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Revenue Recognition

Identifying Performance Obligations

Background

Did you know that the identification of performance obligations requires more judgment than most other aspects of the new revenue standard (i.e., the guidance in [ASU 2014-09](#),¹ as amended²) and that misidentification could result in a material misstatement of revenue? Although the concept of separating deliverables into separate units of accounting for recognizing revenue existed under legacy U.S. GAAP in ASC 605-25,³ the method for identifying a performance obligation is different under the new revenue standard. Under legacy U.S. GAAP, ASC 605-25 generally required an entity to identify units of accounting by determining whether the delivered item or items have stand-alone value to the customer.⁴ Typically, an entity applying legacy revenue guidance focused on whether the items were sold by the entity or other suppliers on a stand-alone basis. In contrast, an entity applying the new revenue standard is required to identify a performance obligation by determining whether a promised good or service is (1) capable of being distinct and (2) distinct within the context of the contract. If the promised good or service does not meet both of these requirements (collectively, the “distinct” criteria), it must be combined with other goods or services promised in the contract until there is a combination of goods or services that meets the requirements.

¹ FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

² For a full list of final ASUs issued by the FASB to amend and clarify the guidance in ASU 2014-09, see [Section 19.2.2](#) of Deloitte’s [A Roadmap to Applying the New Revenue Recognition Standard](#). The guidance in ASU 2014-09, as amended, is codified primarily in FASB Accounting Standards Codification (ASC) Topic 606, *Revenue From Contracts With Customers*, and Subtopic 340-40, *Other Assets and Deferred Costs — Contracts With Customers*.

³ FASB Accounting Standards Codification Subtopic 605-25, *Revenue Recognition — Multiple-Element Arrangements*.

⁴ ASC 605-25-25-5 provides that for a delivered item in an arrangement with multiple deliverables to be a separate unit of accounting, (1) the item must have stand-alone value and (2) “[i]f the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item or items [must be] considered probable and substantially in the control of the vendor.”

Identifying Promised Goods or Services

Before evaluating the “distinct” criteria in ASC 606, an entity must first identify the goods or services promised in the contract. For some contracts, it will be easy to identify all promised goods or services because they are all specifically stated. However, an entity must also identify implied promises to the customer. Such implied promises do not need to be enforceable by law. Rather, if the customer has a reasonable expectation that the entity will transfer a good or service to the customer, that good or service represents an implied promise in the contract.

Promises Versus Activities

There is a difference between goods or services promised in the contract and activities that the entity needs to undertake to transfer the promised goods or services. Promised goods or services are goods or services that are transferred to the entity’s customer in accordance with the contract (i.e., goods or services that result in the customer’s obtaining control of an asset⁵). A good or service promised in the contract must be evaluated so that the entity can determine whether the good or service represents a distinct performance obligation. In contrast, an activity typically represents something that the entity is required to undertake before or in connection with fulfilling an obligation to transfer a good or service to the customer.

Because the core principle of the new revenue standard is for an entity to recognize revenue when it transfers control of a good or service to a customer, it would be inappropriate for an entity to recognize revenue for the completion of an activity. Distinguishing between fulfillment activities and promises to transfer goods or services to a customer can sometimes require significant judgment. Consider Examples 1 and 2 below.

Example 1

Entity LH enters into a contract with Customer CC to transport CC’s goods from Chicago to New York. The truck that LH will use to transport CC’s goods is currently in Iowa. Consequently, LH must move the truck from Iowa to Chicago to pick up CC’s goods. Assume that the contract does not contain a lease.

In this example, LH’s performance obligation is to transport CC’s goods from Chicago to New York. Moving the truck from Iowa to Chicago does not transfer a good or service to CC; rather, it is an activity that LH must complete to fulfill its obligation to transport CC’s goods from Chicago to New York. Because CC does not benefit from LH’s moving the truck from Iowa to Chicago, that activity does not represent a promised good or service in the contract and therefore should not be evaluated as a potential performance obligation.

Example 2

Entity B enters into a contract with Customer C to provide access to B’s software in a hosted environment. Customer C is unable to take possession of the software; rather, C can only access the software in B’s hosted environment (i.e., B is providing the software as a service). The contract requires B to make modifications to the software at C’s request; however, B will control any modifications to the software and can use the modified software to provide software as a service to customers other than C.

In this example, B’s obligation to modify the software at C’s request is not a promised good or service. Rather, that obligation is a fulfillment activity that B needs to undertake before it can transfer the specified service (i.e., software as a service) to C. This is because C does not obtain control of any asset resulting from the customization services since C is only able to access the modified software in B’s hosted environment.

⁵ As noted in paragraph BC125 of [ASU 2014-09](#), typical service contracts create an asset only momentarily since the asset is simultaneously received and consumed by the customer.

Applying the “Distinct” Criteria

For an entity to account for goods or services promised in a contract with a customer as performance obligations, the entity must determine that the goods or services are both (1) capable of being distinct and (2) distinct within the context of the contract.

Capable of Being Distinct

Under ASC 606-10-25-19(a), the first criterion for a promised good or service to be accounted for as a separate performance obligation is that the promised good or service is “capable of being distinct.” ASC 606-10-25-19(a) states that a good or service is capable of being distinct if 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 could be resources that the customer is purchasing separately (including those that have already been transferred to the customer as part of the current contract or prior contracts). Generally, a good or service is capable of being distinct if the entity regularly sells the good or service separately.

The “capable of being distinct” criterion is similar to the criterion in ASC 605-25 under legacy U.S. GAAP that required a deliverable to have stand-alone value to the customer to be considered a separate unit of accounting. However, evaluating whether a good or service has stand-alone value to the customer requires an entity to understand the customer’s intended use of the good or service, which may be difficult or impossible to determine in some situations. Consequently, when the FASB was developing the new revenue standard, it made a conscious decision not to use the same language as legacy U.S. GAAP to avoid implying that an entity must assess the customer’s intentions for the promised goods or services. Accordingly, the assessment of whether the customer can economically benefit from a good or service on its own should not be based on the customer’s intended use of the good or service. Rather, the assessment “should be based on the characteristics of the goods or services themselves” and should exclude “contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity.”⁶ As noted above, a strong indicator that a good or service is capable of being distinct is that the entity regularly sells the good or service separately.

Distinct Within the Context of the Contract

ASC 606-10-25-19(b) provides that the second criterion for a promised good or service to be accounted for as a separate performance obligation is that the promised good or service is “distinct within the context of the contract” or “separately identifiable.” Unlike the “capable of being distinct” criterion, the “distinct within the context of the contract” criterion did not exist in legacy U.S. GAAP and introduces a different framework for evaluating the separation of elements in an arrangement. The FASB developed this criterion to help stakeholders identify “separable risks.” That is, “the individual goods or services in a bundle would not be distinct if the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services in that bundle.”⁷ This evaluation remains a challenging aspect of the new revenue standard, requiring an entity to use significant judgment to appropriately identify performance obligations.

⁶ Quoted from paragraph BC100 of ASU 2014-09.

⁷ Quoted from paragraph BC103 of ASU 2014-09.

To help entities apply this new framework, the new revenue standard provides the following three indicators that a promised good or service is not separately identifiable, and therefore not distinct:

- *Significant integration service* — The entity performs a significant service of integrating the goods or services promised in the contract into a bundle of goods or services for which the customer contracted. That is, the goods or services are inputs that are integrated into a combined output for the customer.

Example 3

Entity L, a contractor, enters into a contract to build a house for Customer H. The contract will require L to provide the materials and labor needed to build the house. However, identifying all items that are capable of being distinct, such as wood and cement, would not represent L's true obligation because H is not purchasing those items individually. Rather, H contracted with L to purchase a house. In this arrangement, L performs a significant service of integrating the individual materials (e.g., wood and cement) into a combined output (i.e., the house) for which H has contracted. Accordingly, the materials are not distinct within the context of the contract and therefore should be combined into a single performance obligation (i.e., the house).

- *Significant modification or customization* — A good or service significantly modifies or customizes (or is significantly modified or customized by) one or more other goods or services promised in the contract.

Example 4

Entity X, a software provider, enters into a contract with Customer Y to provide a customized software solution that will be installed in Y's information technology environment. To fulfill its obligation, X delivers its out-of-the-box (i.e., standard) software to Y but also performs services to implement the software and customize it to meet Y's needs. The implementation services that X performs are not merely general configuration; rather, those services significantly customize the software. Without the implementation services, the software would not meet Y's specifications. Consequently, the software and implementation services are not distinct within the context of the contract and therefore should be combined into a single performance obligation (i.e., the customized software).

- *Highly interdependent or highly interrelated* — The goods or services are highly interdependent or highly interrelated. When evaluating this indicator, an entity should not merely evaluate whether one item depends on the other (one-way dependency); rather, the entity should evaluate whether the goods or services significantly affect each other (interdependency, or two-way dependency). The example below, which is adapted from paragraph BC112 of ASU 2014-09, illustrates the evaluation of this indicator.

Example 5

Entity M, an equipment manufacturer, enters into a contract with Customer P to design KB, an experimental new product, and manufacture 10 prototype units of that product for P. The specifications for KB include functionality that has yet to be proved. Consequently, M will be required to continue revising the design of KB during the construction and testing of the prototypes and make any necessary modifications to in-progress or completed prototypes.

Entity M expects that most or all of the units to be produced may require some reworking because of design changes made during the production process. If reworking is required, P may not be able to choose to purchase only the design service or only the manufacturing service without significantly affecting one or the other. This is because the risk that M assumes to provide the design service is inseparable from the risk associated with providing the manufacturing service. Thus, although each promise may have benefit on its own, M concludes that the promises are not separately identifiable within the context of the contract because the promises in the contract are highly interdependent and highly interrelated.

Other Examples

In some cases, identifying the performance obligations in a contract will be straightforward. In other cases, however, significant judgment will be needed for an entity to identify the performance obligations in a contract. The examples discussed below illustrate arrangements that may require entities to use significant judgment when identifying the performance obligations.

Hybrid Cloud Arrangements

Software providers may offer hybrid solutions in which a customer may have the right to deploy the software (1) as either on-premise software or a cloud-based service (with the ability to switch from one to the other as needed) or (2) by using the on-premise software together with the cloud-based service. On-premise software is installed and runs on the customer's computers and servers, whereas a cloud-based service involves software that is physically hosted on the software provider's systems and accessed by the customer over the Internet. In arrangements involving these hybrid solutions, questions arise about how to identify the promises (and therefore the performance obligations) in the contract since some functionality is provided by the on-premise software while other functionality is provided by the cloud-based service.

Example 6

Entity F enters into a three-year contract with Customer G to provide 1,000 licenses of Product X for a nonrefundable fee of \$100,000. Under the terms of the contract, G has an option to deploy the 1,000 licenses as either on-premise software or a cloud-based service throughout the three-year license term. Assume that the on-premise software and the cloud-based service (1) each are fully functional on their own and (2) provide effectively the same functionality to the customer. At contract inception, G decides to use 600 licenses of Product X as on-premise software and 400 licenses of Product X as a cloud-based service. Six months later, G decides to use 500 licenses of Product X as on-premise software and 500 licenses of Product X as a cloud-based service.

In this example, F may reasonably conclude that it has promised to (1) provide the right to use 1,000 software licenses of Product X and (2) stand ready to provide a cloud-based service (i.e., to host the software licenses). If each of the promises is distinct, there are two performance obligations to which the nonrefundable \$100,000 fee should be allocated on a relative stand-alone selling price basis. Consideration allocated to Product X (i.e., the on-premise software licenses) would be recognized once control of Product X is transferred to G. Entity F's performance obligation to provide the hosting service is satisfied over time; therefore, consideration allocated to this performance obligation should be recognized as revenue over the three-year contract term (i.e., the period over which F is required to stand ready to provide the hosting service).

The functionality of on-premise software and a cloud-based service in a hybrid software arrangement can vary between offerings to customers and between entities. Significant judgment is required for an entity to identify performance obligations when some functionality is provided by the on-premise software while other functionality is accessible only through the cloud-based service. When identifying performance obligations in this type of hybrid software arrangement, an entity may consider the following:

- *Whether the entity's on-premise software and cloud-based service are ever sold separately* — Separate sales of each of these elements suggest that each element is distinct and therefore would be a separate performance obligation.
- *Whether the cloud-based service significantly modifies the on-premise software* — If the cloud-based service significantly modifies the functionality of the on-premise software (e.g., provides artificial intelligence and significantly changes the functionality of the on-premise software), the on-premise software and the cloud-based service may be interdependent and not distinct performance obligations.

- *Whether the entity's marketing materials support a conclusion that the arrangement is for a combined solution rather than separate product and service offerings* — The entity's marketing materials may help clarify what the entity has promised to deliver to its customer and may provide evidence of the customer's intended use of the on-premise software and the cloud-based service.
- *Whether the customer can benefit from each product or service (i.e., the on-premise software or the cloud-based service) either on its own or together with other resources that are readily available to the customer* — If a customer could obtain the same benefits from another cloud-service provider (e.g., storage or computer power) regardless of whether the customer is contractually precluded from doing so, the on-premise software and the cloud-based service may be distinct.
- *Whether the functionality of the on-premise software is limited or significantly diminishes without the cloud-based service* — If, when combined, the cloud-based service and the on-premise software are both required to provide the intended functionality of the solution, they may be inputs to a combined output and therefore may constitute a single performance obligation.
- *Whether the functionality of the combined on-premise software and cloud-based service is additive rather than transformative* — If the cloud-based service only adds functionality to the on-premise software, the cloud-based service and the on-premise software may each be a distinct performance obligation in the contract.

Equipment and Installation

Entities should not assume that equipment and installation always represent distinct performance obligations (or should always be combined into a single performance obligation). The determination of whether equipment and installation represent distinct performance obligations requires careful analysis of the nature of the equipment and installation promised to the customer and how the two promises affect each other.

Example 11, Case C, in ASC 606⁸ illustrates a situation in which equipment and installation are distinct within the context of the contract and therefore are separate performance obligations. This conclusion is based on the following facts:

- The equipment is operational without any customization or modification.
- The installation required is not complex.
- The installation could be performed by several alternative service providers.

Although the fact that the installation could be performed by several alternative service providers supports the conclusion that the equipment and the installation are distinct, this factor is not determinative. Similarly, the fact that installation is only provided by the entity does not in and of itself suggest that the equipment and the installation are not distinct. It is important for an entity to consider why the installation is or is not available from alternative providers to determine whether the installation is distinct within the context of the contract. In a manner consistent with the indicators in ASC 606-10-25-21, an entity should consider the following:

- *Whether there is a contractual restriction that requires the entity to perform installation services* — As noted above, paragraph BC100 of ASU 2014-09 indicates that the identification of performance obligations "should be based on the characteristics of the goods or services themselves" and should not take into account "contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity."

⁸ ASC 606-10-55-150A through 55-150D.

- *Whether the installation significantly modifies or customizes the equipment* — If the installation in effect customizes the equipment so that the functionality of the equipment is significantly modified as a result of the installation services, the installation and the equipment (uncustomized) may be inputs to a combined output.
- *Whether the installation modifies or enhances other assets controlled by the customer* — Some installation services may enhance other assets controlled by the customer (in addition to the equipment). For example, equipment installation may require changes to other plant or equipment to enable the promised equipment to function properly. In these instances, the installation of the equipment may result in a single output (i.e., overall enhanced plant or equipment).

Where to Find Additional Information

For more in-depth discussion and analysis of the identification of performance obligations, as well as discussions of other topics related to the new revenue standard, refer to Deloitte's [A Roadmap to Applying the New Revenue Recognition Standard](#). If you have questions about the new revenue standard or need assistance with interpreting its requirements, please contact any of the following Deloitte professionals:

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