in “Type A” arrangements might have considerable similarity to those described as Types B through D above. For example, a biotechnology company likely cannot unilaterally determine when its scientists will make a research and development advancement for a drug or compound. As another example, a

software company might have *no* major update or upgrade available for release during a contract period, particularly if the contract period is relatively short (for example, a one-year software post-contract customer support – or PCS – renewal period). In those examples, the entity’s performance with respect to a Type A, when-and-if available upgrade right might, similar to those other types of obligations, be dependent upon events or circumstances that are largely outside the entity’s control.

13. Similar to obligation Types B through D, a Type A promise to when-and-if available (that is, unspecified) upgrades is also often about the customer obtaining assurance that it will have access to future improvements to the product it has obtained or the intellectual property it has licensed. Using a software license as an example, if the promise is truly to *unspecified* upgrades (that is, the upgrades are not merely *implicitly* specified and promised to the customer in accordance with paragraph 606-10-25-16 [24] – *see next paragraph*), then the nature of (and benefit from) that promise is the entity providing the customer with a guarantee against obsolescence or defects in the software. **This guarantee provides benefit to the customer by protecting the customer’s investment in the software** (which may include, for example, an expensive implementation that would not be recovered economically if the customer had to implement a new software solution in the near- or medium-term) and/or the customer’s related business interests (for example, a customer that embeds the entity’s software in its own products might want assurance that it will have access to upgrades of the software so that its products remain competitive in the marketplace). Absent the unspecified upgrade right, the entity might charge the customer exorbitant fees in a separate negotiation for the next version of the software or might enter into an exclusive arrangement with another customer that restricts the customer’s ability to obtain the upgrades.
14. In determining the nature of its promise to a customer in a Type A arrangement, an entity should carefully consider whether it has promised one or more *specified* upgrades to a customer even if the contract refers only to *unspecified* upgrades that will be transferred to the customer only when-and-if they become available. Paragraph 606-10-25-16 [24], as well as the discussion in BC87, clearly stipulate that if the customer has a valid expectation (for example, that a *specific* upgrade

will be transferred to the customer), then the customer would view those promises as part of the negotiated exchange. In that case, the entity's promises to the customer might include *both* an unspecified upgrade right (that is, the right to any updates or upgrades that may become available, but are not explicitly or implicitly promised to the customer) and a specified upgrade right (for example, a specific version upgrade, with specifically anticipated additional or changed functionality, or an enhancement that has been implicitly promised to the customer by the entity's customary business practices, specific statements, or other communications), or might just include a specified upgrade right. A promise to deliver a specified upgrade should be accounted for in the same manner as any other specifically promised good or service (for example, a promise to deliver a specified intellectual property upgrade should be evaluated in the same manner as any other license of intellectual property).

Question 2: How should an entity measure progress towards the complete satisfaction of a stand-ready obligation (that is, an obligation for which the entity has determined that the nature of the entity's promise is the service of "standing ready" to perform) that is satisfied over time?

15. The appropriate measure of progress to apply to a stand-ready obligation that is satisfied over time might vary from one type of stand-ready obligation to another, and it generally would not be appropriate under the new revenue standard to default to a straight-line revenue attribution method (for example, over the contract period) for any over time performance obligation if such an attribution would not depict the entity's performance of satisfying the performance obligation. For example, a straight-line revenue attribution resulting from a time-based measure of progress over the contract period would not generally be reasonable in an annual snow removal services contract. Even though the contract term is one year, the pattern of benefit of those services to the customer, as well as the entity's efforts to fulfill the contract, would generally not be even throughout the year because there would be no reasonable expectation of snowfall during the warm months of the year.
16. However, if an entity expects that the customer will receive and consume benefit from the entity's promise, the nature of which is to stand ready to provide goods or

services, equally throughout the contract period, then a straight-line revenue attribution resulting from a time-based measure of progress would be appropriate.

17. Example 18 in the new revenue standard demonstrates the discussion in Questions 1 and 2 in this paper. The example concludes that the nature of the entity's promise is to stand ready to provide the customer access to its health club facilities throughout the contract period. The example at least implicitly determines this on the basis that the customer will receive an unknown quantity of services under the contract (that is, the entity does not know how often or when the customer will use its health clubs or what amenities the customer will use when they do so). The example then concludes, relevant to Question 2, that because the customer will benefit from the entity's service of making the health clubs available for the customer's use evenly throughout the contract period, that a time-based measure of progress is appropriate.
18. The staff think each of the following examples are substantially similar to the health club example, and further illustrate the appropriate considerations for arrangements similar to those described as Types A through D in this paper:
- (a) In a helpdesk support scenario, the entity does not know, and it would likely not be able to reasonably estimate, how often and/or when the customer will actually request support, or the severity of the problem it will help solve. This suggests the nature of the entity's promise is to stand ready to provide support when-and-if it is needed. The customer benefits evenly throughout the contract period from the availability of the helpdesk support, when-and-if needed.
 - (b) In a snow removal scenario, the entity does not know, and it would likely not be able to reasonable estimate, how often (or how much) and/or when it will snow. This suggests the nature of the entity's promise is to stand ready to provide those services when-and-if it is needed. In this scenario, however, as discussed above, the entity might conclude that the customer does *not* benefit evenly throughout the one-year contract period. As a result, the entity would select a more appropriate measure of progress (for example, one based on its expected efforts to fulfill its obligation to

stand-ready to perform, which may be substantially greater during the winter months than during the summer months).

- (c) In a cable or satellite television contract, the entity both (i) does not know how often and/or when the customer will make use of its television services, and (ii) does not know what content it will provide access to or make available "on-demand" throughout the contract period. This suggests the nature of the entity's promise is to stand ready to provide television services when the customer turns on his/her television. The customer benefits evenly from its continuous access to whatever content is broadcast.

19. While not necessarily as intuitive to some stakeholders as the examples in the paragraphs above, "Type A" stand-ready obligations (that is, rights to *unspecified* updates or upgrades) are also often similar to those above in that the entity might not know how many updates or upgrades will become available for transfer to the customer, and it might not be able to predict what those updates or upgrades will be (that is, the entity may provide an upgrade with significantly enhanced functionality or it may only provide a minor update). Therefore, the nature of the entity's promise is to stand ready to provide updates or upgrades when-and-if they become available. The customer benefits evenly throughout the contract period from the guarantee that any updates or upgrades developed by the entity during the period will be made available. As a result, a time-based measure of progress would generally be appropriate.
20. The new revenue standard does not establish a bias between output- and input-based measures of progress. Therefore, the staff also think that in some cases, a time-based *input* measure of progress (as outlined in paragraph 606-10-55-20 [B18]), rather than an output-based measure considering the expected pattern of benefit to the customer, might be appropriate. For example:
 - (a) A time-based measure of progress may also be appropriate in the health club example (Example 18 in the new revenue standard) because the entity's efforts to satisfy its performance obligation (that is, keeping the

health clubs open for the customer's use) are expended evenly over the contract period.

- (b) In a helpdesk support scenario, the entity's costs might be fixed regardless of the level of activity that comes through its call center each day, week, or month of the contract period.

Questions for the TRG Members

1. What are TRG members' thoughts about the issues and discussion presented in this paper?
2. Are there additional implementation issues related to the issues in this paper which should be communicated to the Boards?