FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	**Transition Resource Group for Revenue Recognition**
Paper topic	Evaluating How Control Transfers Over Time

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Purpose

1. Some stakeholders informed the staff that there are questions about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (the new revenue standard), for evaluating how control transfers when a performance obligation is satisfied over time.
2. This paper summarizes the potential implementation issue that was reported to the staff. The staff will seek input from members of the Transition Resource Group for Revenue Recognition (TRG) on the potential implementation issue.

Background

3. Under the new revenue standard, an entity shall determine at contract inception whether it satisfies a performance obligation over time or at a point in time. This determination is made for each performance obligation identified in the contract. A performance obligation is satisfied by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control. The new revenue standard includes criteria to determine whether an entity transfers control over time and, therefore, satisfies a performance obligation and recognizes revenue over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

4. When an entity determines that a performance obligation is satisfied over time, revenue is recognized by measuring the progress toward complete satisfaction of that performance obligation. An entity shall select a single measure of progress for each performance obligation satisfied over time that depicts the entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).
5. Methods that can be used to measure an entity's progress include output methods (that is, revenue is recognized 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) and input methods (that is, revenue is recognized on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation relative to the total expected inputs to the satisfaction of that performance obligation). The new revenue standard does not prescribe the use of a particular measure, but requires that the measure selected be applied consistently to similar performance obligations and in similar circumstances.
6. Selecting an appropriate method of measuring progress toward complete satisfaction of a performance obligation will require the use of judgment. An entity may be required to use more judgement to determine the measure of progress when a combined performance obligation satisfied over time contains multiple goods or services. At its July 13, 2015 meeting, the TRG discussed a framework for how entities should think about determining the single measure of progress when multiple goods or services are part of a single performance obligation (TRG Agenda Ref No. 44).

Accounting Guidance

7. The relevant accounting guidance has been included in Appendix A of this paper.

Implementation question: Can control of a good or service underlying a performance obligation transfer at discrete points in time?

8. Paragraph 606-10-25-27 states that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria are met:

   (a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

   (b) The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.

   (c) The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

9. Some stakeholders have questioned whether an entity that is performing over time (that is, an entity that meets one of the criteria in paragraph 606-10-25-27) transfers control of a good or service underlying a performance obligation at discrete points in time.

10. The staff is aware of the following two views reported by stakeholders about how control transfers over time:

    (a) *View A*—Meeting the criteria in paragraph 606-10-25-27 implies that control does not transfer at discrete points in time. Accordingly, an appropriate measure of progress should not result in a material asset that results from an entity's performance (for example, work in process) being recognized by the entity.

    (b) *View B*—Meeting the criteria in paragraph 606-10-25-27 does not imply that control cannot transfer at discrete points in time. Accordingly, an appropriate measure of progress could result in a material asset that results from an entity's performance (for example, work in process) being recognized by the entity.

View A

11. Proponents of *View A* observe that paragraph BC125 states that in relation to the criterion in paragraph 606-10-25-27(a), an entity's performance in a typical service contract creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. Paragraph BC125 explains that the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs.
12. Proponents of *View A* also observe that paragraph BC128 states that the criterion in paragraph 606-10-25-27(a) is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical in cases in which the entity's performance results in an asset (for example, work in process). Consequently, an entity that applies Topic 606 to contracts in which the entity's performance results in an asset being created or enhanced should consider the criteria in paragraph 606-10-25-27(b) and (c) (that is, criterion (a) does not apply when an entity's performance results in an asset being created).
13. With respect to the criterion in paragraph 606-10-25-27(b), proponents of *View A* observe that paragraph BC130 states that the basis for the criterion in paragraph 606-10-25-27(b) is consistent with the rationale for using the percentage-of-completion revenue recognition approach in current GAAP. That guidance acknowledges that in many construction contracts an entity has agreed to sell its rights to the asset (that is, work in process) as an entity performs. Accordingly, the parties have agreed, in effect, to a continuous sale (that is, the customer controls the work in process) that occurs as the work progresses.
14. Further, proponents of *View A* observe that paragraph BC131 states that the criterion in paragraph 606-10-25-27(b) is straightforward and helpful in cases in which the customer clearly controls the asset that is being constructed or enhanced. However, the Boards observed that for some performance obligations it may be unclear whether the asset that is created or enhanced is controlled by the customer. Paragraph BC131 states that it may be more challenging to determine when control

transfers in those cases and, therefore, the Boards developed the criterion in paragraph 606-10-25-27(c).

15. With respect to the criterion in paragraph 606-10-25-27(c), proponents of *View A* observe that paragraph BC135 states that when an entity's performance creates an asset that does not have alternative use to the entity, a customer could be regarded as receiving the benefit of that performance and, consequently, as having control of the goods or services (that is, the asset being created) as the performance occurs. However, under the criterion in paragraph 606-10-25-27(c) an entity would need to consider whether a right to payment exists to conclude that control transfers over time.
16. Proponents of *View A* also observe that paragraph BC142 describes the relationship between the assessment of control and the factors of no alternative use and a right to payment. The Boards decided that the fact that a customer is obliged to pay for an entity's performance suggests that the customer has obtained the benefits from the entity's performance (that is, control has transferred to the customer).
17. Proponents of *View A* think that the guidance in the Basis for Conclusions referenced above makes clear that if the criterion in paragraph 606-10-25-27(b) or (c) is met, any asset resulting from the entity's performance (for example, work in process in a construction contract as it is created) is controlled by the customer. This, therefore, implies that control does not transfer at discrete points in time.

View B

18. Proponents of *View B* acknowledge that both criterion (a) and (b) in paragraph 606-10-25-27 do not contemplate control transferring at discrete points in time. However, proponents of *View B* think criterion (c) contemplates transfer of control at discrete points in time because paragraph BC135 states that when an entity creates an asset that does not have alternative use to the entity, the customer ***could*** be regarded as having control of that asset as performance occurs. In other words, the use of the word 'could' implies that that in some circumstances the customer does not control that asset.
19. Proponents of *View B* assert that if control can never transfer at discrete points in time, certain methods of progress referenced in the new revenue standard rarely would be permissible. For example, proponents of *View B* assert that it would be

unlikely that an entity could ever use milestones[1] as an appropriate measure of progress. This is because those milestones would have to mirror an entity's performance in order for them to faithfully depict the transfer of control over time. Proponents of *View B* observe that paragraph 606-10-55-17 references milestones as an example of an output method. Further, proponents of *View B* observe that Example 27 (paragraphs 606-10-55-233 through 55-234) includes a long-term construction contract with scheduled milestone payments throughout the contract term.

Staff Analysis

20. The staff thinks that *View A* is consistent with the new revenue standard and *View B* is not consistent with the new revenue standard. The staff thinks that the guidance in paragraphs BC125, BC128, BC130, BC131, BC135, and BC142 makes clear that when an entity meets any of the over-time criteria in paragraph 606-10-25-27, control does not transfer at discrete points in time and an appropriate measure of progress should not result in an entity recognizing a material asset that results from the entity's performance (for example, work in process). However, the staff's view does not imply that an entity would be prohibited from recognizing revenue over time merely because there is (or might be) a gap in an entity's performance (that is, if the entity does not perform any activities towards satisfying the performance obligation in a particular financial reporting period).

21. The staff's view is further supported by the guidance in paragraph 606-10-55-17 that states: "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

[1] Milestones in the context of this TRG submission from a stakeholder refer to intermediate points in time used to measure progress toward completion of a contract when determining the amount of estimated revenue that is recognized. Milestones used to measure progress may coincide with milestones stated in a contract (for example, the points in time at which an entity issues progress billings) or may be developed internally (for example, the points in time at which an entity assesses the extent of work performed since the previous assessment). However, a milestone used as a measure of progress must correlate to an entity's progress towards complete satisfaction of a performance obligation. The term "milestones" is not intended to refer to the "milestone method" that currently exists in GAAP.

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." The staff thinks this guidance supports the concept underpinning the criteria in paragraph 606-10-25-27. That is, if any criterion is met, a customer would control the asset created by the entity's performance.

22. The staff acknowledges that paragraph BC135 states that a customer ***could*** be regarded as having control of an asset when an entity creates an asset that does not have an alternative use to the entity. However, the staff observes that the sentence following that acknowledgment clarifies that an entity also would need to consider whether a right to payment exists in order to conclude that a customer does in fact control the asset. Accordingly, the staff does not think paragraph BC135 implies that a customer does not necessarily control an asset when a performance obligation is satisfied over time. Rather, the staff thinks this paragraph implies that a customer may not have control of an asset with alternative use if an entity does not also have a right to payment.

23. The staff also observes that while Example 27 references milestone payments, it does not conclude that milestones are the appropriate measure of progress. Rather, the intent of Example 27 is to illustrate the application of the guidance on the existence of a significant financing component in a contract.

24. The staff acknowledges that, in some cases, an entity's selected measure of progress may depict the pattern of an entity's performance, but may not perfectly match the entity's performance. This might result in an immaterial asset (for example, work in process) being recognized.

Question for the TRG Members
1. Do the TRG members agree with the staff's interpretations in this paper?

Appendix A: Relevant Accounting Guidance

> Satisfaction of Performance Obligations

> > Performance Obligations Satisfied Over Time

606-10-25-27 An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs 606-10-55-5 through 55-6).

b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).

c. The entity's performance does not create an asset with an alternative use to the entity (see paragraph 606-10-25-28), and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

606-10-25-28 An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation. Paragraphs 606-10-55-8 through 55-10 provide guidance for assessing whether an asset has an alternative use to an entity.

606-10-25-29 An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 606-10-25-27(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. Paragraphs 606-10-55-11 through 55-15 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.

> Implementation Guidance

>> Performance Obligation Satisfied Over Time

> > > Right to Payment for Performance Completed to Date (paragraph 606-10-25-27(c))

606-10-55-11 In accordance with paragraph 606-10-25-29, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)

b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

606-10-55-15 The payment schedule specified in a contract does not necessarily indicate whether an entity has an enforceable right to payment for performance completed to date. Although the payment schedule in a contract specifies the timing and amount of consideration that is payable by a customer, the payment schedule might not necessarily provide evidence of the entity's right to payment for performance completed to date. This is because, for example, the contract could specify that the consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract.

> > Methods for Measuring Progress toward Complete Satisfaction of a Performance Obligation

606-10-55-16 Methods that can be used to measure an entity's progress toward complete satisfaction of a performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29 include the following:

a. Output methods (see paragraphs 606-10-55-17 through 55-19)

b. Input methods (see paragraphs 606-10-55-20 through 55-21).

> > > Output Methods

606-10-55-17 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.

>Illustrations

> > Customer Options for Additional Goods or Services

> > > Example 27—Withheld Payments on a Long-Term Contract

606-10-55-233 An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time, and the milestone payments are scheduled to coincide with the entity's expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (that is, retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.

606-10-55-234 The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance, and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 606-10-32-17(c). The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

Background Information and Basis for Conclusions

Customer Simultaneously Receives and Consumes Benefits as the Entity Performs (Paragraph 606-10-25-27(a))

BC125. In many typical "service" contracts, the entity's performance creates an asset only momentarily because that asset is simultaneously received and consumed by the customer. In those cases, the simultaneous receipt and consumption of the asset that has been created means that the customer obtains control of the entity's output as the entity performs and, thus, the entity's performance obligation is satisfied over time. For example, consider an entity that promises to process transactions on behalf of a customer. The customer simultaneously receives and consumes a benefit as each transaction is processed.

BC128. The Boards also observed that this criterion is not intended to apply to contracts in which the entity's performance is not immediately consumed by the customer, which would be typical in cases in which the entity's performance results in an asset (such as work in process). Consequently, an entity that applies Topic 606 to contracts in which the entity's performance results in an asset (which could be intangible) being created or enhanced should consider the criteria in paragraph 606-10-25-27(b) and (c).

Performance Creates or Enhances an Asset That the Customer Controls as It Is Created (Paragraph 606-10-25-27(b))

BC130. The Boards observed that the basis for this criterion is consistent with the rationale for using the percentage-of-completion revenue recognition approach in previous revenue guidance in U.S. GAAP. That guidance acknowledged that in many construction contracts the entity has, in effect, agreed to sell its rights to the asset (that is, work in process) as the entity performs. Accordingly, the parties have agreed, in effect, to a continuous sale (that is, the customer controls the work in process) that occurs as the work progresses.

BC131. Many respondents explained that this criterion would be straightforward and helpful in cases in which the customer clearly controls the asset that is being constructed or enhanced. However, the Boards observed that for some performance obligations, it may be unclear whether the asset that is created or enhanced is controlled by the customer. Consequently, it may be more challenging to determine when control transfers in those cases, and, therefore, the Boards developed a third criterion in paragraph 606-10-25-27(c).

Performance Does Not Create an Asset with an Alternative Use to the Entity and the Entity Has an Enforceable Right to Payment for Performance Completed to Date (Paragraph 606-10-25-27(c))

BC135. Conversely, when an entity creates an asset that is highly customized for a particular customer, the asset would be less likely to have an alternative use. This is because the entity would incur significant costs to reconfigure the asset for sale to another customer (or would need to sell the asset for a significantly reduced price). In that case, the customer could be regarded as receiving the benefit of that performance and, consequently, as having control of the goods or services (that is, the asset being created) as the performance occurs. (However, an entity would also need to consider whether a right to payment exists to conclude that control transfers over time, see paragraphs BC142–BC148.)

BC142. The Boards decided that there is a link between the assessment of control and the factors of no alternative use and a "right to payment." This is because if an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. This is consistent with other exchange contracts in which a customer typically would be obliged to pay only if it has received control of goods or services in the exchange. Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance.

> Contract Costs

>> Costs to Fulfill a Contract

340-40-25-8 An entity shall recognize the following costs as expenses when incurred:

a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity shall evaluate those costs in accordance with paragraph 340-40-25-7)

b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract

c. Costs that relate to satisfied performance obligations (or partially satisfied performance obligations) in the contract (that is, costs that relate to past performance)

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